MARKETS

'Upstairs' Trading Draws More Big Investors

Big Players Change Tactics in a Fragmented Market

By BRADLEY HOPE

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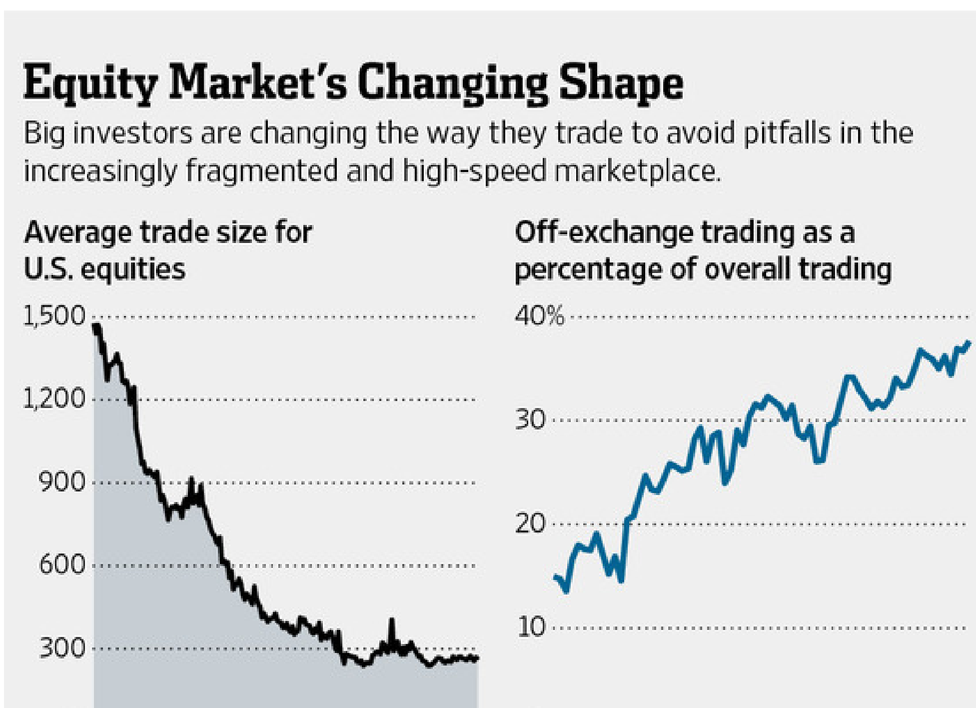
Some of the world's biggest investors are changing the way they trade in U.S. markets in response to what they say are rising risks for institutions of their size.

The strategies include conducting more "upstairs trades," in which deals are executed among big institutions, bypassing the broader market, as well as other sophisticated order-routing techniques designed to avoid pitfalls that have become increasingly apparent to investment managers.

Investors say such measures are increasingly necessary because the proliferation of algorithmic trading and other structural issues, including the fragmentation of the market, are hurting their ability to get the best prices and execute large trades quickly.

A trade has the possibility of wending its way through 13 exchanges and more than 40 "dark pools," off-exchange trading venues that don't publicly display stock trades. A trade could also be executed inside a large broker-dealer that matches buyers and sellers from its own holdings.



Source: Tabb Group The Wall Street Journal

Norway's sovereign-wealth fund, the world's largest at more than $800 billion, is among those executing more upstairs trades. These typically involve institutions negotiating a transaction involving a large chunk of stock through a broker, who may buy the block and resell it or take a fee for conducting the deal.

Mutual-fund giants including Fidelity Investments, Vanguard Group and T. Rowe Price Associates Inc. say they are placing greater restrictions on how their external brokers execute trades, given the challenge of getting the best obtainable price for as large a chunk of a big order as possible. A heightened risk of information leaking about orders is an additional concern.

Andrew Brooks, head of U.S. equity trading at T. Rowe Price, with $647.2 billion of assets under management, described the markets as increasingly "dysfunctional."

To some extent, the concerns aren't new. Institutional investors long have complained that market complexity can make trading more difficult and that high-frequency traders were driving up prices by jumping microseconds ahead of big orders.

