Global Equities

European Equity Trading 2012/13:
Changing the Rules of Engagement

Rebecca Healey | V10:044 | November 2012 | www.tabbgroup.com

Vision

The buy side now requires greater knowledge, ownership, and control over its order flow than ever before. The continuing fallout from investment banks' bets and risky trading behaviour highlights an increasingly risk-averse investment and execution process. As alpha opportunities continue to shrink and turnover in funds slow, the ability to monetize any available alpha to the end investor is essential. Recent trading losses have highlighted the need to develop streamlined businesses that reduce costs, control risk and deliver performance to their underlying investors over the longer term.

Frugal control of valuable commission dollars will ensure lean and competitive asset managers will no longer automatically turn to international bulge bracket brokers for all investment services, but will cherry pick a variety of local specialist and niche product providers to suit their requirements on an ad-hoc basis.

Portfolio managers will have direct real-time data on impact costs, negative selection and volume forecasts, incorporating blogs and social media to analyse risk in the investment process at portfolio level. The ability to provide instantaneous compliance and risk analysis reports that will meet fiduciary responsibilities, facilitate accurate and efficient decisions, and act as a marketing tool to win new mandates.

This ability to manage risk efficiently will be extended to the execution process with traders overseeing internal intelligent algorithms to read news, analyse risk and tweak portfolio strategies on the fly; switching between connected pools of liquidity that offer sufficient economies of scale to lower explicit and implicit transaction costs. Automation no longer equals speed but efficiency, reliability and cost control.

Consequently brokers will dilute their range of products to provide essential services for a chosen few and mainstream basics for the majority, leading the financial services industry towards a more sustainable, efficient, competitve and profitable future. The level of change on market structure from European regulation is unprecendented and still evolving.

Having already resolved considerable challenges as a result of the recent economic crisis, market participants continue to rise to the occasion. A European marketplace with the ability to trade single stocks in multiple locations in harmonized settlement has already been achieved. Two venues now offer full interoperability and as a result now trade more than some national exchanges in their home countries. Exchanges, vendors and venues are working together to create a new industry-wide solution for the consolidated tape. Rather than waiting for the regulators to dictate, industry participants are working to rebuild equity trading from the inside.

Brokers are accepting unpalatatable truths and stepping away from businesses that are no longer profitable and instead are turning to their core strengths to survive. Years of decline and continued economic pain has forced difficult decisions to be made and harsh action to be taken. This unprecendented level of change also extends to research. As commission sharing agreements (CSAs) are onboarded throughout the industry increased specialised research can be created on both a regional or sector level. Research provision is also no longer constrained to single stock fundamental research with new requirements for data to faciliate the execution process.

Change is never welcomed by all. The loss of the valued sales trader is keenly felt by many, long standing relationships steeped in trust and cannot easily be replaced by machines. Quality coverage with focus and vision is essential if the sell side is to retain core relationships. Trust in individuals will now need to be replicated in technology; no mean feat in today's environment of heightened concern.

However, investment in new technology is set to continue and will be the industry prerequisite, not just for a chosen few, changing the rules of engagement for all. Those who accept this change and their new role within this vastly different new environment have the greatest chance of survival.

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Top Ten Findings

1. The relative value of being a core broker is now critical. The number of core brokers is still nine, but the commission pool has collapsed 29% in 2012.

2. Liquidity issues remain the number one priority for the buy side, with over three quarters concerned about the impact of further regulation on order flows.

3. Sixty-two percent of respondents now see electronic execution as the most important service provided by their core brokers in the hunt for liquidity.

4. Forty-five percent of participants have reduced the percentage of order flow routed to sales trading and 66% of these traders are switching into algorithms.

5. Fifty-nine percent of participants now trade more than 10% of their flow in the dark; however, 12% have seen a decline in execution quality with a further third citing quality as venue dependent.

6. Fifty-six percent of participants plan to increase CSA activity in 2013, with a further 20% awaiting the results of regulation.

7. Forty-two percent now use CSAs to pay for independent research bills in particular highlighting the shift from bulge bracket to niche specialist research.

8. Perceived lack of investment by bulge bracket firms in their algorithms is highlighted with 29% seeing no new developments this year. Ten percent of participants say they will increase their development and use of internal algorithms in 2013.

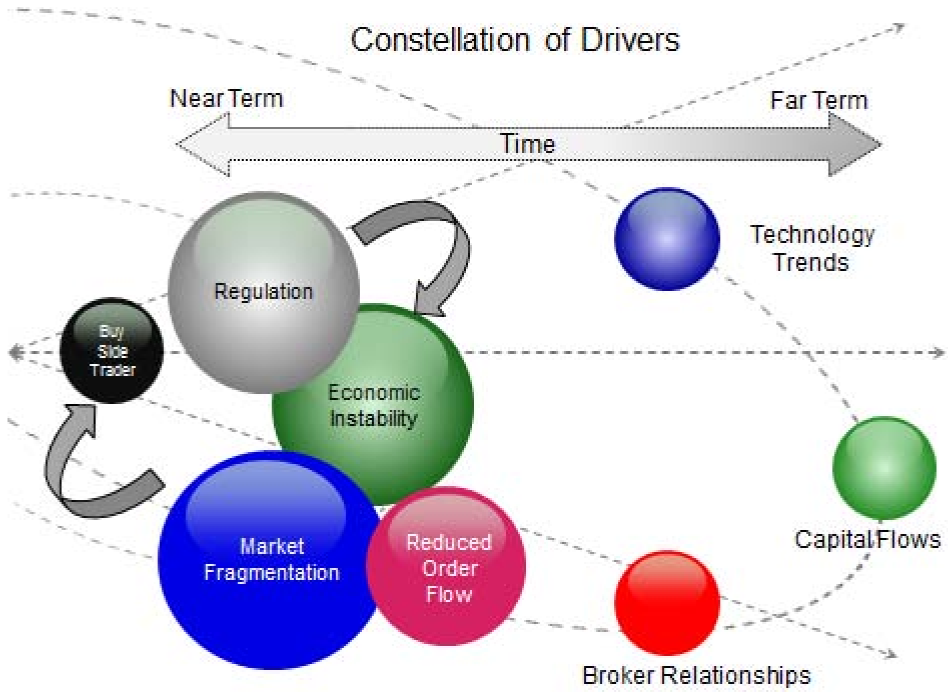
9. To compensate for the new execution methods required, 77% of the buy side accepts the need for the sell side to outsource commoditized services where it is cost-effective to do so.

10. The response to new coverage models proposed by brokers remains muted — with 59% in favour of algorithmic flow remaining separate.

Highlights

Access to research, execution and payment models are undergoing radical innovative change, leading the vanguard for a new era of equity trading. A combination of a deepening economic crisis, increasing regulation, collapsing volumes and commission wallets is escalating the need for immediate action on outdated business models. The status quo can no longer be maintained (see Exhibit 1).

Exhibit 1
Drivers for Change in European Equities



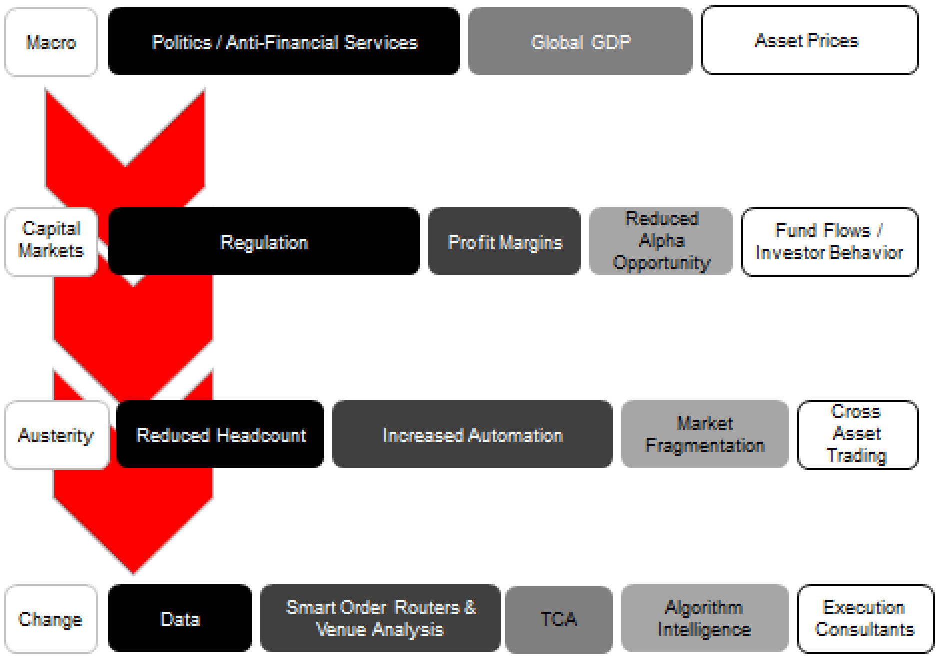
Source: TABB Group

"It's now about sticking to your strengths, be where you need to be. Not every firm can hit you in every region and they should stick to where they add value." (Large US Asset Manager)

Both the buy side and sell side must act swiftly. Buy-side traders are taking on a greater analysis of the services they use, where and whether it adds value. Sell-side brokerage desks are becoming leaner and struggling to work out viable economic models for their products and services and how to segment their clients.

From macro to micro, the changes being forced on capital markets structure together with underlying austerity measures are driving industry participants to greater automation. This level of change is set to fundamentally alter how equity market participants access products and services and from whom (see Exhibit 2).

Exhibit 2
Impact of Change on European Equity Market Structure

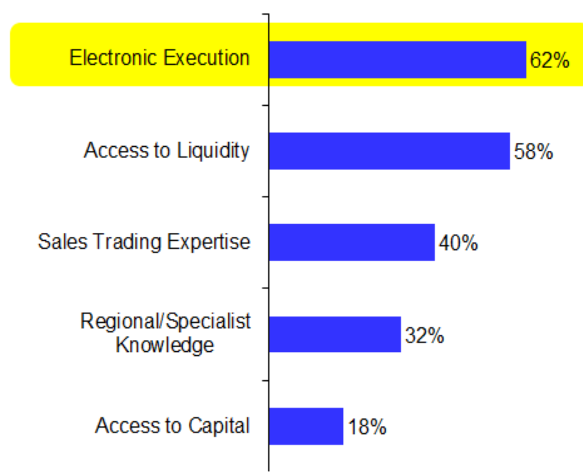


Source: TABB Group

"Net net we have moved away from the bulge bracket in favour of the specialist boutique research, but where the research broker list has increased, our execution broker list has decreased." (Large UK Asset Manager)

The rulebook for European equity trading is being rewritten. Electronic execution is rising to the forefront of change, facilitated by changing adoption rates and regulation of CSAs across Europe (see Exhibit 3). Bulge bracket brokers are leveraging their ability to execute across all asset classes on a global scale independent of exchanges, offering the buy side greater liquidity choices and the flexibility through CSAs to pay other brokers for their services.

Exhibit 3
What Do You Value Most From Your Broker?

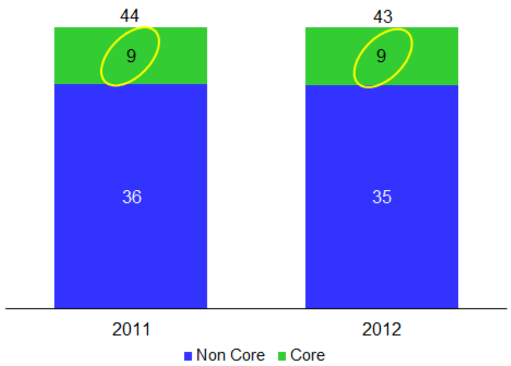


Source: TABB Group

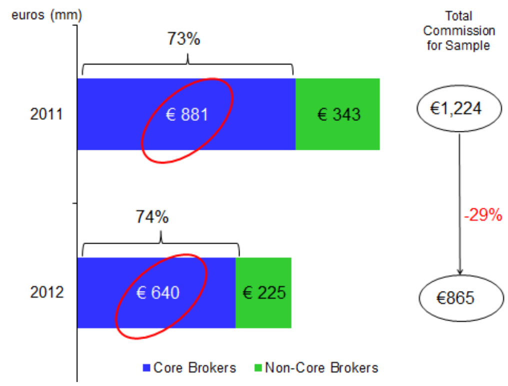
Research is being decoupled from execution as the search for alpha means portfolio managers (PMs) are turning to specialty research and maximizing CSAs to pay for it. There is a growing change in what the buy side constitutes as "research". No longer solely relying on fundamental single stock research, the demand for new services such as real-time and historic market data is expanding as the level of sophistication among buy-side execution strategies rises.

