COLLABORATIVE TRADING FINDS ITS VOICE

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WHITE PAPER 2010

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INTRODUCTION

Given the rapid rise and ubiquity of electronic trading, what will voice trading's role be?

That question is being asked more often, as regulators throughout the world, still reeling from the global economic crisis of 2008-2009, look to push additional trades – particularly trades such as derivatives – off of phone lines and onto electronic exchanges, where there is more transparency about the assets' structures, prices and risks.

In forcing more derivatives to be traded electronically, the new regulations are merely accelerating the migration of trade execution from voice to electronic, a migration that has dominated the trading of equities for years. Yet the squawk box hasn't disappeared from the equity-trading desk; nor will it disappear from the derivatives department. If anything, it seems destined to become more important.

Two factors cement voice's future role: the support that voice systems provide for complex trades and the absolute requirement for voice communications in fostering the relationships and trust necessary to leverage new products of ever-increasing complexity.

COMPLEXITY DRIVES THE NEED FOR COLLABORATION

In the foreseeable future, it will be possible for a single derivatives trader to click "buy" and complete a transaction without being in contact with the seller – perhaps a deal involving a credit-default swap. Before the trader gets to that point, however, dozens of people in his or her office – and perhaps dozens outside of it – will likely be consulted.

Analysts, risk managers, back-office personnel and outside valuation firms may have played a role in recommending the trade; an executive in the head office will probably have had to approve it. A lot of that work will take place in huddled meetings on the trading desk, with the turret, or dealerboard, a central part of the communications process.

Indeed, the vast size of the OTC derivatives market – there is an estimated $615 trillion in contracts outstanding – will increase the need for the sort of fast, secure collaboration that voice systems enable. "Just because this market is moving toward being centrally cleared and electronically traded, doesn't mean voice communications are going to go away," says Larry Tabb, CEO of the Tabb Group, a capital markets advisory firm.

"Turrets didn't disappear from the equities business when it went electronic," Tabb says, "because traders still needed them. They haven't disappeared from fixed-income departments. And they won't disappear from the derivatives desk."

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In fact, when IPC Systems polled financial services industry participants on LinkedIn in September 2010, 84% of 509 respondents answered "Yes" when asked, "Has the need for collaboration with the middle- and back-office increased as a result of regulatory changes?"

"Dealers still need to provide advice," says Stephen Bruel, Research Director in TowerGroup's Securities & Investments practice. "If you still have voice negotiation in equities, all the same activities will have to happen in other markets. There will be plenty of voice collaboration, even in electronically executed many-to-many transactions that get cleared."

To be sure, Wall Street voice trading systems will evolve, probably in the direction of being better integrated with traders' PCs, and with some of the software that has become standard on trading desks, including CRM, OMS and market data applications. But there is no question that voice solutions will remain part of any future trading environment.

YOU CAN'T 'REGULATE AWAY' COMPLEXITY

In the U.S., the Dodd-Frank Wall Street Reform and Consumer Protection Act was created in part as a guardrail to prevent the financial system from running off track. It doesn't, and can't, do much to reduce the underlying complexity of owning or working with derivatives or the complex trades that combine multiple asset classes.

The institutions that work with these complex instruments, just like the institutions that work with fixed-income securities, must be expert at assigning values to them. Hedge funds, asset managers and investment banks can't ship everything off to an outside valuation firm and live with the answers they get; too much is at stake. Derivatives impose capital requirements, and Dodd-Frank increases those requirements for certain capital reserves; the last thing asset managers want is to reserve significantly more capital than truly necessary due to an incorrect valuation.

That means firms that trade derivatives must have analysts versed in the underlying securities; economists trained to look for larger influencing trends; risk managers who understand the structure of the instruments and the sources of potential trouble (e.g., the "Value at Risk"); and a compliance and governance department to monitor positions at a high level and make sure the firm doesn't become overexposed in any one area.

Moreover, because of collateral requirements and the need for daily reconciliations, firms that trade derivatives must employ people skilled at negotiating with counterparties when there are disputes over how much something is worth.

This amounts to a lot of moving parts managed by many different experts, all of whom must communicate with one another leading up to any deal.

HIGH STAKES ALSO LEAD TO VOICE COLLABORATION

Regulators will also be looking at firms' derivatives holdings on a much more frequent basis – certainly quarterly, possibly monthly and maybe even daily. If they don't like what they see, regulators could shut down a trading desk or put a financial services company out of business.

With the stakes so high, firms involved even with exchange-listed derivatives are going to have to find ways to enable collaboration between dozens of front-, middle- and back-office workers. A big swing in Value at Risk, a decision to increase or decrease a position, a move to take on more debt – all of these are going to trigger a conversation, usually multiple conversations, with the trading desk. Voice systems make those conversations more efficient and allow deals to be executed more quickly.

Voice trading solutions will continue to be indispensable for the subset of derivatives trades that won't happen on exchanges or swap exchange facilities (SEFs). These typically involve non-standard products, where the asset is often structured specifically for a single corporate customer. In these cases, it won't be just the lead-up to the transaction, but the bespoke transaction itself that will be done over the phone.

VOICE IS THE BEST RELATIONSHIP BUILDER

Another reason voice systems aren't going away is the role they play in building and maintaining relationships. For proof, look no further than the turrets on the desks of equities sales departments in trading firms worldwide, where virtually all trading is now electronic – yet the voice systems persist.

Equity salespeople maintain a direct line to their big institutional clients – including hedge funds and asset managers – partly to make sure those clients get important information quickly. They may want to relay the gist of a note their chief economist has just issued in response to a rise in the funds rate. Or they may want their institutional clients to know that their star technology analyst just increased his earnings forecast for IBM.

This sort of service often produces a trading fee when the client says, "You know what, we've been talking about adding more IBM to the portfolio; why don't you buy 40,000 shares for me."

The same dynamic, of salespeople trying to build trusted relationships as part of their bid for trading fees, exists in markets trading more complex instruments. If anything, the need for hard information is increasing. There will be plenty of instant messages and phone calls and general hand-holding. Customers are going to say, "I don't understand these assets the way your firm does. Why don't you come to me with an idea that you think suits my purposes? I'll be happy to hear more."

That expression of interest will jolt the deal creators into action. The salesperson will talk to the trading desk, which will talk to the risk management department, which will consult with an outside valuation firm and credit rating agency, and it will all come back to the trading desk. Somewhere along the line, the client will be looped back in, with a few of his colleagues, to hear the firm's proposals.

The same sorts of things happen, with different sets of participants, in equity and bond trading. And the voice system, having already helped cement relationships in these markets, helps speed the communications.

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In the case of derivatives, the relationships won't just be between asset managers and investment banks. Given the need to do a daily valuation of every position that's on the books, broader communications are inevitable.

"There's going to be a tremendous amount of communication that's going to happen between the clearing house and back office to verify the positions and the margin associated with those valuations," says Tabb.

CONCLUSION

It's still too early to know exactly how evolving securities rules will change what happens on trading desks around the world. No matter what final shape reform takes, it won't lessen collaboration among traders, clients, counterparties, and the middle- and back-office teams in their own trading firms. There is a limit to how rich an electronic collaboration can be.

Voice trading systems will continue to play a vital role in financial services. Whether it's to tease out the nuances of a derivatives trade, discuss a newly minted asset class, or negotiate daily valuations and capital requirements, very often the two sides will just have to get on the phone and talk.

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