

The Next Generation of Execution Consulting Services: Leveraging Technology to Build Relationships

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EXECUTIVE SUMMARY

Execution Consulting Services 2.0: Leveraging Technology to Build Relationships, produced by Aite Group and compliments of StreamBase Systems, analyzes key industry trends influencing the future of global trading and the growing prominence of execution consulting services. The study also examines some of the operational and technical challenges that market participants are facing in terms of scaling their execution consulting business based on a survey of 15 broker-dealers during March and April 2012.

Key takeaways from the study include the following:

- Cost control is the overarching market driver for the global capital markets as volumes decrease and the specter of increasing regulation looms.
- Driving much of the adoption in electronic trading has been the continued fragmentation of liquidity across the major regions of the United States, Europe and Asia-Pacific.
- Overall impact of potential regulatory changes is clear for the industry participants who are expecting stringent reporting requirements as well as enhanced transparency into market activity.
- In order to help their customers navigate through these changes and help them find trading opportunities within the new market framework of low latency and market fragmentation, most broker-dealers have created **execution consultant groups** within their electronic trading groups.
- Developing and maintaining effective execution consulting services is no easy task due to difficulty in talent acquisition, as well as the decentralized nature of broker trading infrastructure.
- The market is ready for the next generation of execution consulting services, which can leverage real-time analytics platforms to help brokers effectively manage and provide support for their clients.
- Real-time execution consulting services will enable brokers to become more agile, enabling them to port the same service model to other global markets as well as to other asset classes beyond equities that are becoming increasingly electronic in nature.

INTRODUCTION

The introduction of electronic trading has fundamentally and forever changed the institutional trading market. Still, the somewhat utopian industry prediction of machines completely taking over human traders has failed to materialize. In fact, in a most ironic twist of fate, as electronic execution services continue to become more sophisticated, the buy-side demand for more hands-on support from brokers has increased substantially over the last five years.

The role of the traditional sales trader no longer truly exists in the marketplace. In its place stands a group of specialists known as execution consultants that represent sales traders, relationship managers, market structure experts, technology experts, quants, traders and research analysts. The line between low-touch and high-touch service is becoming increasingly blurred as buy-side clients ask for mid-touch service that blends the self-service execution service with high-touch support in terms of advice and guidance in real-time.

The rapid adoption of electronic trading has also generated much buy-side interest in sophisticated trade analytics and performance measurement tools, often in real-time. The need to react quickly in a microsecond trading environment has also led to growing requests for algo customization and real-time trading monitoring and support. In a way, as buy-side traders have become more sophisticated and knowledgeable in dealing with market fragmentation and next generation execution tools, the need for more customized, hands-on support has increased over the years. This growing world of execution consulting services has now hit the mainstream within the broker-dealer community to help support their buy-side customers.

This study analyzes key industry trends influencing the future of global trading and the growing prominence of execution consulting services. The study also examines some of the operational and technical challenges that market participants are facing in terms of scaling their execution consulting business based on a survey of 15 broker-dealers during March and April 2012.

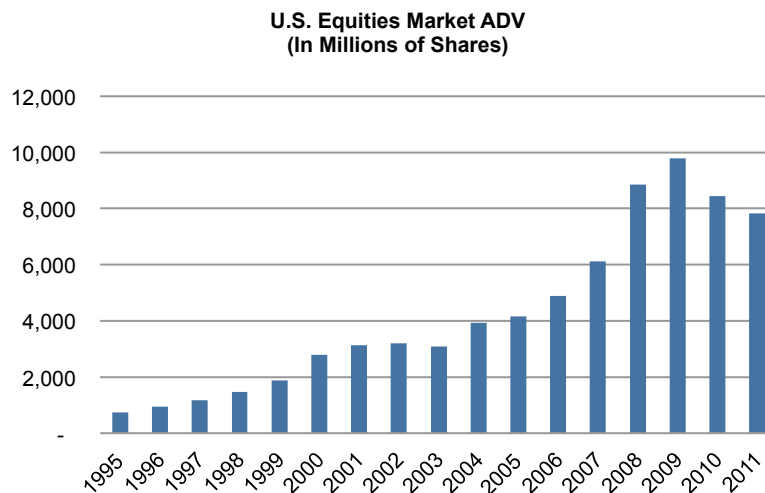
KEY MARKET TRENDS

Cost control is the overarching market driver for the global capital markets as volumes decrease and the specter of increasing regulation looms. Continuing adoption of electronic trading and expansion of market fragmentation globally has forced buy-side traders to take a more active role in managing their trading activities. However, the growing market complexity has also led to brokers providing a more central role in guiding buy-side clients to make accurate and timely trading decisions. For years, most brokers focused on providing self-service execution services such as DMA, algorithms, and internal crossing engines to fulfill their ever expanding role as trading intermediaries. However, with most brokers already providing these tools, the chase for the next new thing is in full swing, as brokers look for the next generation competitive differentiator to attract additional revenue.

OVERALL MARKET VOLUME TRENDS

After years of explosive growth, the U.S. equities market has experienced two consecutive years of decline in terms of trade volume with no real end in sight for a rebound (see Figure 1). Retail investor confidence appears to remain low since the financial crisis of 2008/2009 and significant institutional money remains in the sideline or in safer investment products driven by market uncertainty. Trading volume trends in other major regions reflect this decline.