Exhibits 4 and 5

Average Number of Core and Non-Core Brokers, 2011 vs. 2012



Commission Value of Core and Non-Core Brokers, 2011 vs. 2012



Source: TABB Group

For all market participants, survival means staying relevant. Compared with 2011, the average number of brokers and of these, the number of core brokers, is unchanged in 2012 (see Exhibit 4). Yet the commission wallet of our sample set has plummeted 29%, raising the stakes, but reducing the amount available to the core brokers and leaving commission scraps for the 35 non-core brokers (see Exhibit 5).

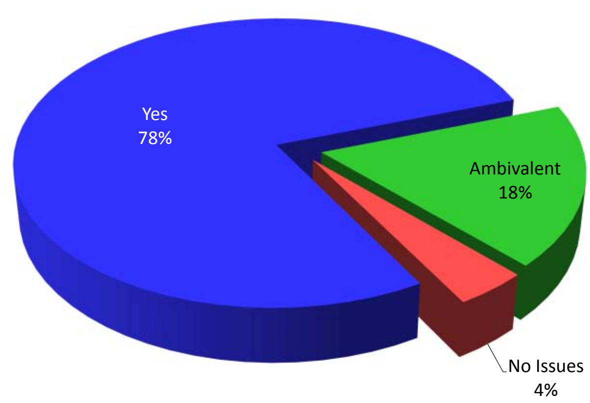
The economics no longer stack up as reduced volumes play havoc with the traditional order flow as a research payment method. Yet brokerage services still need to be paid for and the reduced commission wallet has to be leveraged carefully to wring out every possible service.

"Our core now gets 90% of our flow and the top five get 60% of the 90% — they now have to be in the top five to count." (Large US Asset Manager)

In order to survive brokers need to create two distinct lifelines. First, by focusing on increasing their dominance of the remaining market share so that they become the major liquidity centres or the "axe" in certain stocks. Second, by delivering new specialist services to facilitate execution, such as increasingly intelligent algorithms, putting an execution focus on certain sectors or regions or creating block trading products.

The onslaught of European regulation will continue to force hard choices regarding services and commissions. Over three quarters of participants are already concerned over the growing impact of regulation on order flows and execution (see Exhibit 6).

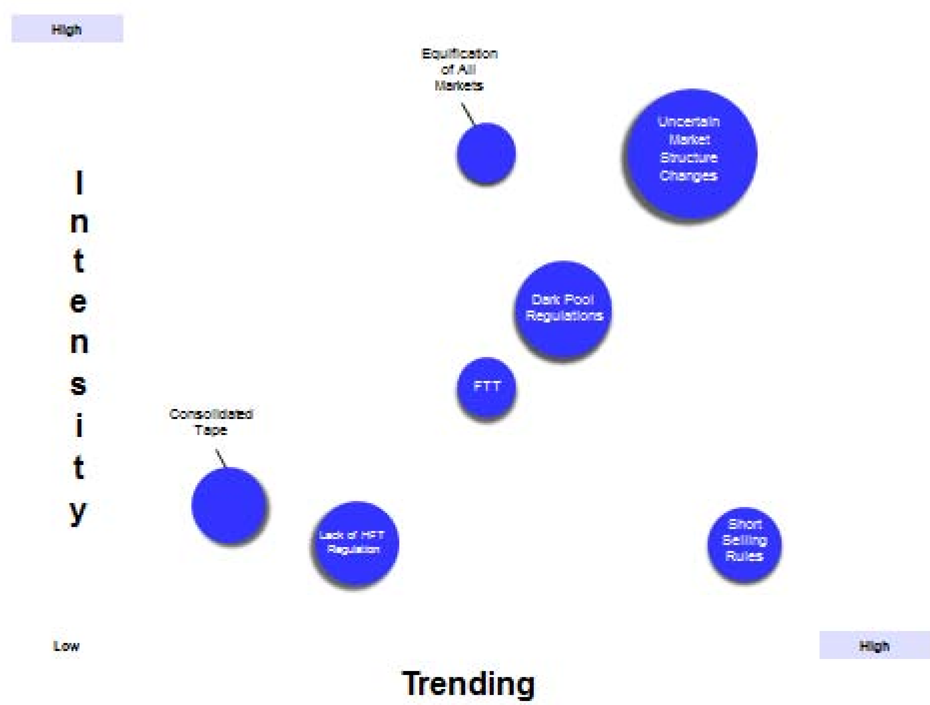
Exhibit 6
Do You Have Concerns Over Current Regulation?



Source: TABB Group

Traders no longer only have to concern themselves with just MiFID II or even Basel III, but also short selling bans, financial transaction taxes, and increased dark pool regulation (see Exhibit 7). The speed and apparent arbitrary nature of trading regulations leave many participants concerned over the future of European equity trading.

Exhibit 7
What is Your Greatest Regulatory Concern?



Source: TABB Group

Liquidity: Catch 22

"Research is now secondary, if they don't have the flow you can have the best sales trader in the world, but without the other side of our trade; we can't trade with them."
(Large sized European Asset Manager) Europe)

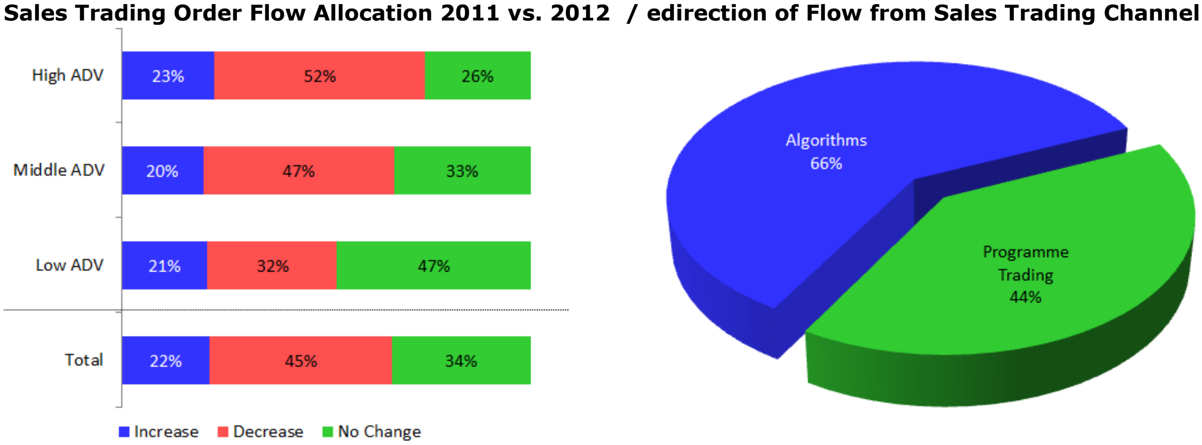
The growing disconnect between order origination and execution means brokers are in danger of being maneuvered out of the game.

Either they will need to provide high-quality sales trading and block trading, or the buy side will continue its exodus towards algorithms and the use of broker pipes for direct market access to find the necessary liquidity. Forty-five percent of participants this year have seen a decrease in their use of sales trading channels (see Exhibit 8) with two-thirds of these participants switching to algorithms as a means to access liquidity (see Exhibit 9).

The fall in fund turnover and volumes mean the research provider may either not have the 'natural' other side of the trade, or has inadequate trading technology to deliver best execution in current market conditions. Then the buy-side traders' dilemma begins.

Without the experienced sales trader to facilitate the process on their traders' behalf, there is only one route available. It is a Catch 22 scenario. The buy side may want to trade more blocks using a sales trader; however, with fewer blocks being created, there is less ability to find natural blocks. Increased automation means that the sales trader no longer sees the flow — so where is the benefit in paying 15bps for a service that no longer exists? In the vacuum that remains, algorithms and smart order routers are now perceived, if somewhat reluctantly, to offer the most viable opportunity to find that diminishing liquidity.

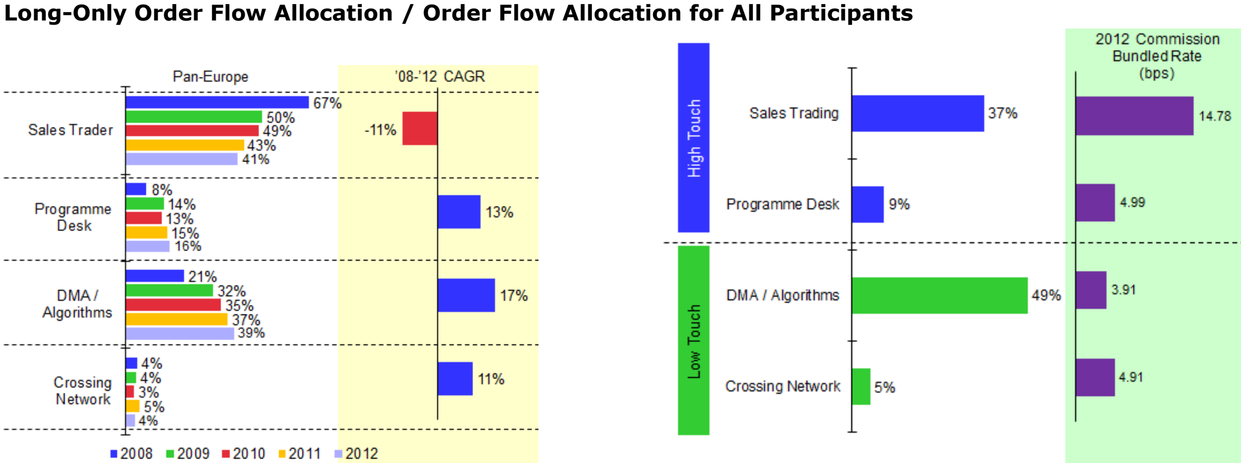
Exhibits 8 and 9
Sales Trading Order Flow Allocation 2011 vs. 2012 / edirection of Flow from Sales Trading Channel



Source: TABB Group

Although their US counterparts have been switching away from algorithms to higher commission payment methods to pay broker bills, in Europe the year on year participants have continued to switch to automation. Forty-three percent of year-on-year participants' order flow now trade algorithmically or via crossing networks, i.e., the lower-cost channels (see Exhibit 10). The inclusion of hedge fund flow increases the proportion routed via low touch methods to over 50% for the first time in Europe (see Exhibit 11).

Exhibits 10 and 11
Long-Only Order Flow Allocation / Order Flow Allocation for All Participants



Source: TABB Group

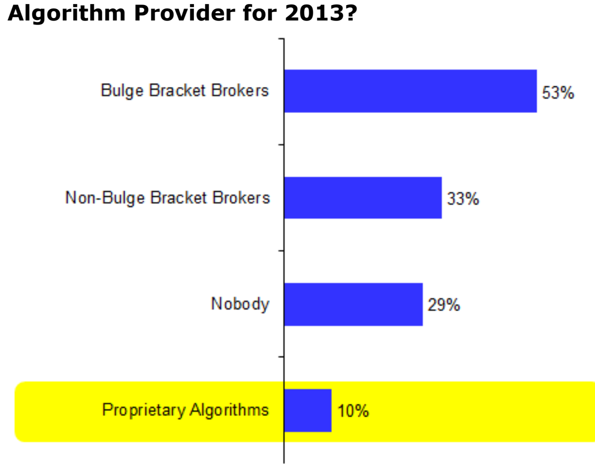
Algorithms: The Bitter Truth

"The days of mediocre performance and we need to pay you — we just don't do that anymore." (Large Global Hedge Fund, Europe)

Innovation momentum must be maintained in the algorithmic space. New requirements will have to focus on technological developments such as algorithmic intelligence, predictive selection and venue analysis in order for brokers to maintain their relevance to the buy-side community.

There is a growing disquiet amongst the buy side regarding the perceived lack of investment by brokers in the algorithmic offerings, with nearly 30% of participants unable to name any broker as offering an enhanced algorithmic service this year (see Exhibit 12).

Exhibit 12
Who Do You See As Your Up and Coming Algorithm Provider for 2013?



Source: TABB Group

As a result, some are turning inward. Internal algorithms can offer improved performance over anything a broker is able to offer, not necessarily due to the underlying technology, but rather for the proprietary "special sauce". With 10% of participants highlighting internal algorithms as a growth area for 2013, TABB Group expect this to increase particularly with the advancement of new broker products which facilitate the buy-side's ability to build proprietary algorithms. The buy side complains that the brokerage community is focusing its efforts on internalizing flow in an effort to cut costs, rather than developing innovative algorithms. Although the benefits to interacting with these pools of liquidity remain, increasing liquidity above improving algorithms may prove detrimental.

> "We get just as good executions trading Algos as we did when we were trading with the sales trading desk." (Small UK based Fundamental Hedge Fund)

If the buy side chooses to use brokers for direct access instead of for algorithms, commissions will come under pressure. This will accentuate the difficulties the buy side currently faces in paying brokers for full service.

