

3 May, 2011



Negotiated Order Flow: Good news and bad news

The recently announced initiative by Euronext ("Negotiated Order Flow") where retail orders will go through the systems of Euronext, but are traded outside the central order book, is both good and bad news.

Let's start with the good news. Finally Euronext also acknowledges that the costs of trading retail orders are too high. It is difficult to ignore the fact that almost 40% of their business is lost to alternative exchanges. This new initiative can indeed save transaction costs for retail brokers and that is the good news. The bad news however, is that this new initiative is similar to off-exchange trading. In other words 'dark pools' which are rightly criticized by many others. Until recently, Euronext was one of the biggest opponents of these 'dark pools' claiming that everything traded outside of the central order book is bad for the price discovery and subsequently bad for the market. Why the change of heart? Regardless of the reasons, this is not good for the market.

It is detrimental to the market to organize closed private parties where a significant part of the (retail) market trades through. In order to maintain efficiency, it is necessary to keep all venues **open**. Each party must be able to compete for the best price against a client order and not only those who have a bilateral agreement with a retailbank or broker perhaps even in exchange for payment. One consequence will be that price discovery will deteriorate if access to these private parties is only for the happy few. After all, an important part of the retail flow will be traded outside of the open market. Therefore, the remainder of business on the exchange is professional flow. The willingness of the market maker to maintain a tight spread will decrease if he can never be rewarded with a genuine retail order. When faced with only professional flow, the market maker cannot maintain a tight spread. Consequently, the spreads will widen and the market becomes more inefficient. As a result of the wider spreads on the open exchange, the dark pool traders do not need to maintain tighter spreads to win the order. The temporary exuberance due to the lower exchange fees on such closed private parties will soon be disrupted because of a market with wider bid/offer spreads.

A better solution would be if Euronext would operate a Smart Order Router that could direct the order to another open exchange with the same or better prices. The advantage of lower costs can be achieved because of the attractive fee structure on alternative exchanges. This enables all players to continue competing for the retail order. Only in this way can we maintain competition.

Willem Meijer
CEO of TOM (The Order Machine)