Figure 1: Declining Trading Volume



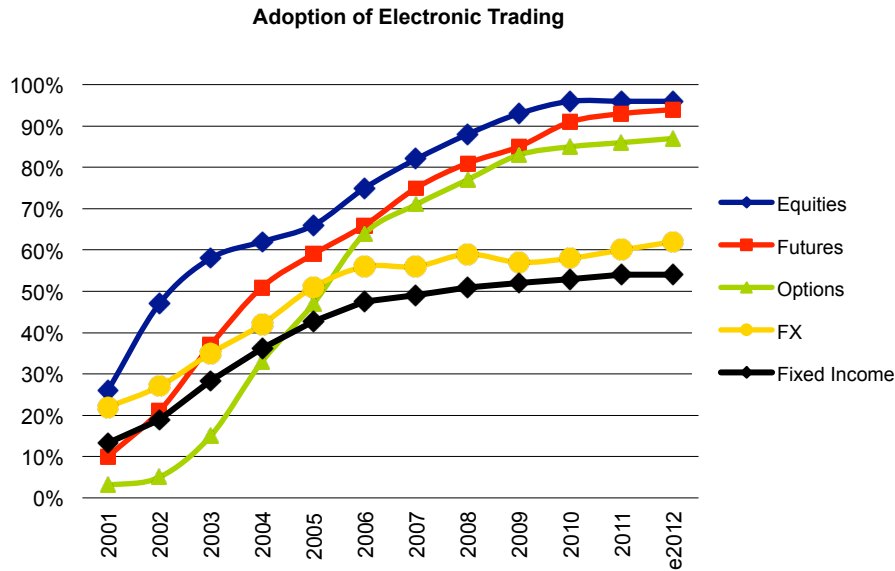
Source: NYSE Euronext, NASDAQ OMX, SIFMA

GROWING ADOPTION OF ELECTRONIC TRADING

Despite the decline in trade volume, electronic trading has become the most dominant form of trading in most major exchange-traded instruments (see Figure 2). The distribution of self-service driven electronic execution tools has enabled major broker-dealers to reduce costs in

terms of personnel while at the same time scale their business efficiently with their core buy-side client base.

Figure 2: Growing Adoption of Electronic Trading

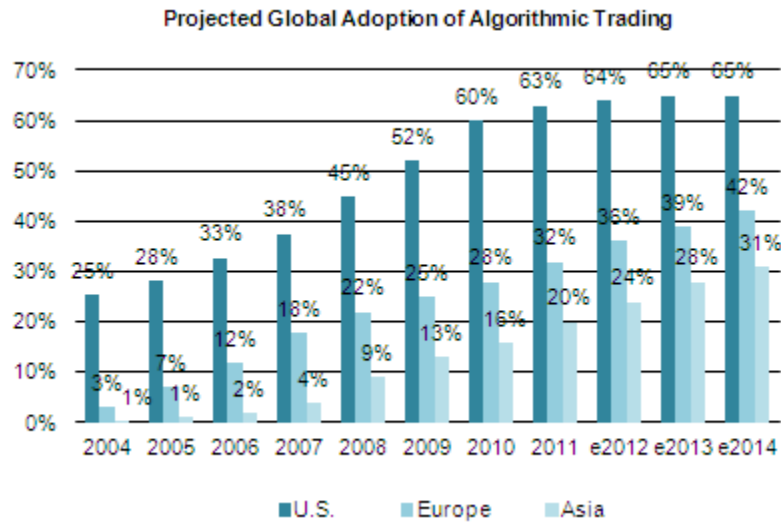


Source: Aite Group

The broker-dealer community has clearly succeeded in marketing their sophisticated electronic execution services as evidenced by the high level of adoption rate in algorithmic trading across the major regions (see Figure 3).

Most major global brokers have committed hundreds of millions of dollars building out their trading infrastructure to support algorithmic trading, and as a result, algorithmic trading has moved on from a competitive differentiator to a competitive necessity, and in certain cases, a commoditized product.

Figure 3: Growing Adoption of Algorithmic Trading

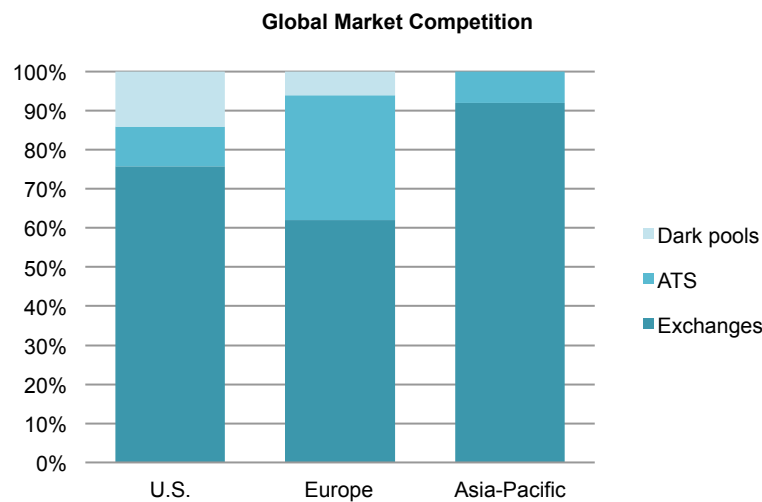


Source: Aite Group

MARKET FRAGMENTATION CONTINUES

Driving much of the adoption in electronic trading has been the continued fragmentation of liquidity across the major regions of the United States, Europe and Asia-Pacific (see Figure 4). The days of traditional exchange dominance are long gone, and every percentage of market share is being contested aggressively by lit and dark alternative execution venues.

Figure 4: Market Fragmentation Expands Globally



Source: Aite Group

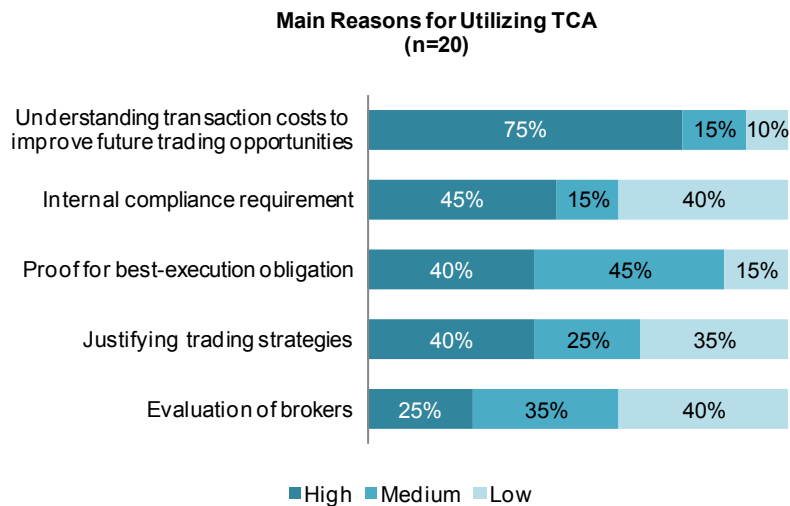
GROWING SOPHISTICATION OF BUY-SIDE FIRMS

As the market has become more complex over the last decade, buy-side firms have become more sophisticated, largely due to the various execution tools being offered by brokers and trading technologies being developed by the third-party vendor community. In addition, the sudden nature of the credit crisis as well as the resulting industry-wide regulatory pressures have pushed buy-side firms to be increasingly vigilant regarding their trading performance.