With access to high-touch order flow increasingly restricted, buy-side traders are adopting more sophisticated trading tools and technology to find liquidity. The increased use of artificial intelligence and predictive analysis to select the right algorithm and the right venue will continue to evolve. Technological advancements not only in algorithms, but also in auxillary services such as data provision and risk analytics are key ways brokers can create differentiation.

Brokers that are banking on their algorithmic offering to pull them through into the next era of European equity trading will need to continue to innovate or find new methods of leveraging existing technology and be able to demonstate this to their clients.

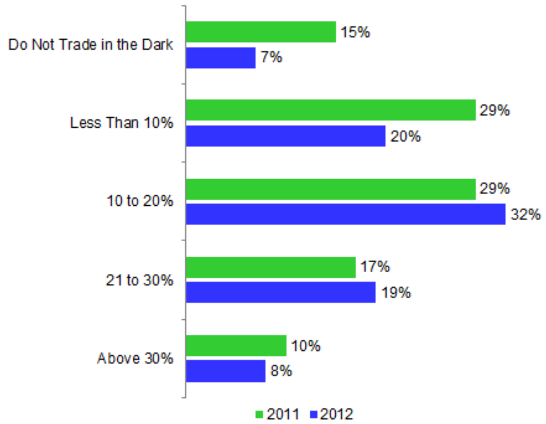
> "We are doing much more in the dark in these markets. We get better execution results by picking our levels and aggressively finding liquidity, rather than stepping up and trading in size." (UK based Large Asset Manager)

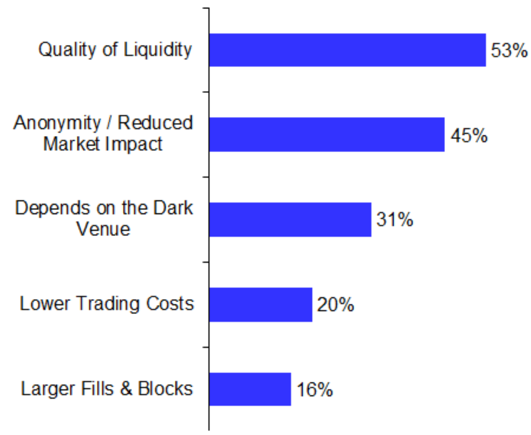
Seeing Through the Dark

Proposed regulatory amendments governing proprietary flow, dark pools, systematic internalisers (SIs) and Multilateral Trading Facilities (MTFs) will change liquidity formation across the lit and dark marketplace. Today's individual pools of dark liquidity will be artificially divided into multiple different pools, increasing market fragmentation, as it will be impossible for the broker to provide one pool of liquidity to suit all clients requirements. With diminishing volume in multiple pools, they need help to trade smarter in the dark. Declining volumes leave market participants trapped between the desire for greater transparency and the requirement to deliver best execution for clients.

The current liquidity dearth has already seen an increase in the number of participants who now trade more than 10% of their flow in the dark, with quality of liquidity and avoiding market impact remaining the top reasons why (see Exhibit 13). However, it is now no longer in any dark venue. As participants become more discerning with experience, one third now sees the value as sporadic and venue dependent (see Exhibit 14).

Exhibits 13 and 14
Dark Trading Order Flow Volumes, 2011 vs 2012 / What Value Is There for You to Trade in the Dark?

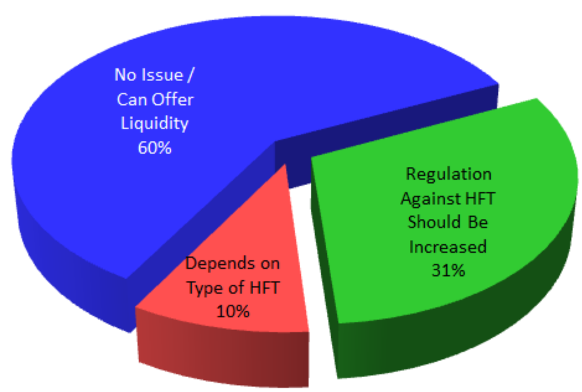




Source: TABB Group

Dark trading has remained a high priority for the buy side due to the level of counterparty protection the Broker Crossing Systems (BCSs) offer. Thirty-five percent of participants have concerns regarding the closure of BCSs, yet only 31% want greater regulation of high frequency trading (HFT) (see Exhibit 15). The lack of liquidity is such that many do not wish to lose the only liquidity they perceive exists.

Exhibit 15
What Is Your Opinion of High Frequency Trading in 2012?



Source: TABB Group

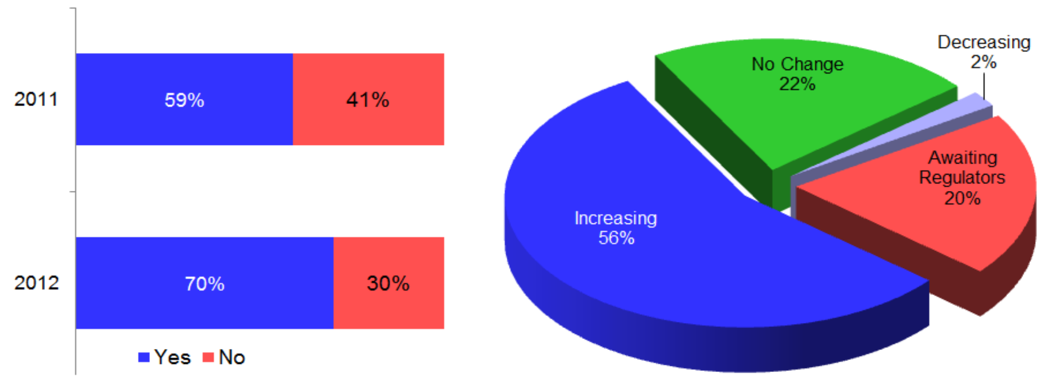
"Net net we have moved away from the bulge bracket in favour of the specialist boutique research, but where the research broker list has increased, our execution broker list has decreased." (Large UK Asset Manager)

Broker technology will require enhancement to reduce market impact costs by systematically and intelligently balancing the potential risks of adverse selection and gaming. The scrutiny of execution quality across mulitple venues is set to expand further. As the risk of incurring market impact increases, execution certainty or probability of fill rates will become as influential in execution decisions as best available price.

As the CSA Dam Breaks

Economic conditions have impacted research departments as well as trading desks and portfolio managers are increasingly turning to specialist research providers for bespoke ideas. As the payment for research becomes decoupled from execution, true unbundling is finally becoming a reality.

Exhibits 16 and 17
Do You Currently Use CSAs (2010 vs 2012)/How Is Your Usage of CSAs Changing in 2012?

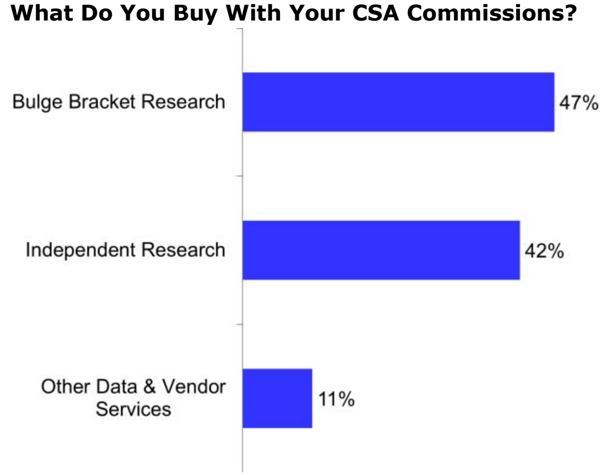


Source: TABB Group

> "We continue to unbundle. CSAs make it a lot clearer. We need to know what we are actually getting from each broker, whether we need it, and if so then we will pay accordingly." (Large European Asset Manager)

This divorce is being facilitated by the increase use in CSAs with three quarters of participants potentially increasing their CSA usage (see Exhibits 15 and 16). In addition, there is now a growing regulatory interest for CSAs to be used as a method of payment for advisory and execution services. Currently a further 20% of participants are anxiously awaiting the outcome of decisions currently under discussion. Early indications show that the Swedish Financial, Supervisory Authority Finansinspektionen, will allow CSAs to be used under certain parameters. Once CSAs become available to a wider audience of market participants, the chasm between advisory and execution services will widen further.

Exhibit 18
What Do You Buy With Your CSA Commissions?



Source: TABB Group

CSA usage is also driving change in execution models. An expanding research broker list is occurring at the exact time as counterparty risk is coming under increasing scrutiny. The research idea may come from a firm not even on the executing broker list. This has combined with a sharp increase in those using CSAs to pay for specialist research (see Exhibit 18).

This new method of research access will work well for both the large global behemoths that are able to provide a holistic overview of services and efficencies of scale as well as smaller firms that wish to specialise. Europe's unique geographical variance mean that buy-side traders still value speaking to local market participants that offer greater colour and analysis than single desk based coverage. In a similar situation to the European Emerging Markets desks, added value can be found in local coverage and the real story behind the headlines which are often in a foreign language.

"The reality is on second and third tier Scandinavian names. If you don't have the ability to go direct, it can now get very messy." (US Hedge Fund)

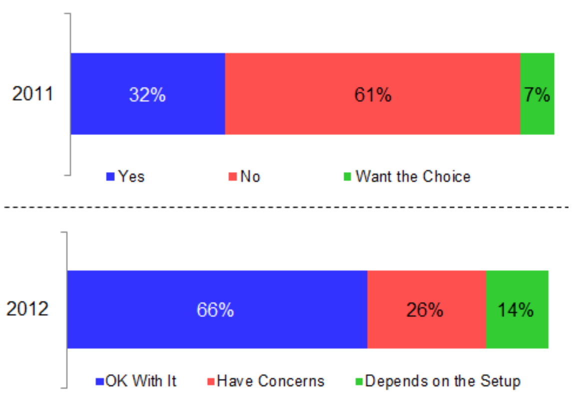
All brokers will now need to establish a method to monetize their research capabilities and demonstrate this to all clients across the board — something which has not been easily achievable in the past.

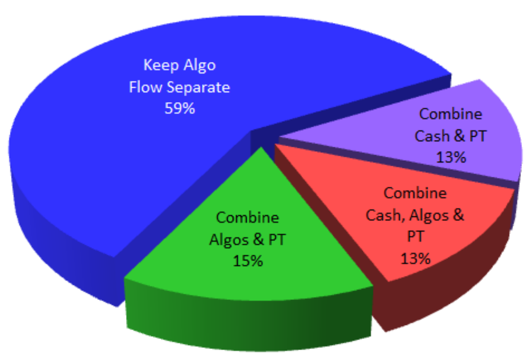
New Roles for Market Participants

Now is the time for hard choices between which brokers, products and services are required; as well as which clients the sell side wants to retain. As the regulatory wagons roll on, all the players engaged are restructuring their businesses and their roles within them.

Exhibits 19 and 20

Are You in Favour of Integrated Coverage Models/ What Can Be Integrated and What Can Not?





Source: TABB Group

The buy side understands the economics dictating new broker coverage models and the acceptance rate of integrated coverage models has doubled since last year (see Exhibit 19). However, it is the form in which that integration takes that will make the difference as nearly 60% want algorithmic flow kept separate (see Exhibit 20). The main challenge perceived is that anonymity will be compromised diluting the benefits of trading low touch. The buy side is also

"There's a different skill set that you need to understand the electronics business. And until the sales traders really get that, it's kind of tough." (Large European Asset Manager)

concerned regarding the impact on sales trading. Both services have unique skill sets that do not easily blend into one individual. New coverage models do need to be established, but should not be a merger into mediocrity. Brokers will need to tailor their services into a larger range of specialized options for a smaller selected client base.

Buy-side participants looking for a high-touch service via algorithms require a partnership with their broker to customize and solidify the relationship for the longer term. Services will include add-on risk capital and block trading with an algorithmic plus commission model, topping up a CSA pot to contribute to research payments.

Others will require low touch "DIY" algoritms based on a direct market access (DMA) cost-plus model — where the buy side will share its flow, but use the brokers as the pipeline to liquidity. There they will require access to liquidity pools and new markets, but could also look to their brokers for additional services such as outsourcing quants or independent risk controls before their orders hit the exchange.

The new economic reality is such that few can cover all products and all regions successfully. Therefore, recognizing individual strengths and focusing on these will allow differentiation to emerge and value to be delivered.

