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ATP004 - Turquoise

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[Music interlude]

Hello and welcome to the Algorithmic Trading Podcast, a series of interviews with leading practitioners and experts on Algorithmic Trading, brought to you by Voices in Business and sponsored and supported by Sybase.

Today's show features an exclusive interview with Eli Lederman, the recently appointed CEO of Turquoise, the brand new pan-European trading platform. Now there has been a lot of interest in the launch of Turquoise, so we are very pleased to have Eli as our guest on the show.

Prior to joining Turquoise, Eli was Managing Director of Morgan Stanley's Sales and Trading division, overseeing their cash and derivative electronic trading businesses for European equity, credit and interest rate products.

Eli spoke to Greg Grimer of Voices in Business and Gavin Quinn of Sybase.

Greg Grimer: So, welcome to the Algorithmic Trading Podcast, thank you very much for joining us today Eli.

Eli Lederman: Thank you for having me.

Greg: Most of our listeners will immediately know who you are and Turquoise has come up, I think, in every interview so far. So, very few people will not know who Turquoise are. So could you give us a very short introduction for the listeners who haven't heard of Turquoise as to what you are and why you exist?

Eli: Sure. Turquoise is intended to be a pan-European share trading platform, a stock exchange effectively. The dramatic name is multilateral trading facility, but that is really what it is, a pan-European share trading exchange.

It has been founded by nine of the leading investment banks of the world. It was founded originally in the form of a consortium, where the banks worked together and seconded people to do work that would ultimately lead to this exchange and the launch of this exchange.

And in November of last year, the founders decided to bring me on as Chief Executive and to reconstitute the consortium in the form of a company and really go into execution mode.

So in the several months leading up to that, a lot of very important work was done by the banks both in defining what the market model would be in doing due diligence on technology providers, in designing and coming to agreement on what the clearing solution would be, that is with Euro CCP and I can go on.

There were a number of very significant must-do things that got done in that period of time, mainly around planning. And now we are on the execution mode, build-out mode towards a September launch of this year.

Greg: OK. Were there particular drivers then to set it up whether to do with market participation or was the algorithmic trading the main reason?

Eli: In general terms, the single most important driver of Turquoise, the motivation for it from the point of view of the founders, is the fact that there has not been adequate competition in the world of exchanges, so to speak, in Europe. And the overwhelming majority of trading is done, has been done historically on the incumbent exchanges, which together were suddenly clearing in execution.

Generally, these silos, as quasi monopolies have had a tremendous amount of pricing power one, and two, as always happens in an environment with too little competition, they haven't had enough incentives to invest in the quality of their service, which is to say the technology and the other things that they do for their members or their users.

So I mean, in general terms that's what the driver is, but there are a number of other important environmental variables that I'd say make the situation somewhat more severe in 2007 and 2008, namely the various parts of the share trading business have gotten to be incredibly competitive and margins have gone down.

But at the same time, things like order sizes, execution sizes, frequency of trading, all of the things that are good for exchanges have generally moved north. And the charges that they pass on to their members and their users have stayed stubbornly high.

And the drivers of that in turn that's various kinds of quantitative strategies, statistical arbitrage, other automated market making firms that have entered European trading, European markets, all of those things have been drivers of ever smaller bid and ask sizes, ever higher frequency of trading, that's algorithmic trading of course, an important environmental variable that makes competition in this marketplace ever more important.

Greg: So in a sense, I mean the exchanges I suppose used to be almost like a utility type business and due to changes that the markets brought on, they found themselves in a position of being in a fairly powerful quasi monopoly position, and this is seeking to adjust the playing field back to a more competitive and lower cost of transaction.

Eli: Well, I mean it didn't happen overnight. I mean there used to be (I guess every exchange has a different story), but in many cases these were actually neutralized

member owned organizations. And they, over the last several years, became for-profit and one can't blame them if you become a for-profit enterprise and you have shareholders, you are about profit and you do what you can to maximize the profit.