Post-trade analysis of trade performance has been around for many years. However, in recent years, buy-side firms have looked to make smarter decisions in real-time via their trade analytics and monitoring tools, and have consequently developed internal solutions or sought upgrades from their sell-side partners.

Buy-side clients are also seeking more transparency in the marketplace, especially in terms of how their orders are being handled by their brokers and even examining the logic behind smart order routing platforms of brokers and vendors.

Figure 5: Growing Reliance on Trade Analytics

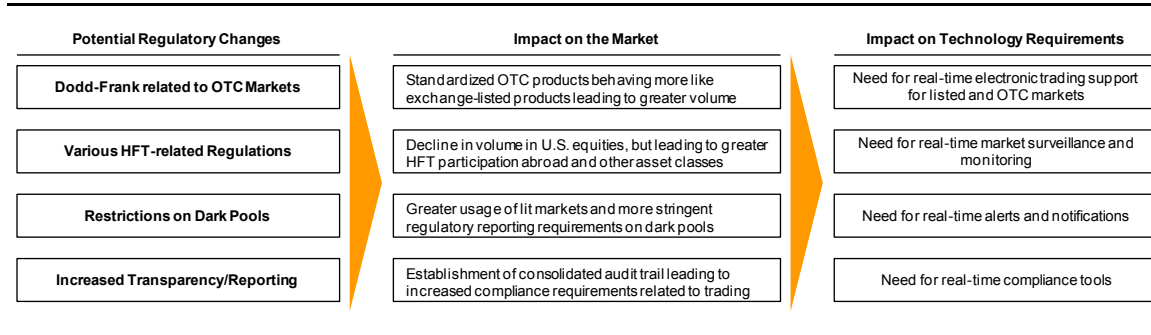


Source: Aite Group survey of 20 buy-side Firms, October and November 2011

REACTING TO REGULATORY PRESSURES

While there have been many proposed regulations, most of rules have not been finalized, let alone implemented. Even the implementation of the historic Dodd-Frank Act has been painfully slow, as different regulatory agencies and key market participants work out the details.

Figure 6: Regulatory Summary



Source: Aite Group

This regulatory uncertainty has become a significant barrier to market innovation as firms try to predict how regulations might impact their future business. Still, overall impact of these potential regulatory changes is clear for the industry participants who are expecting stringent reporting requirements as well as enhanced transparency into market activity.

BROKERS LOOKING FOR THE NEXT NEW THING

Over the last decade or so, the broker-dealer community has managed to control their growth effectively. Even as they were losing their traditional high-touch business, thanks to the IT investments made, brokers were able to navigate through the market structure and regulatory changes and to a certain degree, remain a dominant force in the securities industry. Now, faced with declining volumes along with increasing competition and regulatory requirements, brokers are looking for that next new thing which could help them maintain their vital role within the marketplace. For some, the solution may be in upgrading their systems to offer near real-time execution consulting services.

EXECUTION CONSULTING SERVICES DEFINED

From the buy-side's perspective, the institutional trading market of today looks quite different from the market reality of even a decade ago. The following four factors are forcing buy-side firms to look for more hands-on guidance from their brokers:

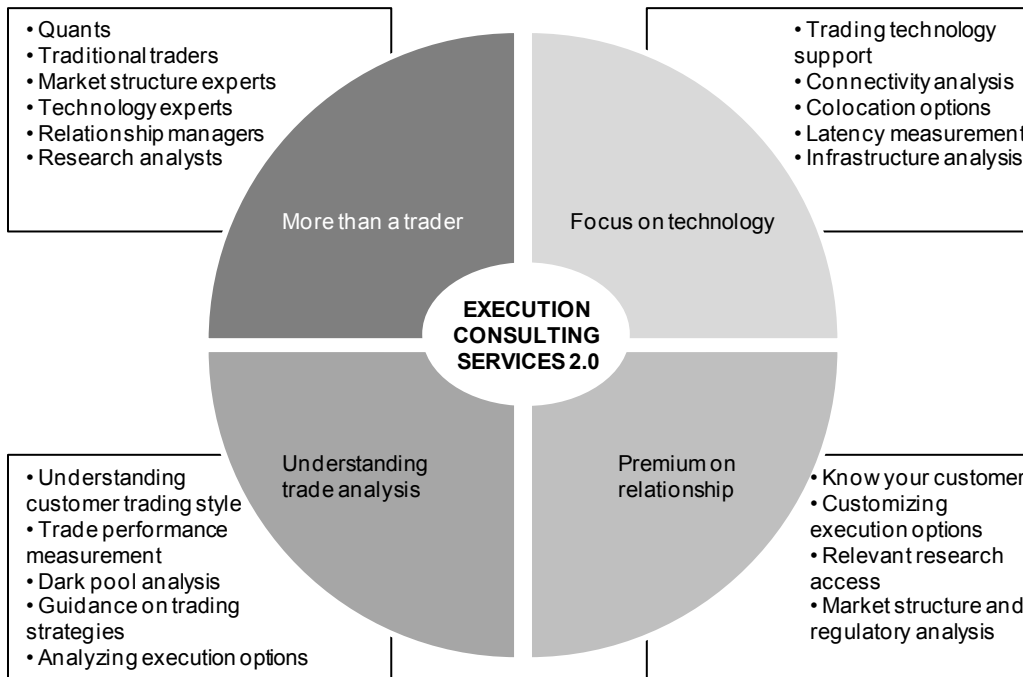
- **Complexity in market microstructure:** While the lit market is dominated by the four largest exchanges accounting for close to 70% of market share, market fragmentation continues in the U.S. equities market, especially in the dark pool arena. As the dark pools continue to increase market share, buy-side firms must take into account trading opportunities in both lit and dark markets.
- **Changing faces of counterparties:** Buy-side firms are also facing dramatic changes in counterparties driven by availability of cost-effective, low latency technologies and market venue competition. Given the declining presence of regulated market-makers and specialists of the past, and brokers' hesitancy to commit capital, buy-side firms are waking up to find out that main market liquidity providers have been replaced by high frequency trading firms that appear to have a vast technological advantage over other market participants.
- **Taking more responsibility:** The wide availability of self-directed services being offered by brokers (i.e., DMA, algorithms, crossing platforms, etc.) along with accessibility of third-party provided sophisticated trading technologies (i.e., OMS, EMS, low latency market data/connectivity, etc.) means that buy-side traders have an arsenal of execution tools at their daily disposal. As buy-side traders take control over their trading activities, the responsibility for making the right trading decision has also migrated over to the buy-side, putting a lot of pressure on buy-side traders to understand changing market structure and new market innovations in order to stay competitive.
- **Regulatory uncertainty:** With so many potential regulatory changes in the pipeline, ranging from flash orders and sponsored access to dark pools and consolidated audit trails, buy-side firms are constantly looking for insight into how these regulatory changes might impact the institutional trading market. Understanding the implications of regulatory change is increasingly being viewed as a competitive edge by buy-side firms. In addition, unlike past regulatory discussions, buy-side firms are becoming more vocal in sharing their views so that they can help shape the discussion toward the potential new regulatory framework for the U.S. equities market.