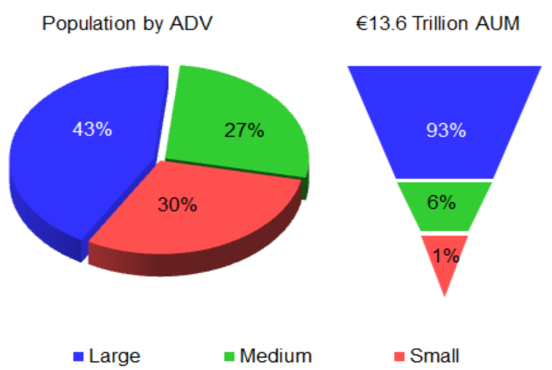
Methodology

This year we conducted interviews with 60 head traders of equity desks throughout the month of August and September 2012. These firms comprise forty long-only asset management firms and twenty hedge funds, managing €13.6 trillion in assets under management (AUM) worldwide (see Exhibit 21). As with prior years, we segment our participants according to size of AUM.

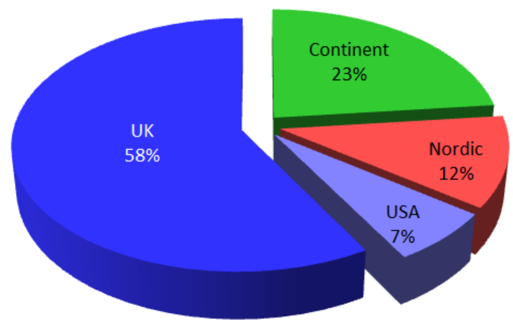
Firm Type	***Large***	***Medium***	***Small***
Asset Managers	>€50 BN	€10-50 BN	<€10 BN
Hedge Funds	>€2.35BN	€380 MLN-2.35 BN	<€380 MLN

Exhibits 21 and 22

Participants Segmented by Assets Under Management



Segmented by Location

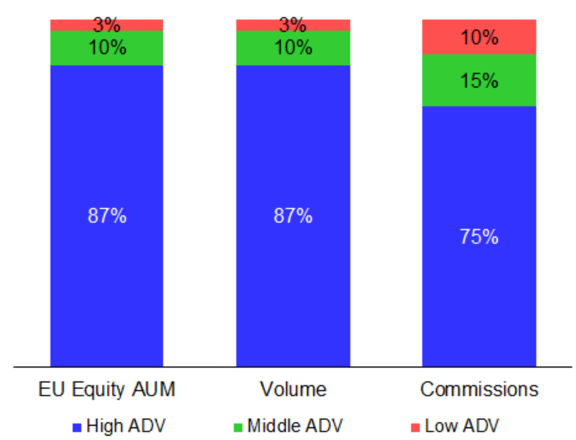


Source: TABB Group

Our participants are primarily located within Europe, but we also include firms located in the United States that trade the European markets directly (see Exhibit 22). This year's report contains responses from 68% of the same firms who participated in 2011. We also segment our participants by size, based on the average daily volume (ADV) to reflect the influence of their flow in the current environment (see Exhibit 23).

Exhibit 23

Participants Segmented by Average Daily Volume



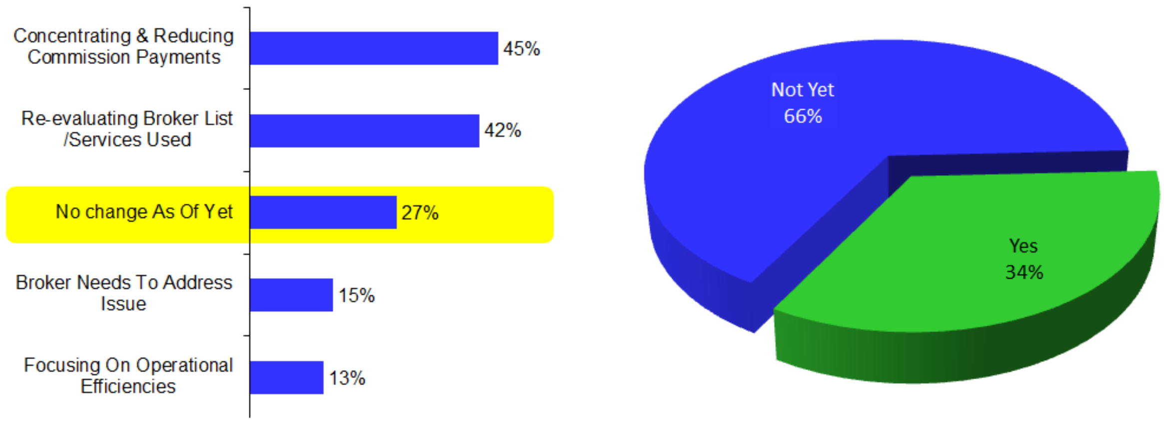
Source: TABB Group

Rising from the Ashes

All market participants need to be prepared to achieve more with less. With no increase in volumes in the immediate future, brokers will need to generate revenues more effectively with reduced headcount and limited resources.

Exhibits 24 and 25

What Impact Are Falling Volumes Having On Your Broker Relationships? / Have You Reduced Your Overall Number of Brokers?

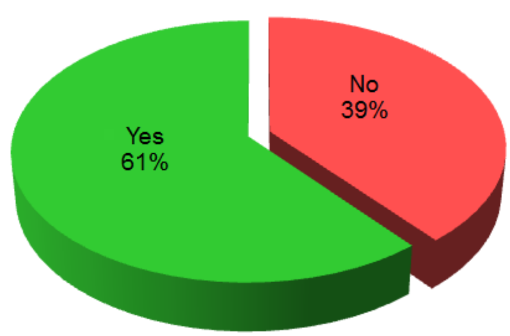


Source: TABB Group

On the buy side, from investor appetite to portfolio managers' decisions, client requirements are also undergoing a metamorphisis with funds not only cutting broker lists, but streamlining internal processes, switching trading strategies consolidating desks and implementing cross-asset electronic execution (see Exhibit 24). The challenge is that two-thirds of buy-side participants have yet to cut their broker lists (see Exhibits 25).

Exhibit 26

Will Any Top 10 European Brokers Make Top Five Next Year?



Source: TABB Group

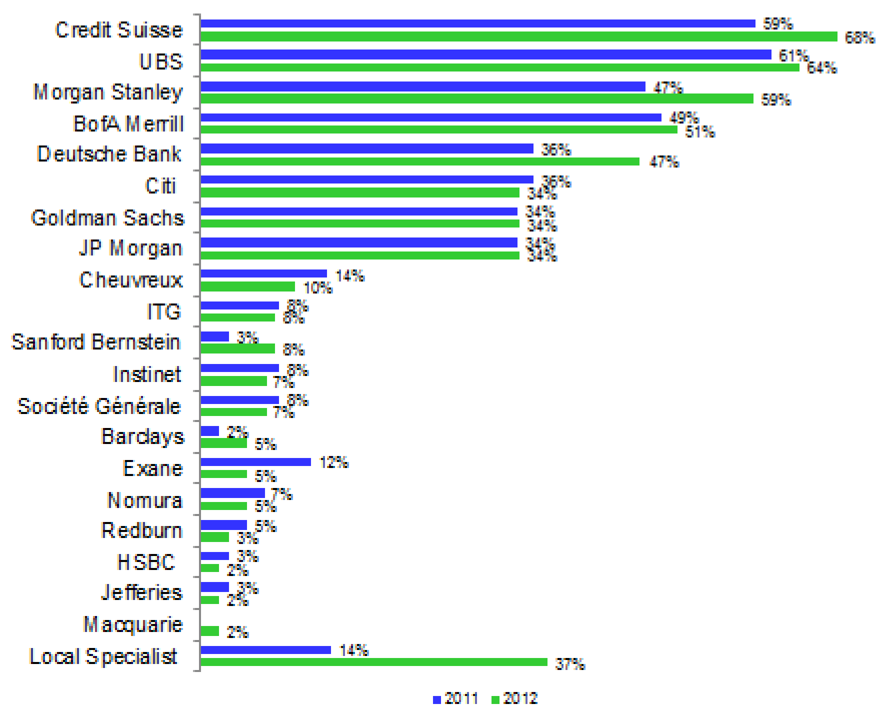
Winners in 2012: Winners in 2013?

As a result of changes underway, over half of the buy-side participants see movement into their top five brokers this year (see Exhibit 26). In response, bold moves are already being made by the sell side with Nomura, Deutsche Bank, Credit Suisse and UBS recently announcing major changes to their structure, all of which will dramatically impact the European landscape in 2013.

"There's still a lot of consumption of advisory from bulge brackets, but it is more from a sales than a research point of view." (UK based Large Asset Manager)

Eight investment banks dominate the broker list in 2012, with the top five increasing their proportion of commissions from 2011 (see Exhibit 27). Credit Suisse is once more top pan–European broker; however, there is little between the top five relative to the rest of the pack, which include UBS, Morgan Stanley, BofA Merrill Lynch and Deutsche Bank. Credit Suisse and UBS excel on all fronts especially block and risk price provision as well as reliable and consistent service. There was unaminous approval of the holistic product offering, front to back, high touch to low touch. Morgan Stanley was highlighted for its innovation, liquidity and market structure support that clients valued during the current turmoil. BofA Merrill Lynch was once more noted for its innovation in the small and mid cap space as well as the improvements made this year to the algorithmic offering. Deutsche Bank was praised not only for its liquidity offering, but also for its brave move towards single desk coverage, despite initial general market resistance to the proposal. Citi and Goldman Sachs were also highlighted for breadth of liquidity as well as leveraging an overall relationship firm wide.

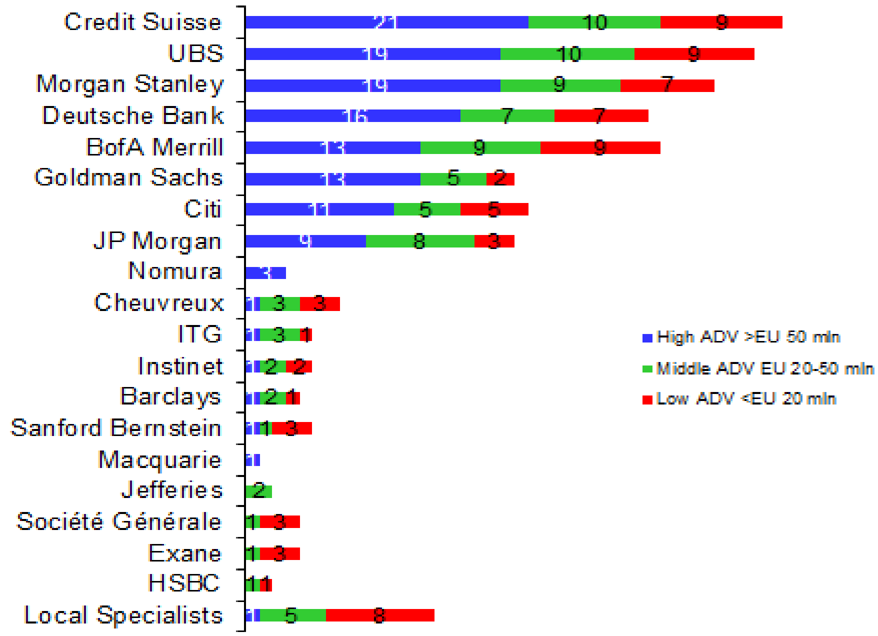
Exhibit 27
Top Five Brokers, 2012 vs 2011



Source: TABB Group

When ranking the top five brokers by average daily volumes (ADV), the dominance of the first five becomes further evident. The buy-side firms with high ADV feature heavily amongst the top five brokers with Credit Suisse leading the pack (see Exhibit 28).

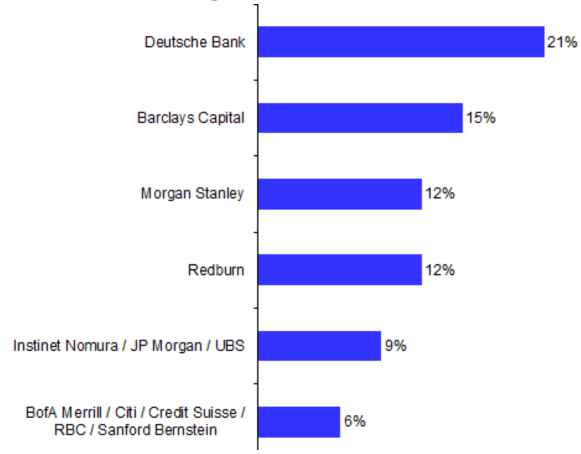
Exhibit 28
Top Five Brokers, Ranked by High, Middle and Low ADV



Source: TABB Group

Although comments were made regarding the dilution of overall service especially in relation to strained sales trading resources, others quoted the top five as delivering consistently strong trading and coverage relationships. However, because declining volumes and commissions will continue, the status quo is no longer viable in the economic climate; and as bulge brackets restrict their activity in certain business areas, a vacuum is opening that new challengers look set to fill. Deutsche Bank is still pushing up the charts,

Exhibit 29
The New Challengers for 2013



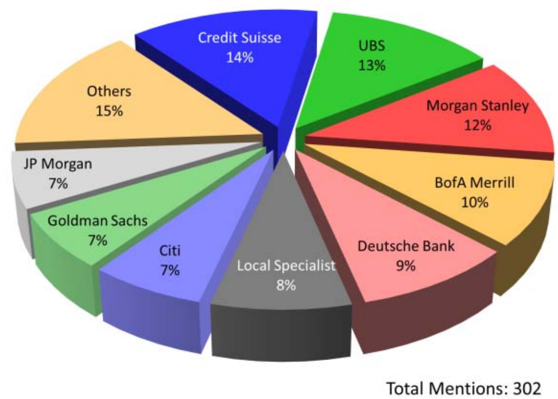
Source: TABB Group

building on its position from last year — with Barclays and Morgan Stanley close behind. The competitive landscape is changing, illustrated by the ability of Redburn, the antithesis of a bulge bracket broker, to compete amongst the global research providers (see Exhibit 29).

