



# The changing role of the broker

## The global financial crisis has triggered a global revolution of the buy-side/ sell-side relationship

Is the financial turmoil of recent months driving change in the brokerage model faster than ever? ITG's Ofir Gefen believes the role of the broker is changing in an irreversible way, and that geographic differences are becoming less relevant to the brokerage model as the more pressing concerns of high volatility and trading costs, counterparty risk and business ownership come to the fore.

Recent turmoil in the financial and investment banking industry at a global level is pushing sweeping changes to the brokerage model across the board. Despite fundamental differences in market structure and buy-side behaviour between the US electronic trading world and that of Asia, the financial crisis is now creating convergence at a quicker rate than anticipated. Both buy and sell-side are being forced to adapt, prioritise and focus on costs, risk and efficiency. As the role of the broker changes, market boundaries

are deemed less relevant as trading costs, volatility and counterparty risk move centre stage.

Having spent many years working in both product development and sales in the US, when I moved to Asia I expected to encounter similar challenges to those we had already gone through in the US. I soon realised it is easy to underestimate the issues created by the diverse market structures, regulations, cultures and trading behaviours across the Asia Pacific markets. As such, I prepared myself for a relatively



By **Ofir Gefen**,  
Head of Product Management  
for ITG in Asia Pacific

slow evolution before the buy-side here would use brokers in a similar way to their US counterparts. The US market was characterised by a highly diversified range of electronic trading tools, mechanisms and providers, where the market had evolved in response to a range of demands from the buy-side, but operated within a homogenised market structure.

In Asia the range of brokers and the services they offer have generally been less differentiated, with markets gradually opening up to DMA and the adoption of algorithms, crossing networks and alternative trading venues still in the comparatively early stages. A 2007 Greenwich Associates report focusing on the US market looked at the evolution of electronic trading in response to sophisticated segmentation of liquidity, while at the same time talk in Asia was more at the mechanical level of developing connectivity and adoption of electronic trading.

As we move towards the second quarter of 2009, similar reports have a very different tone. The December 2008 TABB group study 'US Institutional Equity Trading: Crisis, Crossing and Competition' states: "These are tumultuous times... Trading becomes a treacherous affair, with all previous metrics of volatility and transaction costs going right out the window. Both asset managers and brokerage firms are in uncharted waters. The implications for the relationship between the buy-side and sell-side are far reaching and many of the assumptions we hold about that relationship will be overturned". This is as true for Asia as it is for the US.

### Moving beyond old-style equity execution

The traditional value of the sell-side broker has often been intrinsically linked to the provision of stock research, access to IPOs and capital commitment. In an environment where markets are swinging wildly based on high level economic and social factors, IPO pipelines have dried up and capital commitment is now too risky to offer, the traditional sell-side brokerage model is called into question. This has been compounded by the collapse of Lehman Brothers, the acquisition of some large

### Expected average Asia Pacific trading costs - Q4 2008

Country	Average trading cost (bps)	Standard deviation of cost
India	21.5	429.9
China	22.7	302.3
Korea	22.9	357.9
Taiwan	24.7	265.4
Australia	35.3	329.6
Hong Kong	35.6	507.7
Singapore	47.4	357.5
Thailand	59.7	404.4
Japan	83.5	561.1
Malaysia	105.7	232.5
Indonesia	142.1	671.4
New Zealand	402.5	495.4

Source : ITG research based on the pre-trade ACE model

investment banks and the recategorisation of others to commercial banks. Some asset management firms and hedge funds are now stuck trying to reclaim commission credits from the bankrupted Lehmans and counterparty risk is no longer just the concern of compliance officers. Its

structures, the lack of any common regulatory framework and the logistical challenges buy-side trading desks have faced in establishing trading across the region have dominated the evolution of electronic trading. Traders have often experienced different challenges in finding



effects are now directly relevant to the buy-side trading desks. Simply put, asset managers are needing to move beyond the old methods of equity execution and reduce their dependency on traditional counterparties, wherever in the world they are trading.