In order to help their customers navigate through these changes and help them find trading opportunities within the new market framework of low latency and market fragmentation, most broker-dealers have created execution consultant groups.

Execution consultants are groups of sales traders, relationship managers, market structure experts, technology experts, quants, traders and research analysts that provide a wide spectrum of support for buy-side clients. Some of the key characteristics of execution consultants include the following:

- **Know your customer:** The most important characteristic of an execution consultant is knowing the customer well. In order to provide customized, value-added services to clients, execution consultants must engage and understand the idiosyncrasies of each client.
- **More than a trader:** The movement toward collapsing the dual positions of a sales trader and a traditional sell-side trader into a single, hybrid position has clearly accelerated. The number of traditional cash traders (i.e., block traders) is decreasing rapidly, being replaced both by technology and by a new breed of traders. Although the word “execution” is included, a typical execution consultant is much more than just a trader. The consultant may be a front-line relationship manager with in-depth knowledge in trading; an advanced quant with a Ph.D., capable of building sophisticated trading strategies or performing trade execution analysis on the fly; or a market structure expert, capable of providing expert advice to assist clients through any regulatory changes occurring in the marketplace.
- **A premium on *real-time* trade analysis:** Simple trade execution is no longer a big selling point for the sell-side, especially in light of collapsing commissions and heightened regulatory and competitive environments. It is not only important for the sell-side to develop, guide, and actively manage execution services for the buy-side clients, but it is also becoming increasingly important for them to provide detailed trade analysis so that clients can apply the lessons learned from a previous trading day to maximize their trading objectives.
- **Technology as a differentiator:** Execution consultants also need to stay on top of the latest technology. More often than not, the sell-side has played a vital role in introducing advanced trading technologies to the buy-side. As the market becomes more automated with microsecond executions, the sell-side as a technology conduit is becoming increasingly important.
- **Relationships still count:** In the end, however, relationships still count, even in today’s highly automated marketplace with hype around DMA and algorithmic trading. The ability for the execution consultant to understand the client’s many preferences—including trading style, favorite sectors, details behind the portfolio of stocks, relevant research, and preferred payment methods—goes a long way in deepening any existing relationships, which in turn should help in generating additional revenue.

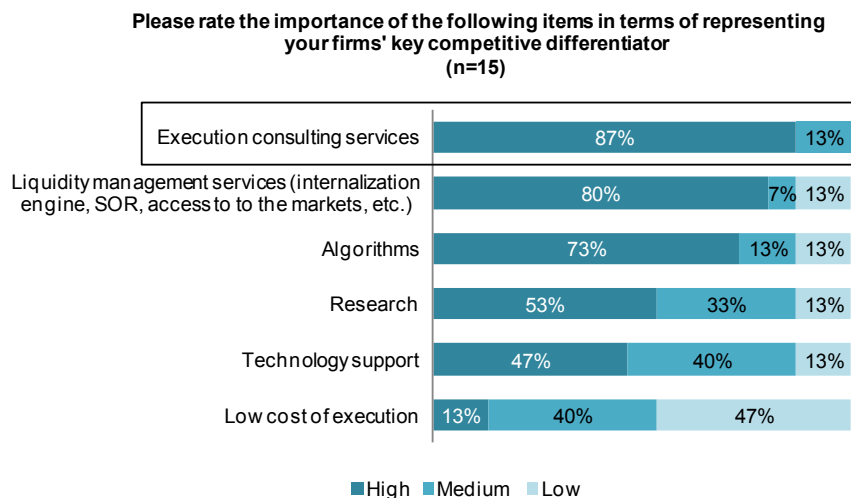
Figure 7: Key Components of Next Generation Execution Consulting Services



Source: Aite Group

The acceptance of execution consulting services within the broker’s overall service offering is quite clear based on our survey with only 1 out of 15 firms interviewed currently not having organized execution consulting services for their clients. In fact, the importance of execution consulting services has now exceeded the provision of core liquidity management services and algorithms (see Figure 8).