"There's still a lot of consumption of advisory from bulge brackets, but it is more from a sales than a research point of view." (UK based Large Asset Manager)

Firms such as Redburn, Jefferies, and Sanford Bernstein were mentioned alongside new names such as Autonomous, AV8 and Monument, for bespoke, high-service level relationships that stand out from the standard research offering currently. Local brokers were also highlighted especially in the Nordic region as well as new entrants such as Fidentiis, combining to come sixth in terms of overall mentions focusing on new requirements to generate the edge for the buy side (see Exhibit 30).

Exhibit 30
Percentage of Mentions for Good High-Touch Coverage



Source: TABB Group

However, flexibility in research models now needs to be matched by technology. Tier two firms not traditionally seen as being able to compete with the bulge brackets in relation to technology are also starting to come into their own, demonstrating greater agility, lower overheads and cost controls, and unfettered by legacy systems.

Measuring the Winners

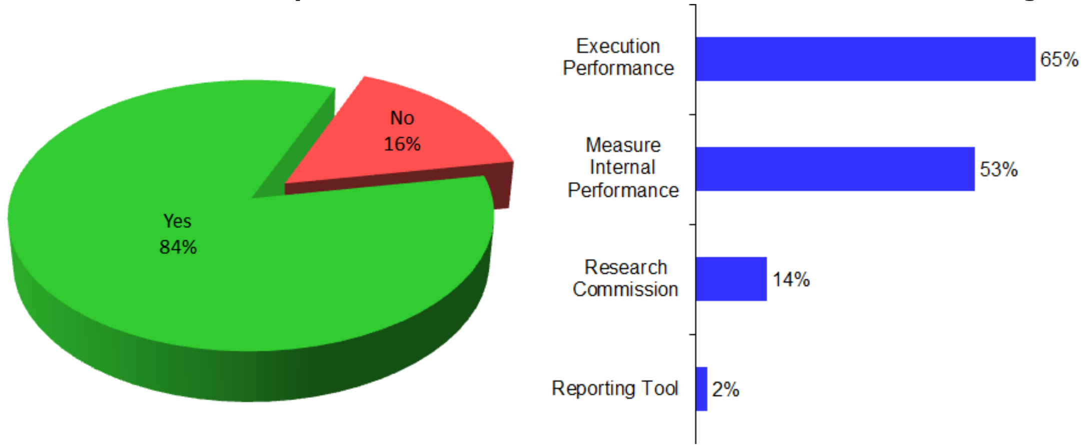
"For us every basis point matters and that's where sales traders still just don't get it." (Large Global Hedge Fund)

Analysis of trading statistics is now vital. However, there is a wide berth between general transaction cost analysis (TCA) and the increasingly granular exact venue analysis some of the buy side wish to delve into, and only a few brokers who are able to offer this service currently. This is set to change given the growing importance attributed to TCA as a method of broker selection.

TCA is still used overwhelming to monitor execution performance, but its usage is extending. From selection of trading styles from the PM, to monitoring execution performance against a variety of benchmarks, TCA is increasingly used for both internal and external analysis (see Exhibits 31 and 32). Compliance and risk teams are also turning to TCA to monitor erroneous trade performance

Exhibits 31 and 32

Do You Use TCA Currently to Measure Your Performance?/What Do You Measure Using TCA? (2012)

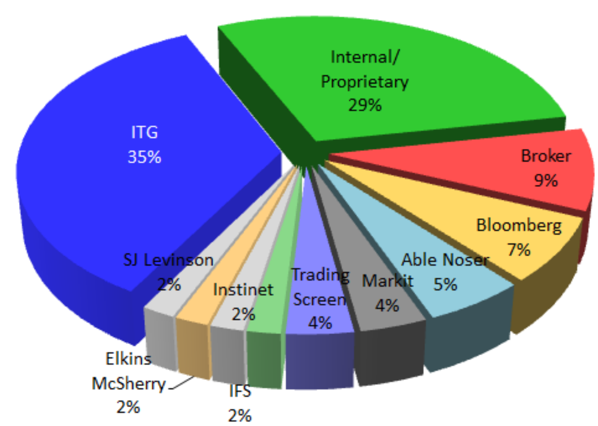


Source: TABB Group

ITG remains the industry leader in 2012; however, the growing use of proprietary systems alongside the main provider shows the increase in monitoring even the TCA statistics. New entrants such as IFS, Markit and Trading Screen illustrate the continued expected growth in this area. Access and ease of use were highlighted as potential pitfalls that remain to new entrants. Bloomberg's TCA product was highlighted as one that overlapped the current Execution Management System (EMS) offering particularly well (see Exhibit 33).

Exhibit 33

Top TCA Providers in 2012



Source: TABB Group

"Our number one focus is transaction costs. We measure the brokers, if certain brokers are performing better than others, we'll allocate flow accordingly." (Large Global Hedge Fund, Europe)

However, as TCA usage expands, there is a level of acknowledgement that the results are only as good as the field data that is entered. Comparing broker to broker when they have only received one section of the order at a different time can skew results unfairly. Unless the volume of order flow can provide sufficient data points to find any statistical significance, the results can at best provide merely meaningless noise, at worst deliver false conclusions.

Alpha in the Algorithm

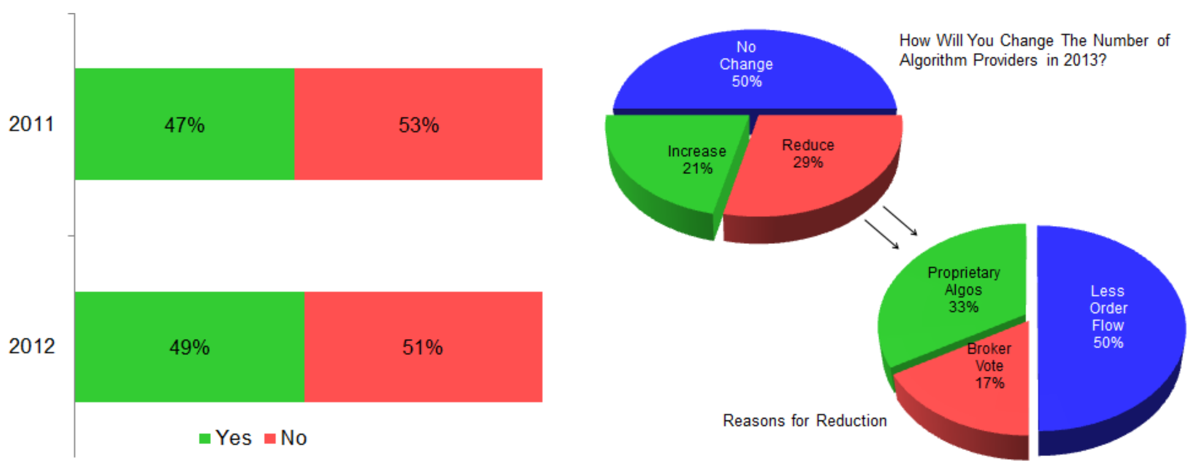
““The future will be access to markets and data – not algorithms.” (Large Global Hedge Fund, Europe)

The door for alpha in the algorithms remains ajar for now; however, the euphoria surrounding algorithmic trading has evaporated. Many believe broker algorithmic innovation is on the wane, when in reality algorithmic intelligence is only just getting started.

In 2012 algorithmic trading is seen more as a means to an end, with little available variation. Those who seek the edge are building it for themselves. The remainder use it as a payment mechanism for their main brokers or to fill their CSA pots: algorithmic trading is now mainstream.

The switch of top algorithm provider continues with nearly half of participants again replacing their number one provider from last year (see Exhibit 34). While the top algo provider is subject to change, getting onto the desktop will be extremely tough in 2013. More than three quarters of firms plan to keep or cut current providers. Of those that cut, the foray into proprietary algorithms means a permanent loss of opportunity to the broker that is unlikely to return when market conditions improve (see Exhibit 35). Brokers will need to work hard to illustrate their algorithmically relevance.

Exhibits 34 and 35
Is Your Top Algorithm Provider the Same as Last Year (2011 vs 2012)? / Predictions for 2013

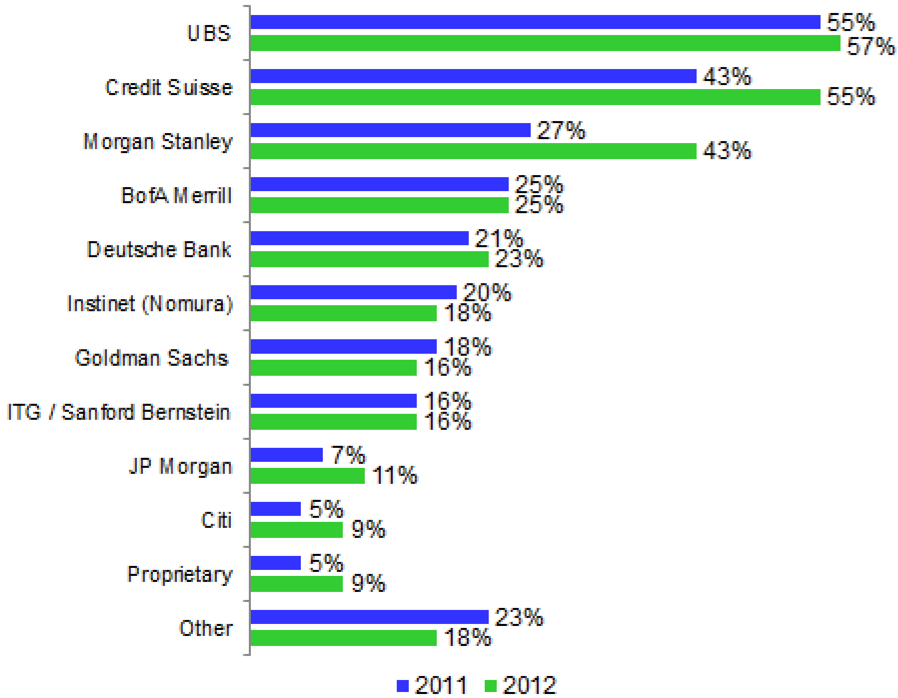


Source:TABB Group

2012 Best of Breed

UBS and Credit Suisse continue to battle it out for top algorithmic provider, with consistency and quality remaining key requirements for the buy side. Again the focus on operational efficiency remains top of mind with reliability and straight-through-processing to settlement being highlighted as key factors in the choice of algorithmic providers. Lack of innovation may be a common complaint, but if the volume is not there, a volume enhancement algorithm will fail to deliver. The ability to deliver 100% reliability in a new epoch of operational efficiency is what really counts for many.