And at the same time you do what you can to defend your turf and make sure the new entrants are marginalized or relegated to the sidelines, so they are doing exactly what one would expect them to do. Look, there are other commercial people out there and when you are commercial and you see a monopoly or a near monopoly, you can be pretty sure that's a commercial opportunity big enough to drive a truck through and that is what we are going to do.

Greg: So ultimately, it is not just about the cost of transaction, it is also the fact that because they have been in this position, technologically they are harder to interface with in a STP type way, so it is harder to get your trades to interface nicely to the exchanges?

Eli: Well, we can go into any number of details about what it is and it is the same in every industry if you have that sort of cornered market situation. You have flexibility in everything you do, but it has to do with the simplicity of pricing, it has to do with the readability of your invoices, it has to do with the quality of your customer service, your support, we can go on and on and on.

And Turquoise certainly, the pedigree of our founders, some of us having come from the sell-side, know the difference between what is the standard now and where we want to go in terms of quality of customer service. We want to have that as a hallmark of what we do, every bit as much as more efficient costing, if you will.

Gavin: I was going to just ask about how you see the market data environment in your new exchange? Presumably, it is going to be ultra low latency, but also does the pricing of the market data, distribution of the market data, capture and storage for analytical purposes, how are you planning on doing that side of it?

Eli Lederman: Sure. Well, it is a very big topic and I will try to take points in turn. The fundamental design principle of Turquoise is that it will be an open platform, which is to say, we plan to work with, and indeed already are working with, all of the major market data providers in terms of them being distribution channels for us. So we want to be completely agnostic about that.

We will be very flexible in terms of how, not just market data providers, but members and potentially other consumers connect with us to get our market data to subscribe to it. We will have an open FIX protocol interface. We will also have a native interface, the relative merits of the two.

In terms of cost, we plan to launch with zero cost for our market data, but we plan not to do that for ever. Over time, our operating principle is and will be that we don't ever want to find ourselves in a situation where other people are making money from our market data and we are not.

So I want to be very clear that while our intention is to launch without charging for market data, as we develop the market, as we develop the market share, it is fully in scope that we charge for market data over time.

Now we think, it is not the most important part of what we do and I wouldn't expect the market data is (as it is for some people) a major driver of revenues for us. On the other hand, I do think that other forms of data that we provide are areas where a platform like Turquoise can create a great deal of value. And we are looking at data and taking the data that we will create; that our members will create.

We are taking a very hard look at it and thinking very seriously about what we can do to add value with it for our members, for other people, by combining it with other data, by analyzing it and repackaging it and by integrating it in reports.

Gavin: Do you feel that there is potential for a change in the pricing model of market data based upon the latency from when it is produced? So there are some consumers who will pay for millisecond delivery, whatever the lowest metric is that you can possibly find. That whole speed of light thing gets in the way sometimes, doesn't it? But you have graduated scale whereby the market data vendors will get it for less or whatever over time.

Eli: Well let me take the first part of your question first. I mean, clearly there is already steep discounting at 20 minutes or other types of delayed data, but I do think it makes sense for people to pay for the technological intensity of the service that they get. It is not necessarily the same technology that delivers data at one second, at 10 milliseconds or below.

So it makes sense to keep an open mind about that kind of differentiated pricing, and we would certainly have that open mind about it. At the other end of the spectrum, very delayed data, so to speak, which is to say, historical data and where Turquoise would be in that position, as we are market data vendors, to acquire data systematically and to store it and again, to package it and this can be real time data, both at the price level but also in terms of depth of market. There is a great commercial opportunity around that.

That data doesn't matter at all to some people, but increasingly it matters not just to the sharpest end of the spectrum, in terms of quantitative funds and people designing algorithms, increasingly it matters to more and more people and we would seek to monetize it if we could.

Gavin: And I think you alluded briefly to the reference data environment that has obviously a great deal of value for people who are trading, especially cross currency with different delivery settlements depending on where the first listing was etcetera, etcetera, that you have all sorts of new arbitrage possibilities that come out, provided that people have the clarity of view. Is that a big area for you?