Figure 8: Growing Importance of Execution Consulting

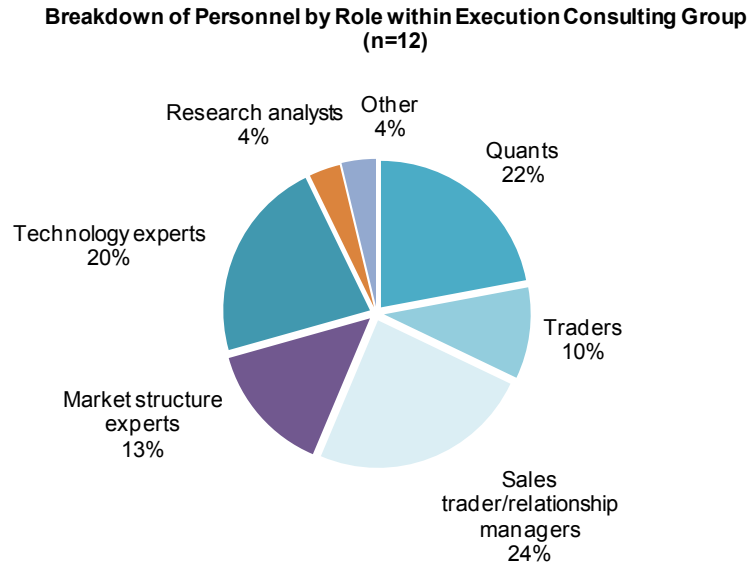


Source: Aite Group survey of 15 broker-dealers during March and April 2012

It is also important to understand the concept of execution consultants not as single individuals, but as a group of highly skilled professionals, each bringing a specific area of expertise to the table (see Figure 9).

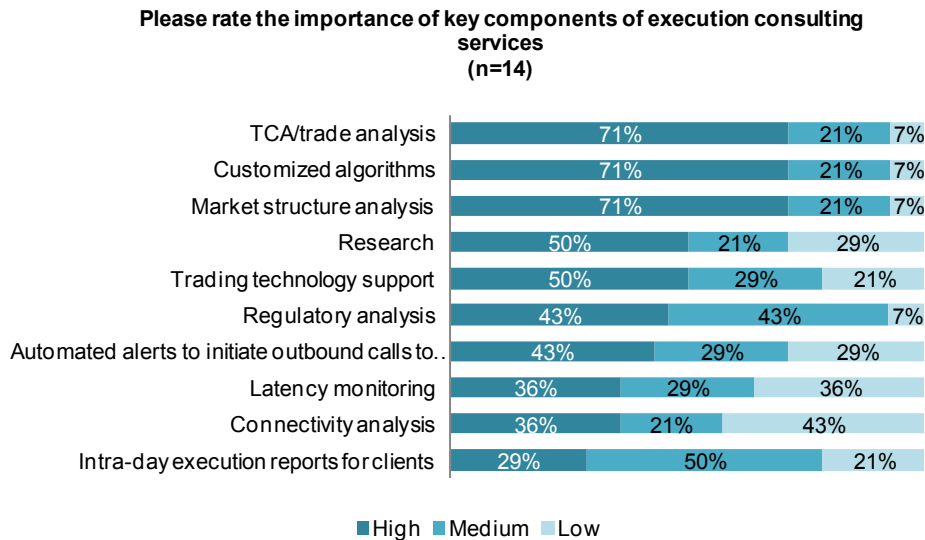
While technology has replaced some of the relationships and services typically provided by the sell-side, the value proposition of a sell-side broker will not disappear in today’s market environment.

Figure 9: Diversity of Role in Execution Consulting Groups



Source: Aite Group survey of 15 broker-dealers during March and April 2012
 Note: 2 out of the 14 broker-dealers with execution consulting services did not provide answers to this question.

Figure 10: Key Components of Execution Consulting Services



Source: Aite Group survey of 15 broker-dealers during March and April 2012

Some of the key services provided by today's execution consultants are the following:

- Educate and guide buy-side clients through various execution options available (e.g., high-touch, program trading, DMA, algorithmic trading, etc.);
- Advise clients on different trading strategies in real-time, with the flexibility to customize algorithms to suit their particular trading objectives;
- Analyze trading activities of clients in real-time and be prepared to provide easy-to-understand, in-depth advice on overall trading strategies using robust pre- and post-trade analysis tools;
- Offer technical guidance to keep clients up-to-date on the latest available trading technologies, functioning as a capable intermediary between the vendor community and the buy-side community; and
- Provide expert advice on the changing competitive landscape, including regulatory changes, new products, and general market events such as merger and acquisition activity.

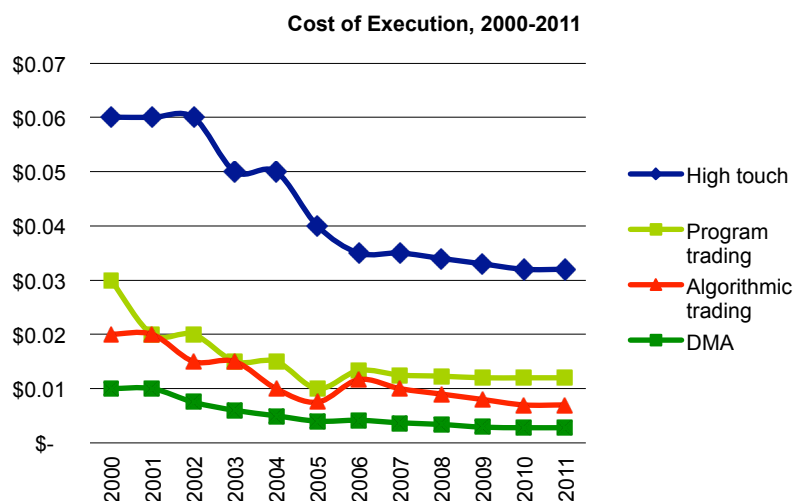
Part trader, part quant, part IT, and part relationship manager, execution consultants will play an increasingly important role in the future of sell-side trading services.