Exhibit 36
Top Three Algorithm Providers by Frequency of Mention, 2011 vs. 2012

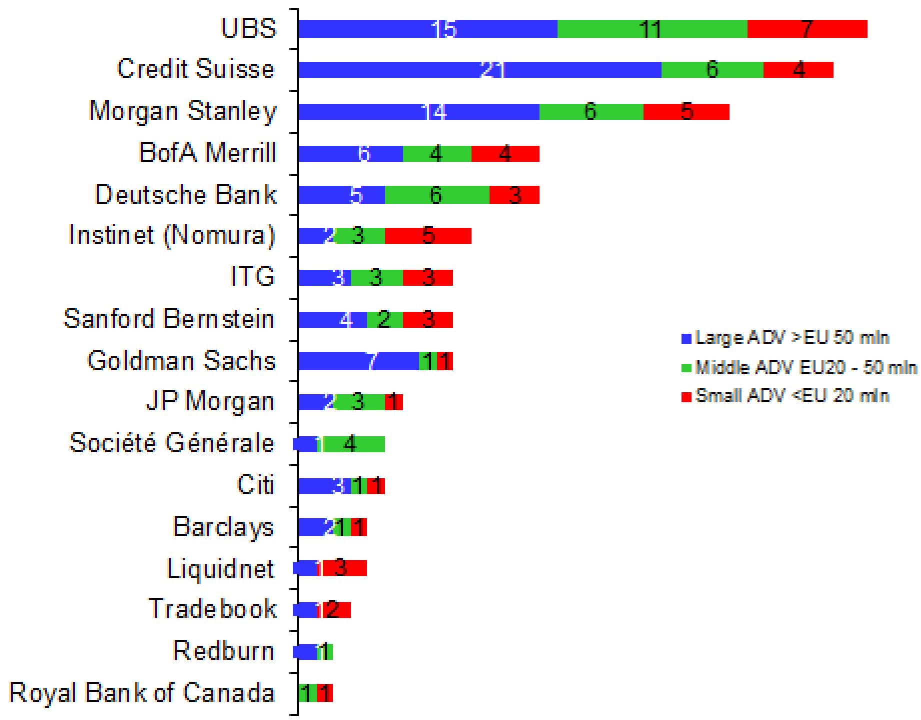


Source: TABB Group

Whilst the top three providers remain the same as the previous year, UBS, Credit Suisse and Morgan Stanley have taken even more market share in 2012 (see Exhibit 36). As predicted in last year's research *European Equity Trading 2011/2012: Looking for Allies in the Face of Adversity*, Credit Suisse has recovered a significant portion of market share as have Morgan Stanley and Deutsche Bank — companies that both moved up the rankings. The new challenger for 2013 —JP Morgan — seems to be a later contender to the European algorithmic space, with 11% of mentions.

Ranked by ADV, the strength of Credit Suisse amongst high-volume traders indicates a greatest share of wallet amongst our participants (see Exhibit 37).

Exhibit 37
Top Three Algo Providers, Ranked by High, Middle and Low ADV



Source: TABB Group

"We don't want to pay the brokers to find liquidity now, we use more and more of the algos to find the liquidity. The strategy now is to find liquidity quickly." (Large Continental Asset Manager)

Of those moving up the broker list for highly rated low-touch coverage, three reasons were highlighted. First, for high-touch service in a low touch environment, second for quality of research, then for improved low-touch performance including improved liquidity seeking offerings. BofA Merrill, Citi and Goldman Sachs were highlighted for their ability to provide high-touch coverage in a low-touch environment. Several firms were mentioned for greater levels of service particularly around market structure issues — Morgan Stanley came up strongly here as well as ITG and Société Générale.

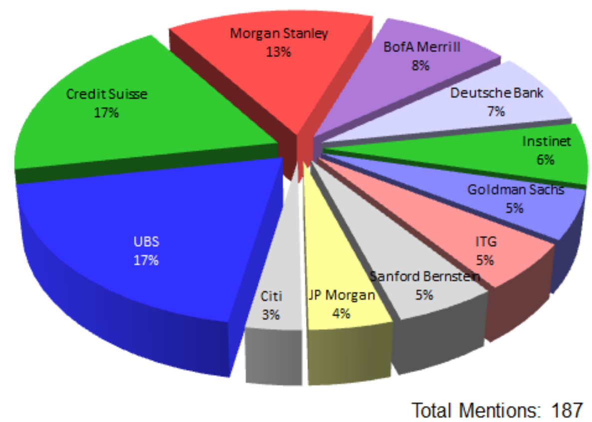
Ease of ability to pay was also highlighted as a deciding factor in where to route. The new research specialist model — Redburn, Jefferies, Sanford Bernstein or Bloomberg Tradebook's new independent research offering were all highlighted favourably. The mix of Instinet and Nomura is also being watched with interest as a possible blueprint for research and execution models moving forward.

The third group was focused on the new challengers pushing up through the broker list. Whilst Deutsche Bank remained top of this group, other firms benefited from last mover advantage with Jefferies being highlighted for building common code across all geographies. All new entrants have a distinct advantage of not being hampered by legacy technology, which may yet deliver significant market share improvement.

> "If a broker tells me they have achieved good results for others using a particular strategy, I'm prepared to listen. I'm not the Messiah, and I can take advice from people." (Large UK Asset Manager)

Finally, those offering added liquidity seeking algorithms such as Barclay's Hydra, Cheuvreux's BLINK, Deutsche Banks's Stealth, Société Générale's Alpha Y and RBC's THOR were all highlighted. The ability to be able to capture liquidity at certain price points even when interacting against HFT flow was highly valued, although a clear winner in this space has yet to emerge (see Exhibit 38).

Exhibit 38
Top Low Touch Mentions by Frequency Of Mention



Source: TABB Group

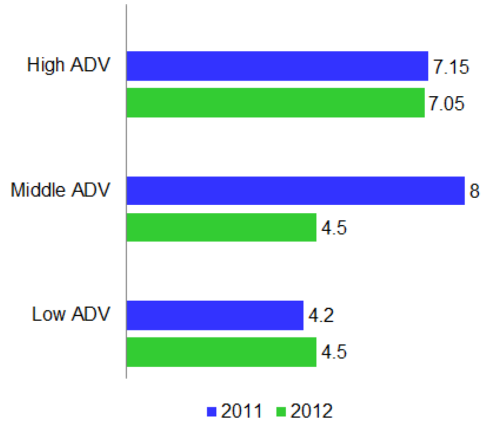
AI: The New Algo

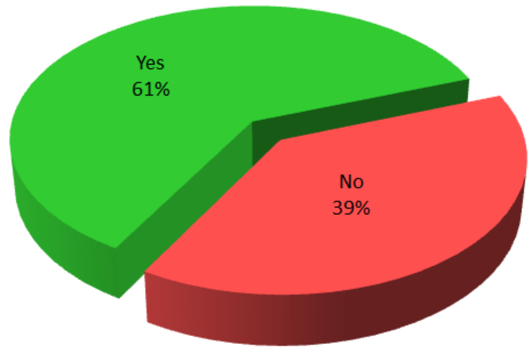
Algorithmic intelligence will continue to drive evolution forward. Further regulation and market structure changes will make it essential to trade in multiple venues, dark or lit. Without the requisite tools and technology, the buy-side trader will remain exposed to predatory behaviour. Greater use of predictive strategies to understand when and where to trade will require both real-time and historic data, news feeds and broad array of market analytics that identify liquidity trends, the signals for an algorithm to listen to and the tactics to be employed.

As buy-side firms continue to reduce the number of providers they access, it will become more a question of figuring out which algorithms work for which strategy and this may become a menu of algorithms from different providers (see Exhibit 39).

If the opportunity for differentiation in 2011 was alpha retention, in 2012 it is algorithm selection and execution consultancy, but not only in its basic form. Education, knowledge and advice surrounding the selection of strategies, and feedback on the performance of orders to alpha enhancement were welcomed as valuable differentiators in a world of supposed mediocrity (see Exhibit 40).

Exhibits 39 and 40
Number of Algorithm Providers, 2011 vs. 2012 by ADV / Does Execution Consultancy Add Value?



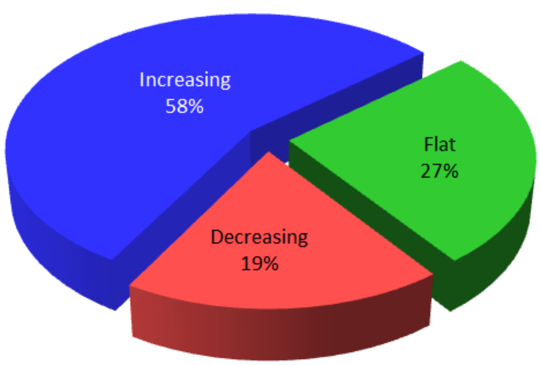


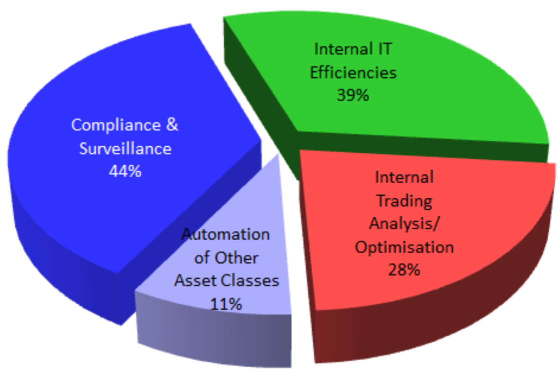
Source: TABB Group

Technology Is the Future

The move to roll out MiFID II across all asset classes offers vast opportunity as the buy side increases its investment in cross-asset systems (see Exhibits 41 and 42).

Exhibits 41 and 42
Is Your IT Spend Increasing? /What Are You Increasing Your IT Spend On?





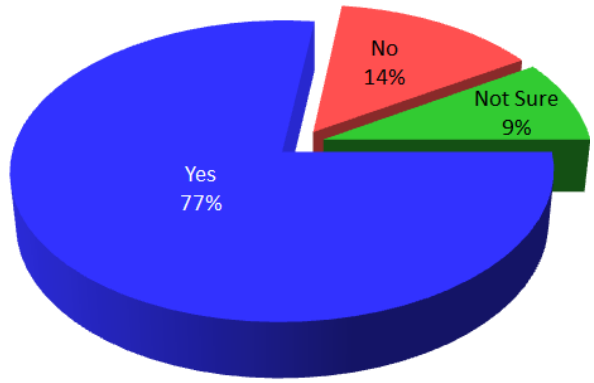
Source: TABB Group

Whereas the execution management system (EMS) played the key role of an independent mechanism to aggregate, deploy and monitor trading algorithms from a host of providers, the switch to trading FX and fixed income products electronically will lead to new requirements such as interoperability, which will have a knock on effect for equity execution and the next stage of its evolution.

"Our OMS has so many fat finger checks that it is borderline annoying, but if it saves me from making a mistake, I'm all for it." (Large UK Hedge Fund)

The growing acceptance of becoming more susceptible to systemic risk is highlighting the need for greater investment in IT spend particularly in relation to compliance and surveillance. However, many buy-side participants also recognise the new economic constraints that the sell side is under in terms of R&D and would actively encourage brokers to outsource their commoditised services where it is cost effective to do so (see Exhibit 43).

Exhibit 43
Should Brokers Outsource Commoditised Technology?



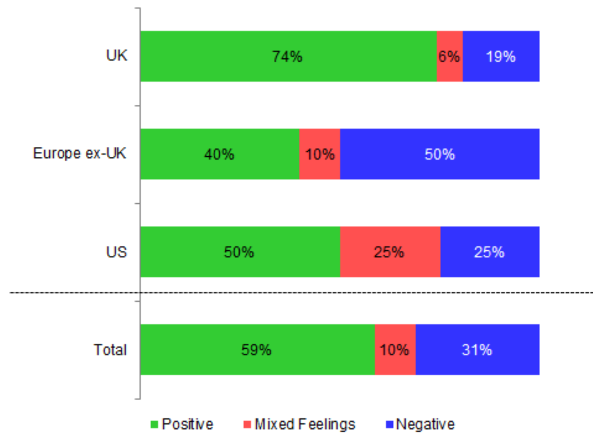
Source: TABB Group

2013: Where Is the Liquidity?

"If the regulators drive HFT out of the market , we are going to see volumes, liquidity, market efficiency all just fall off the cliff." (Large UK Hedge Fund)

As liquidity evaporates, the ability to retain every avenue of execution is critical, whether dark or lit. Despite buy-side concerns of interacting with HFT toxic liquidity, many are taking the view that any liquidity is better than no liquidity at all. What remains vital for the buy side is maintaining the element of choice.

Exhibit 44
How Do You Currently Feel About HFT?



Source: TABB Group

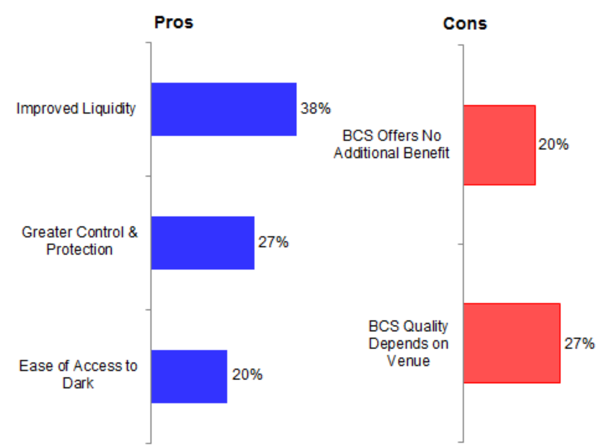
However, views differ dependent on location with nearly three quarters of UK participants positive towards their HFT contemporaries versus under half for Europe (see Exhibit 44). With the proposed demise of the broker crossing system (BCS) as the buy-side sanctity from supposed HFT toxicity, the debate will rage on.

