

# Breaking Up

## ISN'T HARD TO DO

Fragmentation or competition—what role can ATSs play in Canada?

BY TIMOTHY BAIKIE

**ALTERNATIVE TRADING** systems (ATSs) such as Bloomberg, Block Book and Instinet have been operating in Canada for some time. While the evolution of ATSs has raised many concerns about the potential for market fragmentation, the recent introduction of the Pure Trading System by small-cap stock exchange, Canadian Trading and Quotation System Inc. (CNQ) introduces even more issues. In particular, this system competes directly with other Canadian exchanges by providing a visible, electronic, central limit order book. With more service providers planning to bring even more ATSs into the Canadian market in the future, the issue of market fragmentation isn't going to go away anytime soon. What exactly are the concerns? And can they be addressed?

### The rise of the ATS

To clarify, an ATS is a system that matches buy and sell orders outside of the exchange environment. They are regulated as brokers, not exchanges, and have had a number of names over the years, such as NETS (Non-SRO Sponsored Trading Systems) and ECNs (Electronic Communications Systems). Regulators in both the U.S. and Canada settled on ATS as the definitive name. ATSs raise concerns about market fragmentation because, if order flow is diverted among various market centres, it could lead to less-efficient price discovery and execution. Why? Because matching buy and sell orders cannot execute against each other if they are entered in different markets and prices could diverge if participants in one market don't know the price at which the security is trading in another market. A better price in another trading venue may not be available if a

market participant doesn't have access to that venue.

While such concerns are valid, the recent history of ATSs is proof that, contrary to these initial fears, they can make a positive contribution to capital markets. In the U.S., for example, ATSs have provided more efficient price discovery of Nasdaq-listed stocks and more effective execution for those listed on the New York Stock Exchange (NYSE). And, where they have filled a niche, they have prospered. Instinet, among the first ATSs to appear on the scene, offered institutions an alternative to the upstairs block market, giving them the ability to negotiate block trades without revealing trading interest to a broker.

In the beginning, this didn't represent any direct competition for exchanges because orders of that size would rarely be ordered on an exchange due to fears of adverse price movement (i.e., sellers will pull their orders or raise the price if they know a large buy order is coming). This has begun to change with the advent of electronic algorithmic trading systems that allow institutions to break a large block into a series of small orders and execute them over the course of one or more trading sessions without market impact.

Other ATSs have developed that exploit inefficient market structures. Until recently, Nasdaq was a pure dealer market. The quote for a given stock showed bids and offers only for market makers' proprietary accounts. Customer orders were not displayed and market makers could deal at inferior prices to unexecuted customer orders. ATSs such as Island offered a market in which customer limit orders could be displayed and executed, often at better prices than those available in the Nasdaq quote.

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## Competition without fragmentation

Market fragmentation can be avoided through visibility and access. Consolidation of order and trade information will give market participants a picture of trading on all markets and so-called smart order routers, which are common in the U.S., can route orders automatically to the markets where they will get the best fill. However, some marketplaces do not have pre-trade transparency and some have minimum order sizes (i.e., 25,000 shares) that would deny access to most retail investors.

Ultimately, the fragmentation that results from the introduction of ATSs cannot be avoided. But that does not mean there is no answer to the questions they raise. One possible solution can be found in the nature of the marketplace and the overall trading context. An ATS can offer an opaque market for trading large orders among institutions that don't want to disclose trading interest for fear that the market may turn against them. Buyers and sellers can then negotiate a price without knowing who is on the other side of the trade or what the true size of the order is. The price may be higher or lower than on a stock exchange, but the institutions will be satisfied that it is a better price than they would have received had they exposed the order.

In such situations, the ATS acts as a price discovery mechanism for block orders, just like an exchange does for orders in its market. For this price discovery to be effective, limitations on access are necessary. While large minimum order sizes might be seen as a barrier to retail investors, such orders would likely be dealt with upstairs and not entered on an exchange. The result would be similar to situations where two exchanges offer different trading methodologies (i.e., one is fully electronic and the other is a floor-based auction). Orders that can be executed in one market might not be executable in another on the same terms.

What is critical is that details of the price and size of the completed block trade be made public, so that participants in other marketplaces can react to the trade and adjust order prices if desired. This is not the case on exchanges such as the London Stock Exchange, where large trades are not reported until well after the fact to give the dealer an opportunity to offset a liability position that is taken on as a result of the trade.

Fragmentation is harmful if orders are withheld from public markets where they could be executed. Counter-intuitively, this has traditionally been a concern with the

activities of members of exchanges rather than activity by ATSs. The old Nasdaq market model was highly fragmented, with individual market makers paying for order flow that they executed at advantageous prices for themselves. As noted previously, customer orders were not displayed and did not interact with each other. Trades were done at the market maker's bid and offer price, even if better prices were available. Pressure from the U.S. Securities and Exchange Commission and successful competition from ATSs forced it to develop its own electronic order book, where customer orders in its own market and in ECNs are displayed.

## Canadian experience

Canada was not immune from this activity, as some dealers internalized their retail order flow, trading against it at the bid or offer price on the Toronto Stock Exchange (TSX). The trades were reported as crosses after the fact; there was no exposure of the order in the public market to determine if it could be executed at a better price. In the late 1990s, the TSX adopted rules requiring dealers to expose small customer orders on a market and to give retail clients price improvement (i.e. a better price than the customer would have received had the order been entered on a market) when trading against them in a customer-principal trade. These rules have been adopted by Market Regulation Services Inc., the Canadian market regulator, and apply to dealers trading in any Canadian market. The fact that Canada has a national market regulator also mitigates another harmful outcome of market fragmentation—regulatory arbitrage, where orders are sent to a market with looser standards to avoid application of rules designed to protect investors and foster market integrity.

ATSs have been successful because they addressed a niche or exploited inefficiencies in market structure. In doing so, they brought new participants to the market, increasing overall participation. Since there is no further need to be physically present on an exchange floor to access it, the presence of competing, electronic, visible marketplaces will increase choice and liquidity for investors and dealers. Competition will spur cost reductions. Technology allows for electronic trading and permits participants to see the prices available in different marketplaces, accessing the best price wherever it is. New marketplaces should not be feared due to market fragmentation. Rather, they should be seen as enhancing overall liquidity to everyone's benefit. ■