CHALLENGES FOR EXECUTION CONSULTING SERVICES

While leading brokers have clearly identified execution consulting service as an essential ingredient for future growth, developing and maintaining an effective execution consulting services is no easy task. Some of the key challenges include the following:

- Clients demanding more for less:** The obvious downside of rapid adoption of electronic trading from the broker's perspective has been the dramatic downturn in cost of execution (see Figure 11). Prior to 2010, brokers were able to make up the lost revenue by explosive market volume growth, but the recent decline in daily trade volume has created a very challenging environment for those brokers heavily reliant on transaction volume for core revenue stream. Unfortunately for the brokers, buy-side clients' demand for more services and support has not declined and, in fact, risen over the same period.

Figure 11: Downward Pressure on Execution Cost

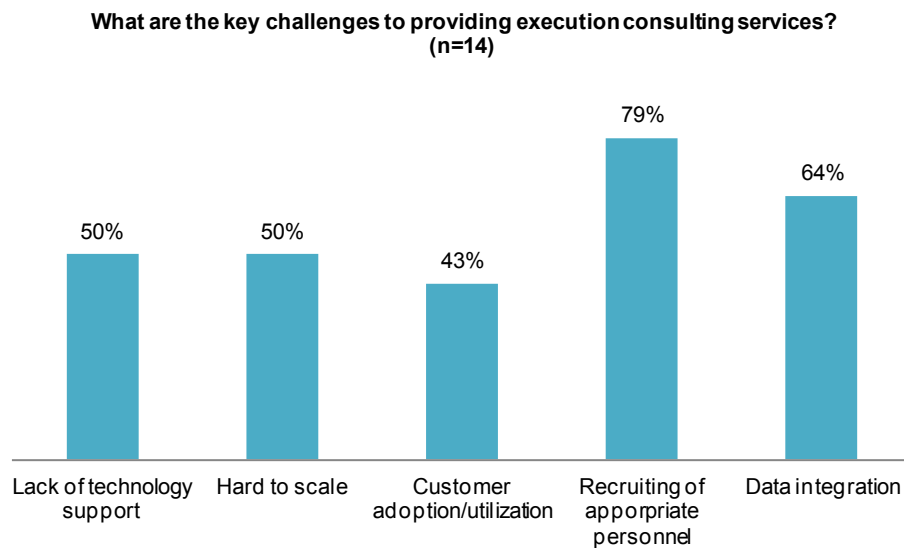


Source: Broker-dealers, Aite Group

- Looking for the elusive competitive differentiator:** Similar to algorithms and dark pool offerings, existing execution consulting services have the potential to become a commodity service as most large brokers add these to their offerings. Providing custom algos has become a competitive necessity for most brokers at this point, as well as support for execution performance measurement and reporting. Even within the context of execution consulting, brokers are searching for that elusive competitive edge, and near real-time might just be it.
- Tough to scale business:** Ironically, as execution consulting services continue to be developed within the context of electronic trading services, execution consulting is becoming a resource-intensive endeavor, involving many experts with different skill

sets. While global brokers can continue to commit more resources at developing an execution consulting team, it is becoming an incredibly difficult business model to scale properly. Being able to recruit and retain necessary talent can become a full-time job for most firms. Even for the global brokers, most of the focus in execution consulting services is targeted towards very large clients. It would certainly be beneficial for brokers to be able to take this business model downstream to those clients who might not be large enough today but have the potential for transforming into an important client with a little more hand-holding by their brokers.

Figure 12: Challenges of Maintaining a Competitive Execution Consulting Service



Source: Aite Group survey of 15 broker-dealers during March and April 2012

- Managing data from disparate systems:** Another issue around execution consulting services is the fact that typically, there is no such thing as centralized execution consulting applications that cut across all of the major products that might fall under the business umbrella of execution consulting. In order to create an effective execution consulting service, brokers need to fully understand all activities of the clients, including risk profile, trading objectives, asset classes they trade, preference for execution venues and algorithms, and more. Unfortunately, all these data points reside in multiple applications and databases, and trying to manage all of the vital client data from disparate systems can be a huge challenge.
- Difficulty in driving actionable, automated advice:** Related to the data management issue is the difficulty in capturing real-time data to push out actionable, automated advice to clients. The ability to resolve this issue alone could go a long way in brokers developing an execution consulting service platform that be scaled effectively to create a clear competitive advantage.

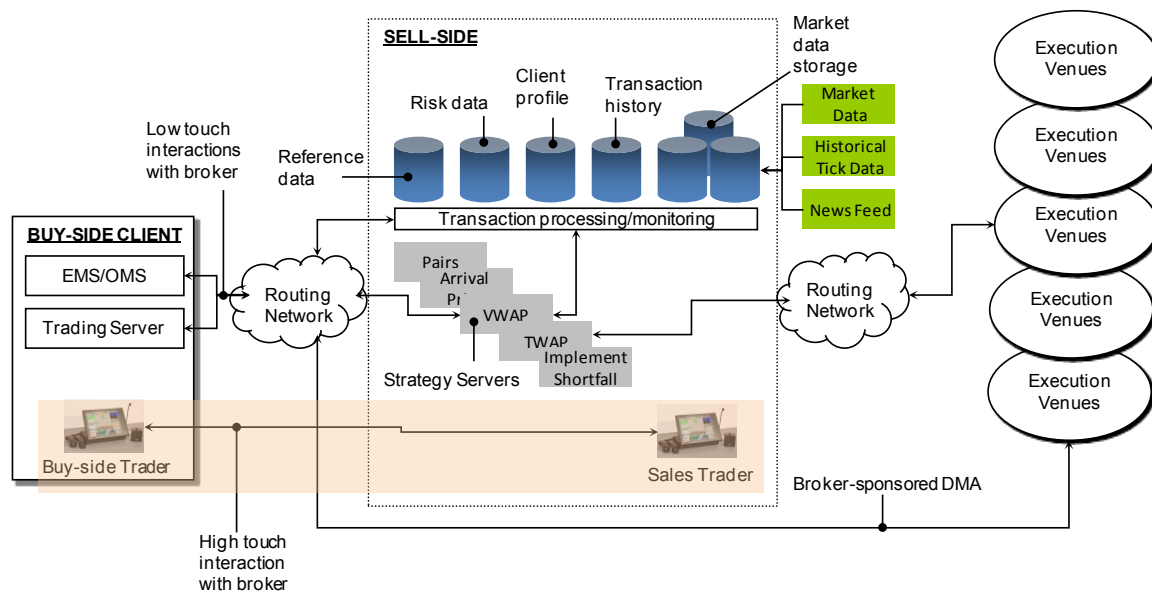
TECHNOLOGY SOLUTION TO A BUSINESS PROBLEM

Execution consulting services have become the next generation offering for broker-dealers. Early adoption is done and the market is ready for a new level of execution consulting offerings. However, many challenges still exist that hamper brokers from scaling their execution consulting services properly. In order to address those business challenges, brokers must turn to technology for an efficient solution.