Broker Crossing Systems: What Next?

""It used to be the case that all dark is good. Now, I think selected dark usage is good. There are some orders that I now have no interest in putting in the dark." (UK-based Large Asset Manager)

Whereas sending a portion to a broker pool to establish market activity was once a prerequisite, buy-side traders are becoming more hesitant, even acknowledging that on certain venues, European dark is diminishing in quality. More than a quarter of participants cite that performance depends on the BCS selected (see Exhibit 45).

Exhibit 45
What Value Do BCSs Provide?



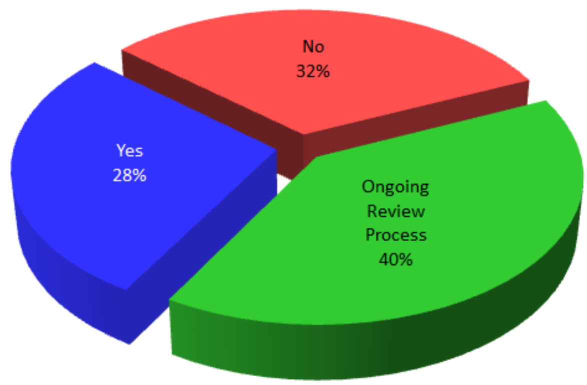
Source: TABB Group

Dark trading via a BCS still remains a critical function with over half of the participants citing greater liquidity access and ease of accessibility to the dark as the main benefits for accessing broker crossing systems.

"Dark trading is essential and it is not a problem. It's a problem if the regulator forces everyone into one style of trading." (Small Asset Manager)

However, there is much the brokerage community could do to repair damaged reputations. There are conflicting views whether a tier one broker's performance now significantly differs from a second tier firm that has no internalization capabilities at all. Brokers that are more transparent and willing to disclose their matching logic are increasingly being rewarded with flow.

Exhibit 46
Are There Any Dark Pools You Will Not Connect To?

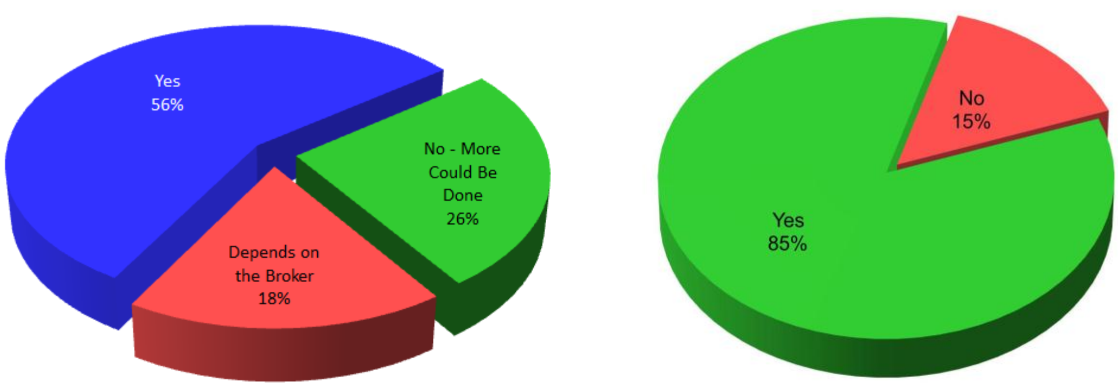


Source: TABB Group

Buy-side Traders acknowledge the answers they are given depend on the questions they ask, with 40% of participants now constantly reviewing dark pool activity and performance to establish which venues incur greater market impact or information leakage (see Exhibit 46).

The increasing use of Fix Protocol Tag 30 and now Tag 851, offers the opportunity to establish the final execution venue and whether the fill was executed by a liquidity provider or liquidity taker, thereby providing greater assurance as to knowing when, where and with whom they have traded. The majority of participants perceive their routing demands are being met by European brokers, with 85% confident they are aware how much of their flow is now executed in the dark (see Exhibits 47 and 48).

Exhibits 47 and 48
Are Your Demands For Routing Transparency Being Met By Your Brokers? / Are You Aware Of How Much Flow You Execute In the Dark?



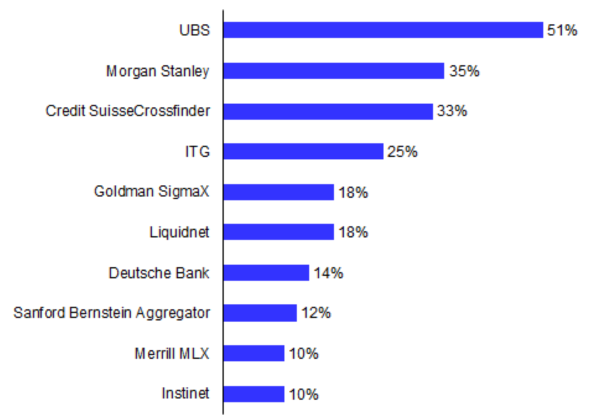
Source: TABB Group

Lack of liquidity is the main reason why traders utilise the dark as a comparison to the lit. Market equilibrium depends on the right balance of HFT and dark. If the regulators restrict either HFT or dark activity, brokers will have to return to the fore to fill the vacuum. It could potentially take a while for liquidity to normalize given recent levels of HFT activity.

"It's suicide to put market orders in the market. You're asking for trouble, and I would say (you are) not doing your job properly." (Medium Asset Manager)

Nevertheless there is clear evidence that where the buy side feels most comfortable is where the majority of the order flow is routed, and subequently where the majority of the liquidity pools. UBS remains the top beneficiary of continued broker dark pool usage (see Exhibit 49) with both Morgan Stanley and Credit Suisse receiving over 30% of the mentions. UBS was cited as the main broker to focus its dark pool offering on differing client requirements with the options of UBS PIN and UBS MTF.

Exhibit 49
Top Three Broker-Owned Dark Pools



Source: TABB Group

Final MiFID regulation will be the decider here. Dark will not disappear completely, and will reappear in another guise — whether MTF or SI, but the impact on overall trading has yet to be determined. Dark or lit, the neutrality of MTFs will ensure that participants will no longer be able to look to their brokers for counterparty protection, and will need to rely on the sophistication of algorithms and smart order routers when accessing liquidity.

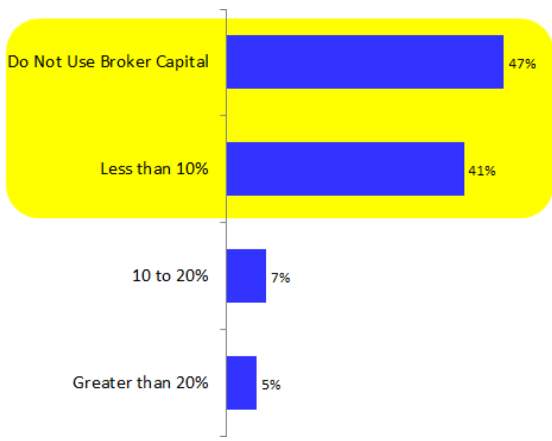
"People make excuses for why they don't trade as a block, but ultimately, they're scared of making a bad decision." (Large UK Asset Manager)

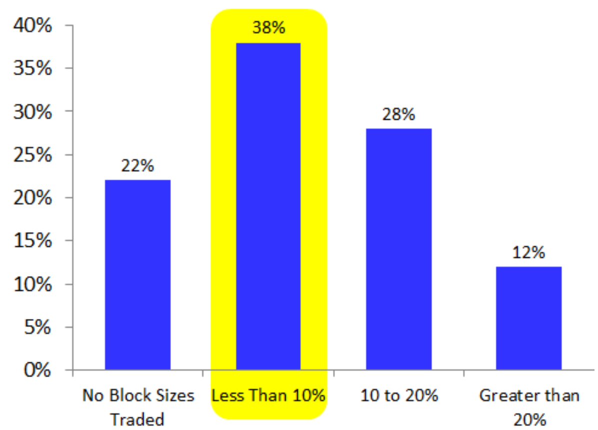
The Return of Risk Capital or Blocks

With current market conditions set to continue, many within the buy side see improved execution results by picking market levels, aggressively trading where they find liquidity at the right price rather than stepping up and trading in size. All of which contribute to the need for brokers to continue to change their execution offerings to the buy side, either by bulking up their block offering or creating new methods to replicate this facility.

The advance of systematic investment — in addition to the full impact of Basel III filtering through — are both impacting liquidity. By automating the entire investment and execution process front to back, nuances are regularly made to portfolios, tweaking percentages or notional values or sector weightings. Risk adverse PMs are nervous of showing their full hand and many participants referred to portfolio managers splitting orders up in the hope they averaged out, rather than risk buying or selling at the wrong level. As a result, very different order flow is now reaching buy-side trading desks, which is further exacerbating the execution agony for single stock traders.

Exhibits 50 and 51
Do You Trade Using Risk Prices? /What Percentage of Your Flow Is Now Traded As a Block in 2012?



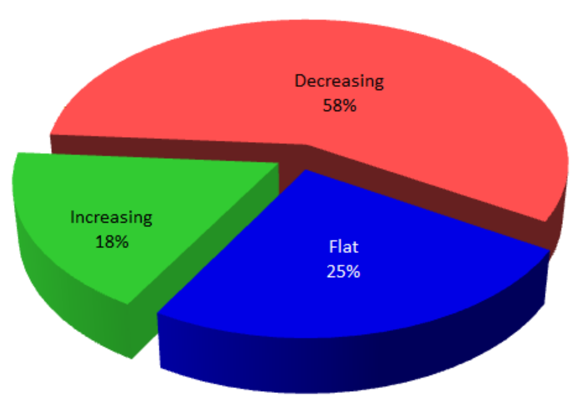


Source: TABB Group

The buy side complains of risk prices being unavailable, believing that brokers are only advertising the bare minimum. However, the reality is the psychological shift in the market means that there is now little requirement. With risk now only available for privileged clients, only 12% are able to trade more than 10% of their flow on risk, and nearly half are no longer trading risk at all (see Exhibit 50).

"We all talk the talk but don't walk the walk when it comes to block trading."
(Large UK Asset Manager)

Exhibit 52
How Is the Percentage of Your Block Flow Changing?



Source: TABB Group

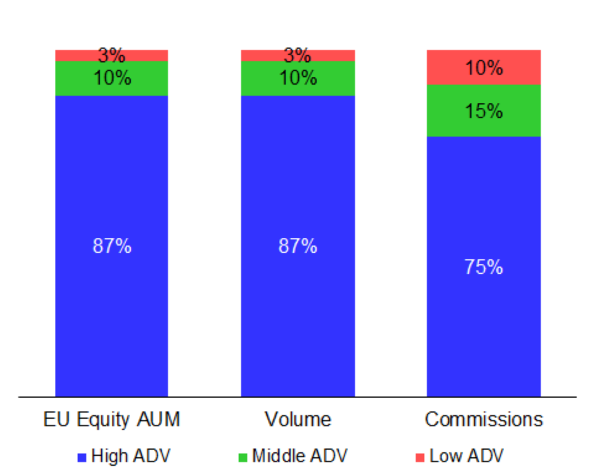
Likewise those who choose to lean towards the sales desk to provide blocks are struggling to execute. Over half the participants either no longer trade blocks, or are only able to trade a minimum of order flow (see Exhibit 51). This demise is expected to continue (see Exhibit 52).

New Payment and Coverage Models

"With a separate CSA provider I get to execute with who I choose – and that is now entirely driven by liquidity." (Medium sized European Asset Manager)

In a world of falling commissions, brokers and buy side alike are struggling to establish effective payment models in the new paradigm. Some buy-side firms are still on the ascent and increasing the commissions they pay; however, for many, commisisons continue to fall. Trading strategies dictate flow and European markets are becoming polarised as a result (see Exhibit 53).

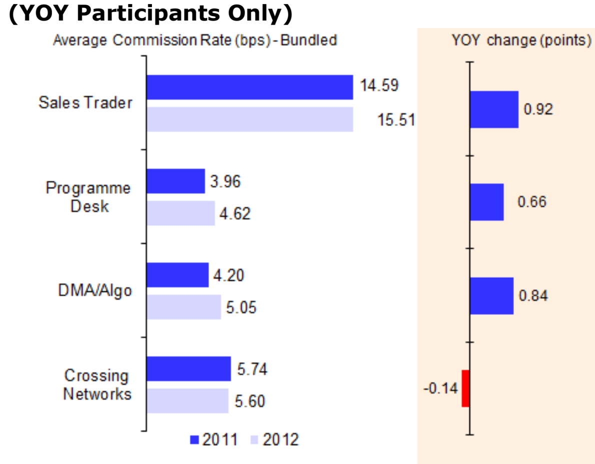
Exhibit 53
Breakdown of Participants by ADV



Source: TABB Group

Brokers that leverage additional auxiliary services as well as traditional revenue streams will survive. If rates are too low to cover research payments currently, as algo rates continue to move to a cost plus model, brokers will continue to struggle to generate the revenues of previous years, especially considering the inflated cost of trading. The commission rates are largely unchanged for now with small increase for year on year participants in order to pay research bills (see Exhibit 54).