Eli: Well, reference data itself is more something that we have to navigate than an opportunity I would say. We have to have incoming market data also and incoming reference data. And that is a challenge for every trading platform. Really have to get that right; there is very little fault tolerance for getting that wrong.

So it is an area that we are tuned into from a point of view as consumers really that we have consistent reference data and that people know what they are getting when they connect to us, so to speak.

The other part of what you are asking I think is the extent to which things are traded on different markets and the opportunity in that and the potential even in different currencies; that clearly would be an opportunity for us over time.

Gavin: Well, I think historically people have always known with regard to a certain degree of their reference data, that if it was 'X' share traded on 'X' exchange, that it had these characteristics and this sort of trading, this settlement and clearing characteristics. And to a certain extent, it obviated an awful lot of what they might have to be doing in the future, where you could almost cherry pick.

And at one level, you could argue everything is fungible but another level, it could possibly create difficulties in terms of clearing as the things, as well as the cross currency arbitrage opportunities of doing that in the same platform.

Eli: Well I would say introducing a new venue in Europe given the history here, given some of the legacy systems, especially operationally, it makes really deep thought and careful planning about interoperability, an important thing to get right.

Gavin: Another area which offers the potential perhaps for differentiation with other exchanges is the number of decimal places that you can go to. And we have seen another alternative trading venue spring up that has gone to a third decimal place giving it an advantage it seems over some of its peers at least being the first to get hit supposedly for an awful lot of algorithmic trading activities. Do you have any plans to go to additional decimal places?

Eli: We are looking now at what is really the best thing to do. I think it is important that you look at things in this domain really holistically. And it is possible with any of these things really to go too far, and too far for one set of names may not be far enough for another set of names, so you have to be pretty granular in your approach to this.

But taking an ever diminishing tick size as an example or an additional decimal place is another example. These are decisions not without consequence - design decisions not without consequence, not without knock-on effects and knock-on requirements for users. So for example, has enough thought always gone into the interoperability of platforms in terms of smart order routing?

A lot of people don't have smart order routing in place yet, but they will as you have to

take an individual order and slice it up and send different parts to different venues. Well, it is entirely possible that the logic related to the pricing is going to have to be different on different venues if you start having extra decimal places and so on.

So you have to have another layer of logic (or some people will) on their algorithmic trading, on their smart routing. And it is a consideration that you shouldn't take lightly. So what we are doing on this and on many other issues, is consulting with our users. And we want to make sure that we do the thing that our users want and I want to say in as democratic a way as we can.

I mentioned before how important it is in a competitive industry that you be receptive and responsive to your users. So I want that to be a hallmark of how we interact with them and this is an example of us doing exactly that and we will take it from there.

And whatever decision we come up with on that, we will be very public about. We will give the market as much advance notice as we possibly can and we will have to reserve the right to revisit it. So any solution that we have will have to design some functional flexibility around because we may well have to change it.

Greg: Can you just address on that point then, just following on from that, what kind of mechanisms do you plan to have in place to be receptive and responsive to users? I know there are things like web-based forums. How would a user or a prospective user communicate with you in an ongoing two-way communication?

Eli: Well, we have a sell-side advisory panel already, where experts from trading, from technology, from the meeting point of trading and technology advice us on different matters, I didn't mention operations, but all of the areas of expertise that the sell-side have to have in-house in order to operate trading businesses.

We have delegates from those various departments or functions at investment banks represented on sell-side advisory panel or really panels because there was some specialization. We are doing the same thing, although the buy-side are not really our end-user. We are forming a buy-side advisory panel where we hope to air issues that matter to buy-side firms, things like transparency and confidentiality and other things.

And similarly, although it is a much looser forum because we have to respect everyone's privacy and even secrecy, we are out meeting regularly now with some of the biggest trading houses in the world, whether buy-side or sell-side, to consult with them on what we are doing.

Greg: And presumably as you launch, you will be available at some of the larger industry get-togethers?