TRADITIONAL SERVICE MODEL

Implementing a technology-driven execution consulting services is still far from reality. Much of the challenge lies with the fact that brokers rely on multiple applications and databases when interacting with clients (see Figure 13).

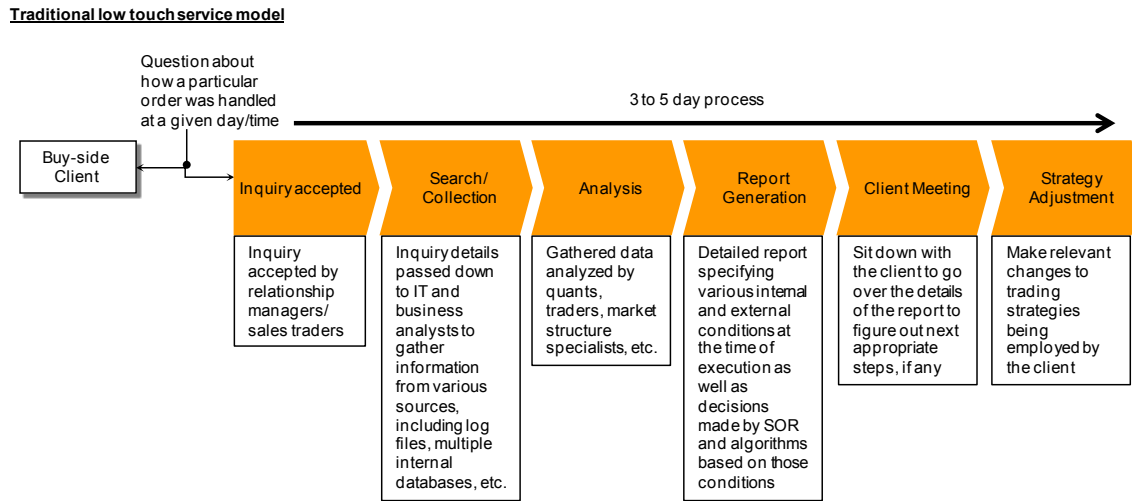
Figure 13: High-level Complex Reality of Broker Infrastructure



Source: Aite Group

Simply put, brokers have to rely on data from a multitude of disparate systems to gather and analyze certain activities that might impact their clients’ trading activities on a daily basis. Given this infrastructure limitation, providing proactive guidance under the guise of execution consulting has been a tough endeavor. As a result, first generation execution consulting tended to be post-trade in nature with days sometimes weeks going by before providing actionable advice for clients to implement.

Figure 14: Reactive Nature of Traditional Client Service Model

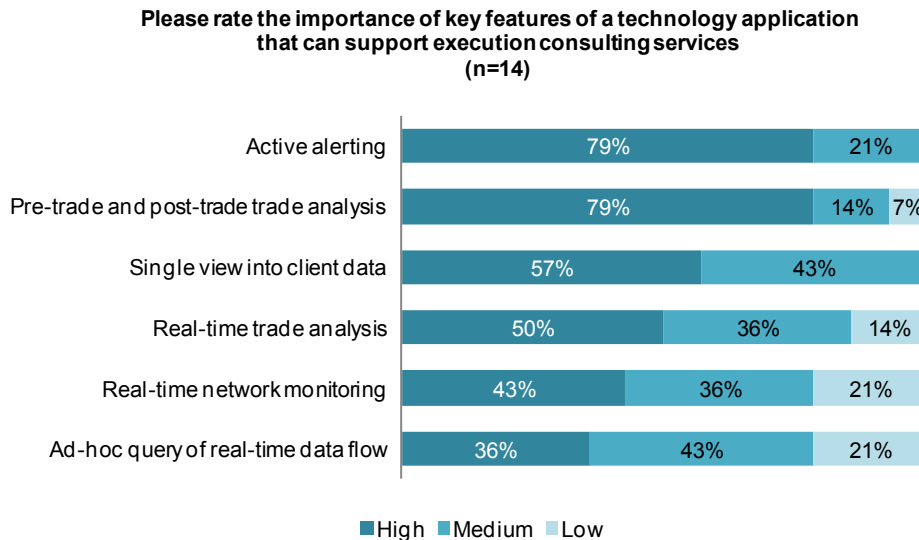


Source: Aite Group

BENEFITS OF TECHNOLOGY-DRIVEN EXECUTION CONSULTING

Survey results validate the fact that brokers are focusing much of their time on becoming more proactive and real-time in terms of enhancing their service model under the execution consulting service (see Figure 15).

