General Discussion*

Ian Domowitz responded to the discussion regarding the cost savings afforded by electronic trading by emphasizing that once the difficulty of the trade is taken into account, these cost savings are still there and can be broken down. He said that in terms of immediacy, comparing Archipelago with the NYSE floor, roughly 90 per cent of the Archipelago orders are executed in under 2 seconds, whereas less than 34 per cent of the NYSE orders are executed in less than 15 seconds. In other words, there is more immediacy from the electronic markets than from the floor.

Domowitz thought that it may be appropriate to regulate financial markets with respect to various areas of public concern such as fraud and fiduciary responsibility, but not to regulate market structure. He emphasized that the paper says that the market is going to take care of things competitively, and that regulation is most suited where some form of market failure is observed. It is not clear that market failure exists in the context of the structure of markets. He said that is certainly true in the United States, and probably in Canada, as well. He stated that this reintermediation concept—to the extent that it is actually being carried out—is providing increased levels of transparency for different types of trades and that this is good for the market. Domowitz suggested that best execution might be defined as what is best for the customer, as opposed to being pegged to any benchmark that happens to be good for one clientele and not necessarily good for all.

* Prepared by Michael King.

He said that with respect to linkages and associated tools—especially given the new Regulation ATS (alternative trading systems) that are being promulgated—the paper also suggests that there is no need to mandate consolidation. He added that the market is going to do that—the broader the market for the technology, the broader the market for the execution service—because the process of reintermediation is a profitable one. He thought it has already done so in the United States, and that it is happening in Europe, as well. He did not see any reason why it would not happen here in Canada.

Randall Powley noted that reintermediation implies recompensation. He asked whether the author saw that as being a natural evolving process. He said that there are some fairly complex structures in place for compensation, particularly at the institutional level, and that these could be related to the lack of penetration at the NYSE. Powley asked whether there are any problems.

Domowitz replied that some types of compensation are changing already, for example, with decimalization in the United States. He added that it is certainly common knowledge that market-makers have had a fairly hard time on the Nasdaq—pretty close to failure in some cases. This suggests that the compensation structure, which is basically not to charge a direct commission but to take it out of the spread, is no longer serving well, and neither is payment for order flow. He said that sort of compensation structure is rapidly disappearing, and we are starting to see charging of explicit commissions on Nasdaq. This, Domowitz felt, is a situation where things are happening by themselves, and he did not see anything wrong with either of those developments.

Domowitz then asked Powley if he was referring to the case where reintermediaries are supplying certain types of services and charging a commission for those services, and are they giving away the technology—and in a sense informally “softing” the product.

Powley wondered whether a firm could break into the soft-dollar business that is already established.

Domowitz said that the soft-dollar business that exists is largely in terms of third-party fundamental research on basic companies. He admitted that there is a certain amount of giving away of computers and that sort of thing, and that it is true that they hide certain costs relative to the end users of institutional investment funds, namely the retail people who are sending in their cheques to buy their shares. But, by and large, he did not see the softing activity increasing as a result of this form of reintermediation.

Powley asked whether Domowitz had any thoughts on the lack of penetration by electronic communications networks (ECNs) on the NYSE. Domowitz said that he did, but that it was not the puzzle that had been presented that morning. He felt that although ECNs are different and have different strengths, there is very little difference between electronic systems and trading floors in terms of market quality. He indicated that the NYSE is a remarkably low-cost provider for what it does, and that he did not see it going away any time soon. Furthermore, he added, since it is a low-cost provider and since liquidity is very centralized there, penetration in terms of market share has got to occur at a slower pace than would have been observed in an already decentralized market structure, where there was not a central mechanism for trading and where costs were extremely high on average, namely the Nasdaq. He said that even though Instinet has been around for a very long time—in principle, since 1969—and has been a so-called ECN since 1986, ECNs really only burst on the scene with the order-handling rules in 1997.

Domowitz said that ECNs were attempting to break into a relatively high-cost market with a very low-cost product, which was fairly easy. He thought that they have done remarkably well in achieving what they have in so little time, and that some ECNs—most notably Archipelago, which was just registered by an exchange in the United States—are now wanting to crack the listed market. He indicated that this was the first explicit run on that market, and that it was a business decision that hadn't been taken before. But, he noted, sufficient time has not yet elapsed to allow one to draw any conclusion as to what the action will be. He added, however, that the NYSE is a low-cost provider; liquidity is concentrated there, and it will be a tougher nut to crack. While electronic markets will not supplant everything, he said, it is certainly true that a lower-cost provider that can pass on those cost savings and a community of intermediaries that can support those market structures will cause a change.

Asani Sarkar asked Domowitz what role he saw for electronic trading systems where customers are interacting directly with each other. He added that it seemed that implicitly underlying the presentation was the idea that those kinds of systems would have a very limited role in the future.

Domowitz agreed that their role would be limited. He did not think it was simply the issue of the provision of capital. He said that firms can certainly make markets very effectively with electronic systems—it is done all over the world—and market-makers can easily use electronic systems that cater to direct access by retail clientele. But why isn't that going to happen? He said it was a fiduciary problem. For example, e-Bay is wonderful, but would you buy several thousand shares from person X on the basis of a goodness rating on e-Bay? Probably not, he suggested. He also doubted that the regulators would allow it.

Domowitz concluded by saying that any electronic system that hopes to solve the retail-to-retail problem without intermediation by some form of broker is going to have to solve the “deep-pockets problem.” The system would have to provide a mechanism to automate what amounts to the good faith and responsibility that the broker takes on with respect to making good on the trades. He added that Instinet invested quite a bit of money—it is said to be on the order of $40 million—in such an endeavour and, to the best of his knowledge, has cancelled the project. He said that it is a very difficult problem to solve because it goes beyond the execution process, and it would take true automation of the clearance and settlement system from the point where the customer signs up as a subscriber, right to the end. He said, however, that this isn’t a problem for institutions, and that institutional trading is common.