

The View from Batterymarch

■ EQUITY TRADING INSIGHTS

Colocation and Liquidity Provisioning: An Uneven Playing Field

Enhanced access to trade execution venues has attracted considerable attention from industry professionals, the financial press and regulators. Dragan Skoko, Batterymarch's Director of Trading, discusses how one major type of enhanced access—colocation—has tipped the balance between liquidity providers and users.

In the past, trading in exchange-traded asset classes was facilitated by brokers, local traders and specialists with a physical presence on the trading floors of the exchanges. Admission fees for this access generated meaningful revenues for the exchanges, and the floor presence gave brokers and local traders a competitive advantage that outweighed the costs of buying or leasing their seats.

This approach worked well for those in the business of liquidity provisioning and trade facilitation. Meanwhile, liquidity consumers such as retail investors and institutional money managers, who paid steep commissions and fees and had limited insight into the exchange-based trading activity, often griped about costs, poor execution and a lack of transparency.

With the regulatory changes and technological advances of the past 10 years, most exchange floors have shut down, and the remaining ones struggle to stay competitive. As trading floors have given way to data centers, the exchanges have found new ways to extract fees from liquidity providers and high-frequency trading (HFT) market participants—through colocation services. The fees once collected for seats on the exchanges have been replaced by revenues generated by leasing space in their data centers and selling enhanced data feeds, including sensitive information about other participants' transactions.

By offering colocation services, exchanges have managed to stay relevant in the new trading environment. At the same time, close proximity to trading venues gives those firms whose business models depend on liquidity provisioning and other HFT strategies an apparently small, but clearly non-trivial, advantage in terms of speed.

HFT traders have been slowly displacing specialists and designated market makers by cutting their profit margins. Institutional and retail investors alike are increasingly meeting their liquidity requirements by interacting with HFT participants while proportionally diminishing their interaction with designated liquidity providers. In fact, some estimates indicate that HFT now accounts for 61% of US equity market share volume.

The current system in many ways appears to be successful, with HFT playing an important part in liquidity provisioning. Proponents point out that HFT traders provided much-needed liquidity during the 2008-2009 financial market crisis, and trade facilitation in the US equity market remained orderly despite the seismic plunge in equity prices.

Yet it has traditionally been the role of the exchanges to facilitate orderly trading, in large part by imposing liquidity provisioning requirements on their members. With the ascendance of HFT, the exchanges have to some extent ceded responsibility in this area. HFT traders profit from liquidity provisioning, but are not obligated to provide liquidity during difficult market conditions.

According to some reports, HFT currently generates \$8 billion or more in annual equity market profits, out of a total of roughly \$20 billion in profits across all trading strategies and asset classes. The profit opportunity for HFT participants through colocation privileges, combined with their lack of obligation to provide two-way liquidity, has created a disproportionate shift in their favor.

In Batterymarch's view, those who benefit from presence on an exchange, whether physical or technological, should be obliged to help maintain orderly two-way markets for liquidity users. Enforcing this obligation through regulation would help re-establish the traditional balance between the firms that generally provide liquidity and those who consume it.

Important Information

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