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Harborside+ Offers a Large-Block Trading Facility But Building Awareness Is the Paramount Challenge

Large-block trades of 100,000 shares or more of listed stocks are often difficult to execute. To achieve their goals, investment managers and their broker-dealers employ a practice known as "shredding," in which the large block is broken down into smaller lots and bought or sold over longer periods of time, likely weeks. In recent years, however, technology has enabled new solutions to surface that ease the need for shredding and allow firms to execute trades of much larger orders speedily. One of these firms is Harborside+ [Harborside Plus], which marries an electronic platform with a traditional trading desk. *Global Investment Technology* spoke with Robert C. Hall, President and Chief Executive Officer, Harborside+, about the challenges inherent in creating and running a block trading platform.

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GIT: *Since large trades are not easy to execute electronically, how has block trading changed and progressed in recent years?*
RH: There are many aspects to it. The large, sell-side firms are committing less capital to the block trades, due both to profit-and-loss issues, the increased size of institutional orders, and decimal pricing; a factor that has contributed to the collapsing of spreads. Additionally, the intense consolidation of the buy side has in many cases created portfolios so large that the orders they generate are greater than the size of the market. Front-running, a long standing problem in capital markets, has led to a significant shredding of blocks as a defensive tactic. As a result of all of these issues there has been a significant drop in block trading; not that blocks don't need to be traded, but people are shredding their blocks to minimize market impact. Market impact is hard to measure. You can look at the market over the period of time it might have taken to do that trade in the shredding process, and then look at it if you had done it at the point in time when you first entered the market. If you entered the market now and did the trade at the midpoint or close to it, then that's the price. But if you shredded it and did it over a week, you would have to look at whether there was price erosion. Some would argue you can get price improvement, but that's market timing.

GIT: *How much of an obstacle is shredding of blocks for Harborside?*
RH: It's an issue. If someone says they're doing fine by shredding, we say then continue; they have a lot of transactions, granted, but they can get them all off at 500 or 1,000 shares each. However, they will have a lot of

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transaction costs. They will get multiple prices and, particularly for a less liquid stock, the process has to be managed over weeks to get the trade done. Then there is market impact during that timeframe. If we can complete a transaction in a single trade, costs go down, and we're obviously trading with a lot less market impact. Also, there's a discount or very competitive price for the transaction; clearance and settlement costs are lower, and [the client] gets a known price. One of the problems of shredding is that you're subject to whatever the market is doing and where the price discovery is happening. Right now, the price discovery for listed stocks takes place on the NYSE, but it is done through small trades. We represent the only vehicle in the market today that facilitates price discovery for large blocks.

GIT: *What are some of the hurdles you face in building critical mass?*
RH: There are a lot of investment firms that trust their existing relationship with their broker or have a lot of chits to pay and aren't interested in doing anything different, which has nothing to do with the argument about best execution. Given the overall pressure in the industry and the previous abortive attempts to address this problem in some way, such as [the failed] OptiMark [system] and others, people are very leery of new things. So awareness is harder to build.

[As] the average trade size is split into smaller and smaller chunks, there's exponential growth in the actual amount of transactions required per person.

GIT: *How would you compare and contrast Harborside's methods for creating liquidity with those of Liquidnet, a main competitor?*
RH: There are several differences. One significant difference is that we include the sell side as part of our liquidity pool, which we think is a significant pool to draw from. The second issue is that we have a variety of ways that enable people to check our liquidity pool for contra sides to their own trading interest. They range from a simple FIX connection, to an application that [links to] the client OMS and to our secure server. This allows the client to automatically check us for liquidity without keystrokes. Phone lines, and instant messaging add to the variety of ways a customer can check us for liquidity. Liquidnet requires in most cases the installation of a file server. We're much easier to start up. [We have] the ability to tap into lots of firms that don't have order management systems and are easier to access from that standpoint. The third piece, and probably our biggest, is that we have a trading desk that becomes involved once a contra side is found. We don't get involved until, both a buyer and seller are identified for a given stock. Then we facilitate the negotiations. This allows us to impart important nuances to both sides of the trade while protecting the confidentiality of both clients.