Eli: Yeah. One of the people we have hired - this is a real company now, we have Chief Executive and Chief Operating Officer and a Chief Technology Officer and Head of Client Relationship management. We are formulating a strategy around all of these things

in terms of our advisory panels, in terms of our conference participation, in terms of how we interact with the press, do podcasts, but we have been very public recently.

And whereas, some people were critical and I think fairly critical of Turquoise in the middle of last year that it was opaque and the initiative was accused of only ever having unnamed spokespeople. We have really turned that around completely and we are very open. We have launched a new website where there is some pretty interesting content and it will get more interesting as we put our specifications and market model up there.

But we are really very focused on making this into a more transparent organization, transparent business.

Gavin: I was wondering if you would like to just discuss why it is that so many exchanges are specific to one particular asset class historically. And when we have gone through all of these various different mergers and acquisitions, commodity exchanges and futures exchanges seem to take each other over as opposed to being a sort of vertical thing, which given the user community and some of the other advantages that could be broughtS together, why it is that anybody has actually gone into equities, commodities, fixed income, etcetera, etcetera?

Eli: It is a very interesting question. It should probably be studied in more detail. I think a lot of it is just evolutionary. And you have fixed income historically and it is definitely moving away, but you have fixed income products being more over the counter. And getting back to our discussion a moment ago about reference data, well equities were exchange traded and very much at the counter for so long that the electronification, in a sense of the equity world, was just a vastly simpler undertaking.

So I think that is why you have the proliferation of first the ECNs in the U.S. and arguably MTFs in 2008-2009 in Europe on the one hand. On the other hand, in terms of derivatives exchanges, as you mentioned, the futures, the commodities exchanges, there is tremendous similarity in what they have to do and what equity exchanges for example have to do.

And I think it is reasonable to expect those overlaps will materialize in time. You look at the New York Stock Exchange or "NYSE Euronext" just having bought Amex or one of the things Amex operates is very large options exchange, right? So there is some convergence. And I have spent some time in electronic trading of fixed income and as these multi broker platforms build out and more people connect to them and they become more real time from a quoting point of view and less sort of indicative, more actionable, which is definitely underway now, some of the fixed income platforms look more and more like exchanges in the equity sense. So I think there is a convergence coming.

Greg: But do you think, for example, in the algorithmic trading world, the fact you need low latency, connectivity speed, low operational cost, settlement cost, could that actually be a driver to converge? In other words, those things become so important to trade from an algorithmic perspective and algorithmic trading gets to be such a large part of trading

overall that it is actually in the interest to have one exchange that can do all those things well. Because typically, if exchanges are personified by one thing at the moment, the very reason you exist as a business, is that they are not doing that particular part very well.

Eli: Well yeah, I don't want to say there is going to be one exchange that does all those things, because then you theoretically get into a competitive situation again or noncompetitive situation again. But certainly you can look at this in two dimensions and say that one dimension is geographical and the other dimension is by asset class.

And one of the things Turquoise is doing is enforcing the convergence from a geographic point of time, so whereas used to have to plug into London Stock Exchange and Deutsche Borse and Euronext and do effectively the same thing with slightly different rules and different billing mechanisms and so on, and different times, with Turquoise you make one connection and you have pan-European access. So let's say we've addressed that dimension of the problem and maybe--I mentioned NYSE, Euronext a moment ago--they may have some convergence over time, but the other dimension of asset classes is sure to happen as well.

Greg: Can we just address an argument that's been made in the past in terms of an article written about six months ago in June saying that the competition in this area leads to fragmentation, and fragmentation leads to operational complexity from the perspective of this sell-side with more venues. You've specifically stamped on this argument before but can you run through that again as to why you don't think that's a fair assessment of what competition might do in this market?

Eli: Well, you have to look at the source of the argument that competition is.. effectively, people who were saying that this competition is going to lead to fragmentation which is bad, well it was entirely disingenuous. It's a protection ploy and it has to be treated exactly as that. I mean, competition is clearly required in this market; it's not as if traders don't have the wits about them to choose which venue to trade on.