But big investors say the cat-and-mouse games are growing more elaborate—and counterproductive—by the day.

Proponents of high-frequency trading say that such firms provide much-needed liquidity at a time when trading volumes are diminished. Many participants believe competition between trading venues has reduced costs for most investors.

Still, the Investment Company Institute, a trade organization for mutual funds and other big investors, has hosted a series of conference calls in recent months to discuss market-structure issues with its members.

Regulators also are paying closer attention: The Securities and Exchange Commission launched a website in October to publish data about its research into the consequences of market fragmentation and high-frequency trading. On Oct. 1, the U.S. Financial Industry Regulatory Authority, Wall Street's self-funded watchdog, proposed a rule to increase oversight of dark pools.

A few years ago, dark pools were considered a partial solution to some of these problems. The pools allow institutions to anonymously deal in blocks of shares and avoid some of the problems caused by high-frequency traders in the exchanges.

However, although dark pools still offer a limited degree of anonymity, they aren't drawing as many big trades, making them less appealing as a way for investors seeking to buy or sell large chunks of stock undetected by other market players. Now, many market participants both in dark pools and on exchanges use trading algorithms that break up orders into numerous tiny pieces.

That process often extends the time needed to execute the total trade, making it riskier, given the possibility that prices could change. That was one motivation for Norway to pursue more upstairs trades.

Oyvind Schanke, global head of equity trading at Norway's Norges Bank Investment Management, said the country's sovereign fund, the Government Pension Fund Global, now does about a quarter of its U.S. stock trading in the upstairs market, compared with 10% five years ago. The bank does 50% of its trading directly in the stock market through trading algorithms, compared with 65% in 2008, he said.

The fund owned $108 billion of U.S. equities as of Dec. 31, according to data provided by Norges Bank, the fund's manager.

"We've found that this strategy has become cheaper for us," Mr. Schanke said in an interview. "If we sent our orders into the market, we would have to wait days or weeks for our brokers to execute the trade. Even then, there are risks of information leakage."

Overall, off-exchange trading is near an all-time high, comprising 37.3% of all trading in October 2013 compared with 26% in January of 2008, according to Tabb Group.

Investors also fear the rise in off-exchange trading because it can give brokers incentives that negatively affect an institution's overall performance. Instead of trying to sell the biggest possible chunk of stock at the best price available, a broker could route an order to venues that offered the highest rebate for trading, or the lowest fees. The result can be higher overall costs for an institution, said Richard Steiner, global equities liaison to regulatory and government affairs at RBC Capital Markets.

"Institutional investors are concerned that they could experience worse trade performance as a result of brokers routing to reduce their trading costs instead of maximizing the amount of shares accessed," he said.

To avoid such risks, big mutual-fund firms are holding their brokers accountable and, in some cases, building up their own research teams to keep up with the whirlwind of data produced by trading activity.

Fidelity has increased its staff of quantitative equity analysts to four from two. They pore over data to analyze the fund's cost of execution, how well algorithms are performing and which dark pools are prone to leakage of information.

"In this marketplace, you have to measure everything," said Robert Minicus, head of global equity trading at Fidelity, which has $1.9 trillion of assets under management.

One consequence of the analysis is that Fidelity has stopped trading in some venues and now only uses "a fraction" of available dark pools, Mr. Minicus said.

Vanguard Group is also more aggressively measuring the conditions of trading venues, including how much prices move before trades.

"We have to analyze each venue and tell our broker we don't want orders to go to some of them if we detect higher levels of toxicity," said Michael Buek, head of the equity index team at Vanguard Group, which has $2.4 trillion of assets under management.

The intricacy of the equity markets creates unnecessary steps for large investors and distracts portfolio managers from what should be their main focus of increasing returns, said Mr. Brooks of T. Rowe Price.

"It's like trying to fill up your gas tank, but you have to go to 15 gas stations," Mr. Brooks said. "By the time you get to the 15th one, they've increased the price because they've heard you were coming. Wouldn't someone rather go to two or three stations and fill up the tank in blocks?"

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