The only way to do all that work is with tools and rules-based technologies that meet the productivity demands increasingly pressuring traders.

We think it's important to read the nuances where a trader can ask if the other guy is real — we can say "Yes, we've known him a long time, he can currently trade 50,000 at the price, but his portfolio manager is coming back in an hour and he is sure that there is further interest." Just having that confidential dialog without disclosure is a significant asset for a seasoned trader. In Liquidnet's model, where you're implementing all your queries on a computer, you don't know anything about who you are negotiating with. Do they have more to do? Is there greater size at a different price? Do they reload? It is also extremely difficult, for example, to read tone of voice, or urgency in an e-mail. There is no effective replacement for human interaction in our opinion.

GIT: What are the challenges in finding liquidity for large orders without significant market impact?
RH: We make no outgoing calls. The only way you find liquidity in our system is if there are two sides in there. If you put in a side and you're a seller and there are no buyers, we can't help you. But we do get a lot of matches and our thesis is that we have the capability to say to someone who has a tough-to-trade stock: Put the indication in there and leave it. If we find the other side, we'll call you. We don't get a 50 to 60 percent match rate, but we don't charge to put the indication in, and there's no market exposure to have it in there. We don't even know what's in there. Our computer is secure in that basis, and even our trading desk doesn't know you are a buyer or a seller of a specific name unless there is a contra side to your indication.


***Hall:** Creating a liquidity network.*

GIT: What drove the doubling of Harborside's volume for the fourth quarter?
RH: We continued to add users both on the buy side and sell side. We now have over 400 users that have sent us IOIs [indications of interest]. It's an increased number of users and the number of IOIs per user that builds volume. We're getting the IOI count higher, which increases our liquidity pool. The more liquidity we have, the more trades we do.

Every full service firm will have to offer some sort of direct-access vehicle for institutions and their retail customers.

GIT: What role does the choice of trading venues or methods play in seeking best execution?
RH: Best execution has a lot of different definitions. Unfortunately, the simplistic viewpoint is the bid-and-ask, the quote service, which represents quite small orders — 200 by 200, or some other small volume. We think best execution and the risk of market impact or exposure in trading large blocks are very significant. One of the elements of best execution that has been minimized is market impact that results from executing a stock trade over a significant period of time.

As institutions grow in sophistication, they will realize trading [entire] portfolios is much cheaper than trading single stocks.

When you really get down to best execution, the price you're paying is not just the commission or how much better you did than the close. VWAP [Volume Weighted Average Price] will do that, giving the average price over the day, but again you are taking price rather than discovering the price for your block, which is what occurs in our system. Our system mitigates market impact and facilitates price discovery; there is no other system out there that does both.

GIT: How is the order management system (OMS) interface that Harborside established in December contributing to its business?
RH: It's allowed us to make connections to a significant number of institutions that have a variety of OMS packages. Whether it's LongView, Eze

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Castle, Macgregor or whoever, we can interface with it. We can also interface to a proprietary system, which makes it very easy to come in and load the application, regardless of the OMS. We have a very broad range of input capabilities. Because of the way our system works, our clients don't have to use an OMS; that's a significant advantage. We just want to be able to interface with whatever our customers have on their trading desk and accommodate the way our clients want to indicate [trading interest].

The second factor we're continuing to drive for is to increase the size of the liquidity pool. We know that, mathematically, the more we can increase our liquidity pool, the higher the odds of a match on the other side. So we want to continue to drive that rate up. We [want to] bring in more customers who will put in more indications. [Growth in IOIs and the liquidity pool] is the key to success as opposed to true transactions volumes. The size of the liquidity pool is the key indication of the value we bring. People will sample that pool to see if there is anything that is a contra.

***GIT:** What are the challenges to innovation in the current global economic and political climate?*
RH: There is continued cost pressure on the trading firms themselves. The sell side is looking for ways to improve the productivity of the trading desk. We can enable that and help sales traders find [the other side] they couldn't find on their own. The lower yields and lower growth potential of the buy-side portfolios are also a challenge. If stocks are returning 8 percent a year versus 20 percent, surely the lower returns will put a higher premium on minimizing market impact and pursuing more innovative solutions. ❏