Figure 15: Key Technology Solutions to Support Execution Consulting

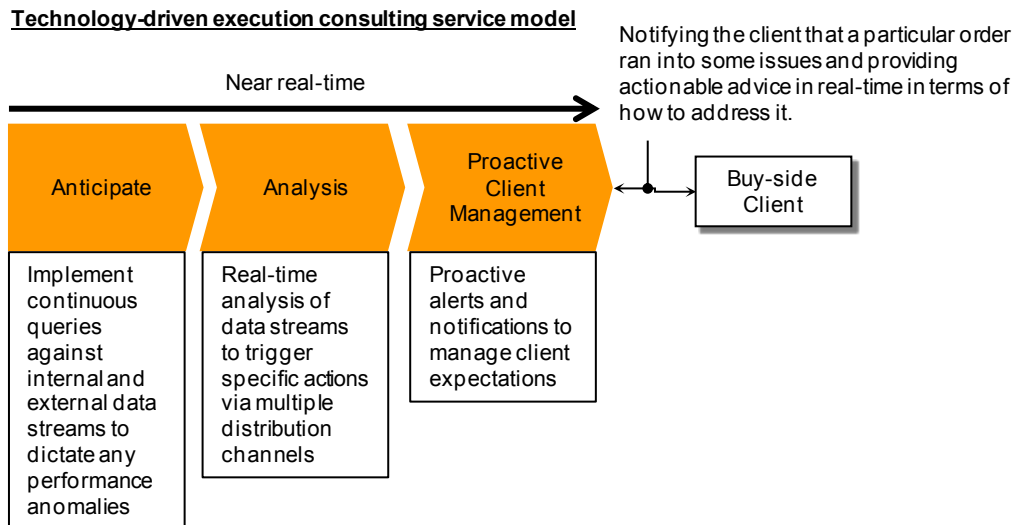


Source: Aite Group survey of 15 broker-dealers during March and April 2012

At its core, execution consulting services are all about anticipating market anomalies and providing real-time analysis of data, which can lead to actionable advice for clients (see Figure

16). This way, brokers can provide a much-needed, value-added service on top of their existing low-touch service. Other key benefits of a technology-centric execution consulting services include the following:

Figure 16: Next Generation Execution Consulting

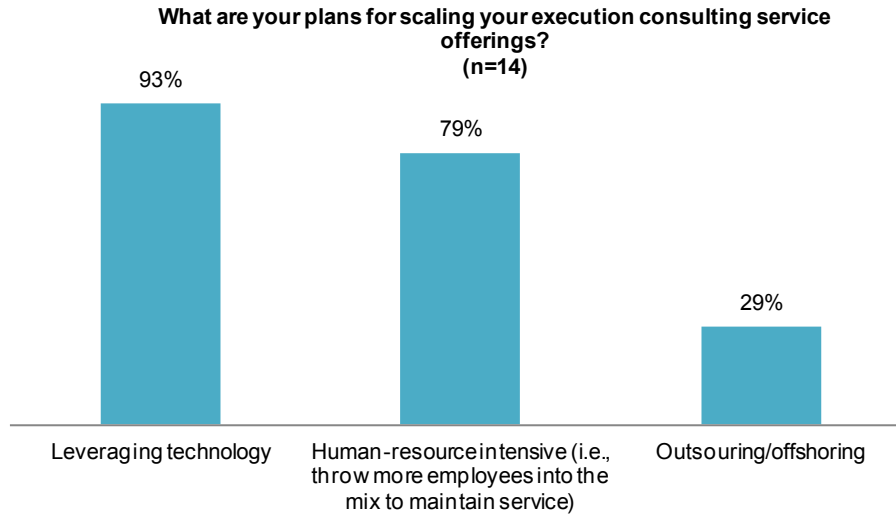


Source: Aite Group

- **Real-time monitoring and advice:** With a low latency, real-time analytics platform at its core, brokers can begin to monitor all vital stats of existing clients and actively alert and notify them when market conditions change or when specific trading strategies need to be tweaked. The same platform can be used to monitor any latency issues related to connectivity or as a surveillance system to ensure that all compliance requirements are being met in real-time. The development of such a platform and all of the necessary connectivity and integration work that would follow can become the solid technology foundation for creation of a truly scalable execution consulting service.
- **Achieving operational efficiency:** As client activity and market monitoring become automated, firms can achieve operational efficiency, reducing potential for trading errors for both themselves and their clients, as well as capture all necessary data for risk analysis and compliance requirements. The drive towards improved operational efficiency can help firms better manage their human resources as well as looking for other new opportunities in other markets and asset classes.
- **Leveraging technology to build relationships:** With real-time analytics in place, execution consulting services can leverage technology to build a much deeper, fully scalable relationship with clients of all sizes. Firms can also utilize the real-time monitoring capabilities to provide timely advice to clients so that they can deal effectively with any unforeseen market events. It is clear, based on the survey responses, that brokers are looking to leverage technology as well as human

resources to help them fully scale their business and create deeper relationships with clients (see Figure 17).

Figure 17: Growing Importance of Leveraging Technology



Source: Aite Group survey of 15 broker-dealers during March and April 2012

- **Technology foundation for global expansion:** The creation of a single execution consulting services technology platform will enable brokers to become more agile, enabling them to port the same service model to other global markets as well as to other asset classes beyond equities that are becoming increasingly electronic in nature. This core technology capability will also help brokers truly support those large clients that have global investment and trading mandates.

CONCLUSION AND RECOMMENDATIONS

Despite sporadic signs of improvement in market conditions, cost pressures will not go away any time soon. The difficulty in finding, training, and retaining appropriate staff for maintaining world class execution consulting services will continue for most brokers. An increasing number of sophisticated buy-side clients are clamoring for more real-time transparency into order handling and decisions, and based on recent regulatory pressures, regulators are expecting the same thing. Under these tough internal and external conditions, brokers must focus on the following areas to maintain their overall competitive positions:

- Continued investment in training and retaining appropriately skilled staff within the execution consulting groups will be vital.
- In order to efficiently scale its overall execution consulting business, brokers need more investment in real-time monitoring and decision-making tools, which will form the core of execution consulting services.
- Next generation execution consulting services will be driven by real-time capture of data and analysis, leading to proactive alerts, notifications, and advice to clients.
- Leveraging execution consulting service capabilities to expand globally and across multiple asset classes, further deepening relationships with clients with little added costs in terms of additional infrastructure.

ABOUT AITE GROUP

Aite Group is an independent research and advisory firm focused on business, technology, and regulatory issues and their impact on the financial services industry. With expertise in banking, payments, securities & investments, and insurance, Aite Group's analysts deliver comprehensive, actionable advice to key market participants in financial services. Headquartered in Boston with a presence in Chicago, New York, San Francisco, London, and Milan, Aite Group works with its clients as a partner, advisor, and catalyst, challenging their basic assumptions and ensuring they remain at the forefront of industry trends.

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