In Asia Pacific, the variety of market

liquidity than their US counterparts. Nevertheless, buy-side adoption of DMA, algorithms, dark liquidity and crossing has been steadily growing, helped by the commitment of firms with different types of brokerage models to bringing new electronic options to the region. In the past few years, not only have the investment banks invested

significantly in developing electronic trading tools for the region, but innovative agency brokers, crossing networks and, imminently, MTF-like structures have brought new opportunities to the market.

### Driving adoption of trading technology

However, the current financial crisis has exacerbated a lack of liquidity the effects of which are keenly felt in Asia. High volatility and widening spreads have resulted in dramatic increases in the anticipated costs of trading (see chart on previous page), combined with even higher increases in the standard deviation of costs. With risk management and cost control now at the top of every firm and fund's agenda, an emphasis on efficient execution is more important than ever. This is accelerating the rate of change in Asian adoption of trading technology and the corresponding demands from the buy-side about what the sell-side must provide.

At the heart of the process of controlling trading risk and costs is understanding

to make cross-market comparisons and determine whether their costs of trading are proportional to market averages, and do not unnecessarily erode fund alpha. This demand for transparency is being reflected onto brokers, who will now need to prove they are providing quality execution and delivering value for their fees. While in calmer markets this has promoted growing buy-side use of 'low touch' DMA and algorithmic trading tools which help control costs, in volatile conditions the value-add from an experienced broker trading desk or sales trader is also vital. This is true of any market, but particularly for Asia given the diversity of market structures and inter-linked economic and regulatory factors.

### Playing CSA catch-up

The focus on costs of execution also means that Asia Pacific buy-side firms are rapidly catching their global counterparts in the adoption of CSA structures that unbundle execution from research. The differences in how the buy-side and sell-side interact, and the resulting changes in

volumes of proprietary flow, the traditional large sell-side model is facing serious challenges.

### Avoiding a buy-side pile-up

Finally, the relationship between sell-side and buy-side is now developing in more fluid ways as the sell-side adopts an important role in buy-side education and execution advisory services. For many years the buy-side had no choice but to ride on the sell-side 'execution bus'; but as the market has developed every buy-side firm can now access its own 'car' to take themselves wherever and whenever they want. This gives the buy-side more control and flexibility over their execution. But without the proper instruction the wrong route can be taken or crashes can occur. Brokers that can continue to add value in helping the buy-side develop and take better control of their trading are more likely to succeed. The balance of power is shifting, and those that can develop an interactive relationship or an advisory role in terms of trading will end up as stronger trading partners.

The brokerage model post-crisis is likely to look very different to before. Those that succeed will have to add clear and quantifiable value to the buy-side, whether through the provision of high quality execution using technology, unique market insight and advice or - most likely - a combination of the two.

I have a first-hand understanding of how different the Asian markets are to those in the US. However, the current crisis has highlighted the fact that business concerns are the same across the globe - and while the mechanics may be different in each region, the role of the broker is changing at a fundamental level everywhere. Independence and transparency have become more valuable than ever, and Best Execution is the top priority as risk and cost management now dominate the buy-side/sell-side dynamic.

#### Any thoughts on this or other articles?

Please send any comments, referring to this article as Vol 2 Issue 9 AP 3, direct to [editorial@fixglobal.com](mailto:editorial@fixglobal.com)



where and how they are arising. This is driving demand for Transaction Cost Analysis (TCA). TCA is already widely used in the US and Europe: TABB Group projected adoption rates of almost 90% across the US and Europe by 2009 in light of the regulatory requirements of Reg NMS and MiFID. Now Asian buy-side desks need

demand for the various brokerage services is now less defined by geography and more by business model. Agency-only brokers with transparent balance sheets and a business focused solely on Best Execution services are valued counterparties across the globe. Without the natural advantages of IPO access, capital commitment and large