It's not as if they don't have the technology to re-aggregate liquidity. This is competition that is going to improve trading for everyone because you can re-aggregate liquidity. You should have of which venue to execute on.

If the current providers weren't doing everything for free, you can argue that the competition wouldn't be required if they're also doing things well and for free. But in this environment, the competition is designed very specifically to address the inefficiencies in the exchanges as they're constituted today. That is from execution through the whole vertical solution of clearing & settlement. So that's what we're endeavoring to do.

Greg: Upon launch, can you give us any numbers? Are you prepared to talk about numbers or percentages that you're confident of grabbing on launch of Turquoise in terms of the volume of trades compared to the overall volume?

Eli: Well, this sort of thing is very, very difficult to predict although we will, over the coming months, have been in a better position to model it. There are market-making requirements in place for some of our members. We expect other members to be on board at launch who will be market-making as you see happening on one of our competitors already.

So I think it's going to be a very vibrant market. There will be price improvement from the very outset. The fact that there will be price improvement and there'll be price improvement with reasonable frequency will make Turquoise really a nondiscretionary connection for anyone who's serious about the quality of their execution. If you'll add all of that up, I like our odds to have a significant market share but we're not in a position yet to model what it's going to be.

I pointed some things more metaphorically important like the fact that our partner in trading technology, Cinnober, was also the technology behind both which is not a dissimilar organization historically although we've changed how we operate and they've gone a different path. But from a technology point of view, they went live on day one, November 1, and they had trade reported 90, 000 transactions and had a 20+% market share. I like to think that's a harbinger for what's to come in our world.

Gavin: By the same token, is there any reason why you shouldn't, at some stage, take some sort of trade reporting function onto your own platform?

Eli: Well, very focused on what we're doing right now which is creating this European MTF which will be self-reporting in and of itself. That's job one and arguably job two, three, four also. There are a number of other things that we could do in the future but that's not one that we talk about at all.

Gavin: Historically, many exchanges have fought shy of the opportunity to be taken on CCP status or if they did they charge through the nose for the privilege of that guarantee in the lowering perhaps of some of the risks. Firstly, do you see that's being a CCP is going to be a key differentiator for you and how do you envisage that it will all work in terms of the capital and risk aspects of it?

Eli: I don't think it's going to be a key differentiator for us because the market is going to be pretty open in that regard and people are very likely to figure out early how they can be competitive in that regard. I think it’s important. I don't think it's going to be a lasting differentiator.

Gavin: Exchanges hadn't actually been part of the risk perspective historically; do you think that that will change? That there will be future requirements whereby there'll be exposure monetary against an exchange and your banks will be required to monitor them as a risk exposure in the same way as they have done on counterparties?

Eli: I think maybe in some way but probably the world is moving against that. Let me explain what I mean. As you introduce additional venues, you introduce the possibility for any individual firm to split up what they're doing and they can have very different

exposure on platform one than they have on platform two. In fact they can have, by any measure, a massive exposure in platform one but a canceling exposure upon platform two.

So it wouldn't make that much sense for the exchange to have responsibility for monitoring that. It does speak to what is underway which are (in this regime anyway), that some of that responsibility is passed on to a regulator with the requirement that the data be accessible to that regulator who then becomes the aggregator of all things.

I think it's a very big undertaking probably to get to where everything has to get for the kinds of security that you can imagine being important in the trading environment that we have today. So banks aren't well suited to it and for the very reason that we at Turquoise are getting into this, exchanges themselves won't be well suited to the task. Everyone will have their part to play.

Greg: OK, thank you very much for your time today.

Eli: Thank you very much.

Announcer: That was an interview with Eli Lederman, CEO of Turquoise. The Algorithmic Trading Podcast, sponsored by Sybase was brought to you today by Voices in Business, helping our sponsors to achieve full leadership in their business sector. To find out more about Voices in Business, visit www.VoicesInBusiness.com. We strongly encourage feedback, so please submit your own questions either by email or in the comment section of the website at www.AlgoTradingPodcast.com.

Thanks for listening. Goodbye.

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