Exhibit 54
Average Bundled Commission Rate 2011 vs 2012 (YOY Participants Only)



Source: TABB Group

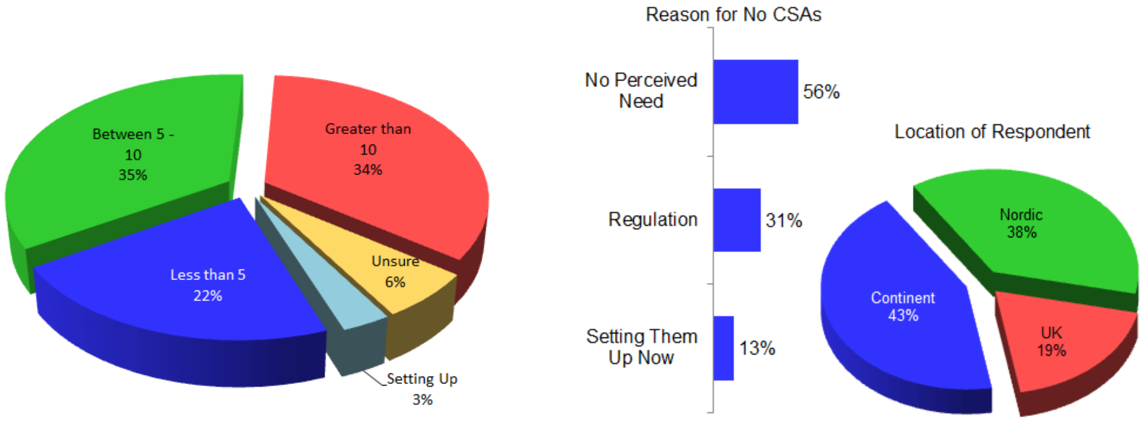
"If a broker joins the desk, why would I want to put any business to the cash desk at 20bps when I could whack it through the algo at 3 and still get full service on it?" (Small UK Asset Manager)

For buy-side traders who have become used to the discount model and are comfortable with executing their own order flow; the option of trading at execution only rates with "top up" commission payments into a commission sharing agreement (CSA) research pot is increasing in appeal.

In the hunt for dwindling liquidity, use of CSAs will facilitate true best execution. In addition to vanilla research payments, CSA payments include auxiliary services around the execution process. Data, risk metrics and portfolio management tools provide effective risk management and better cost controls and help improve investment performance.

These new models of use and new participants such as data and analytics providers, in the game are all designed to facilitate the commission payment process. Those who use CSAs see their usage increasing both in volumes and number of providers (see Exhibit 55).

Exhibits 55 and 56
How Many CSA Providers Do You Now Use? /Reasons for Not Using CSAs



Source: TABB Group

""New clients are coming onboard who now demand participation in a recapture program. Brokers who don't hesitate to contact me are definitely able to get their foot in the door." (US Medium sized European Asset Manager)

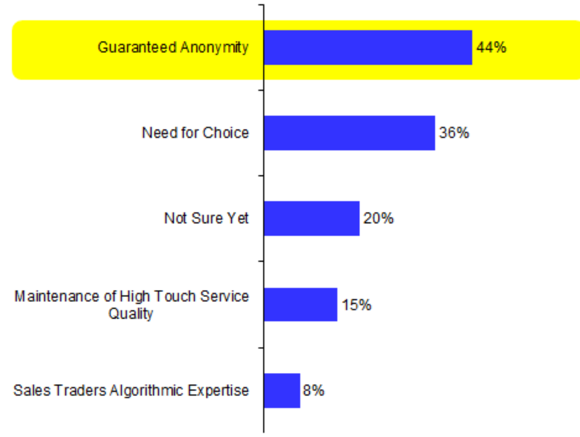
There is still a sector of market participants who do not yet access CSAs. However, this too looks set to change. The regulators have commission and research payments now set firmly in their sights across Europe and look to establish whether the buy-side institutions and their end investors are getting value for money. Of those who do not currently use CSAs, the majority were based in Continental Europe with just under half either waiting for regulatory change or in the process of setting up CSAs currently (see Exhibit 56). In addition as hedge funds are expanding their client base to pension and endowment funds as well as high-net worth individuals, an increasing number of their clients are asking for participation in commission recapture programmes.

New Coverage Models

Although the algorithmic desk has increasing relevance to the buy side, the introduction of the new blended desk is causing broad consternation even amongst those who are implementing these changes. Overall, European buy-side traders would appear to be prepared to accept the new proposals, on the provision that they are able to dictate terms.

For the majority, loss of anonymity is the top concern (see Exhibit 57). Whilst many participants see a blended desk as inevitable, there is a clear distinction between those participants who perceive a blend of cash and electronic desks as feasible.

Exhibit 57
When Would the New Coverage Model Be Acceptable?



Source: TABB Group

"If they keep firing all of my coverage guys, I'll start using more algos." (Large European Asset Manager)

Some are concerned about the increased temptation to record order flow and analyse behaviours, and brokers will need to prove they can allay buy-side fears. The fundamental concern is that the skillset required for cash and electronic services do not match. Any attempt to artificially impose this match will result in a dilution of service. There is also the technical aspect of it — not only in terms of understanding the algorithms, but also understanding when things go wrong and how to identify and fix them, which could have very dire consequences if not done correctly.

High Touch, Low Touch, No Touch

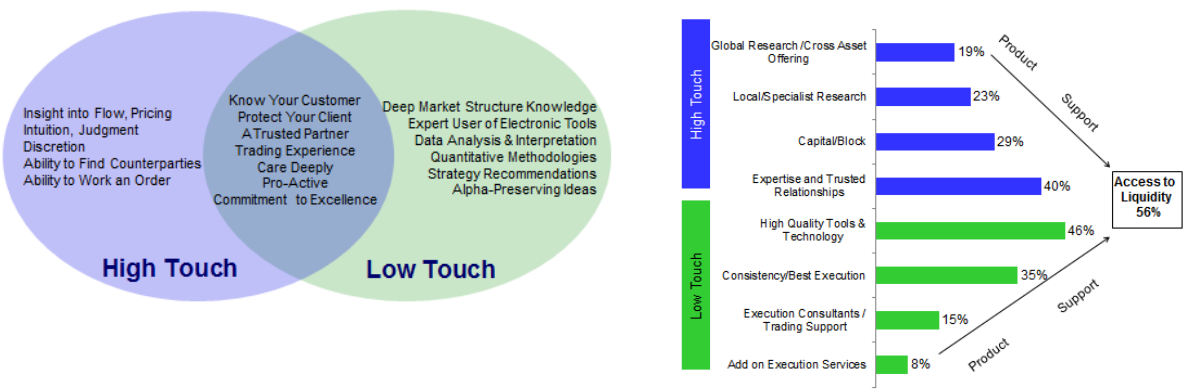
Although the buy-side desk has become more self-sufficient, many within the buy side still highly value the role of the sales trader. The smaller firms in particular use the sales trader as their outsourced trading desk. A good sales trader will know a client's investment style, who has shown interest where and when, and how particular clients wish to react to market movements. These are invaluable skills for a small buy-side firm currently over-stretched and unable to source these skills internally.

"The high quality sales trader is the dark pool that can make the match happen — this will only hasten their demise, and that bothers me." (UK medium sized Asset Manager

New coverage models could work depending on the level of sensitivity and the need for anonymity — all these factors depend on market conditions and the underlying order. Brokers that give the buy side the right to choose will encounter more willing partners for their new coverage models.

There is little difference in the underlying aim for all the buy side: access to liquidity is the number one priority and the differences lie in how the buy side chooses to reach this goal (see Exhibits 58 and 59). Traders must find brokers who understand their investment style and who they trust. This trust may be placed in an individual or alternatively in the underlying tools and technology.

Exhibit 58 and 59
Services Required from High Touch and Low Touch / What Services Do You Value Most?



Source: TABB Group

Brokers will need to focus on individual client objectives in order to deliver trading strategies that are optimal in today's market environment; however, the crucial difference will be to pull key attributes together without jepordising high- or low-touch offerings. If a client is paying to ensure anonymity, high touch must not dilute the low-touch offering. Buy-side participants are willing to pay for services they value, but have to face the reality that they can no longer expect a wide range of services that they do not deem essential.

"I don't need market colour or to be told the ECB is cutting rates — I need to know if their algo is down in Spain and I need to route away." (UK Hedge Fund)

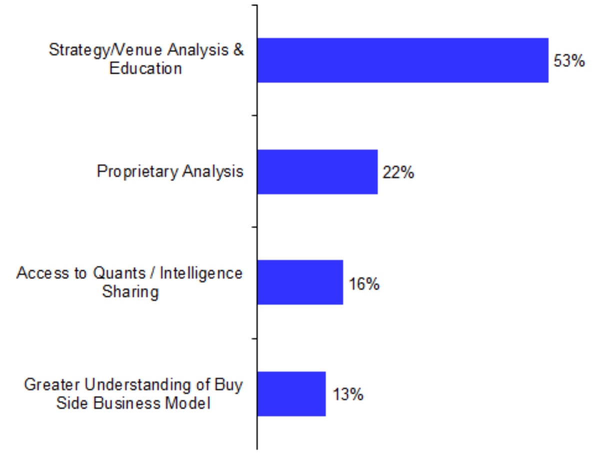
Coverage is evolving and many are willing to work with their brokers to develop the right blend and balance. Dialogue, trust and choice are essential to maintain the right balance of personal service and expertise.

The Consultants

The level of consultancy required depends on the level of sophistication of buy-side trading. There are still those who choose not to access algorithms direct themselves, but depend on their sales trader accessing them on their behalf. For these participants, education over usage still offers brokers considerable leverage. As the buy side becomes more concerned with execution performance, effort spent on education around how algorithms work, how traders should use them, adapting available liquidity patterns and added intelligence will produce dividends (see Exhibit 60).

"The specialist guys can still bring value. I just don't want a firm that's going to tell me the difference between three algos; I'll shoot myself." (Large Overseas Asset Manager)

Exhibit 60
Where Does Execution Consultancy Add Most Value?



Source: TABB Group

Then there are those who understand their own algorithms and how they operate within the European market structure; however, the differentiator here is the combination of the above with someone who better understands the end clients trading needs and can offer enhanced recommendations as a result. BofA Merrill Lynch, Morgan Stanley and UBS were highlighted in this area.

Sharing the Knowledge

An increasing number on the buy side now see execution consultancy as a more in-depth analysis of a broker's algorithms relative to its individual order flow. Hearing from the quants as to how algorithms are built and how performance can be enhanced is seen as an evolving partnership between broker and buy side. Credit Suisse was mentioned in this area along with newer entrants such as Jeffries, Société Générale and RBC.

"Execution consultancy for us is collaboration between asset manager and broker in the development of our strategies. That's a huge factor in who we work with." (Large Asset Manager)

However, it is hard for individual brokers to deliver extra performance without the buy side being more open with the full extent of its order flow. Those who are prepared to build long term relationships of trust and seeing more traction here — with the added benefit of buy-side funds less able to switch providers on the fly. Although the edge in proprietary information cannot always be shared, the ability to partner with brokers for access to markets and venues and independent risk controls still offers opportunity for European brokers.

Conclusion

2013 will be a watershed year for European equities. After years of demise, Europe is turning the corner and breaking free of the shackles of the past to emerge leaner, fitter and ready for the upturn.

From investment to execution to settlement the rulebook has been ripped up and thrown away. Who stood for what and why has fundamentally changed. Slowing fund flows, reduced commissions, and a persistent shift away from developed markets and vanilla equity products, mean market participants dramatically changing the rules of engagement in order to survive. Success in 2013 will continue to be defined by those brokers who are still able to deliver their clients requirements whatever the economic environment. Whilst consistent coverage and strong research products will ensure valued trading partners — it is the variety of what constitutes the right European coverage that will provide opportunity for differentiation and ensure a greater share of dwindling commissions.

Access to liquidity remains the number one priority for the buy side and electronic access will remain the mainstay but will require multi-faceted interaction. Therefore brokers will need to maintain investment in technology or they will be out of the game or will need to turn their attentions onto a new game. The status quo is no longer sustainable.

Lack of liquidity means fund performance is ever more reliant on alpha retention and cost controls. As the buy side switches providers to find improved execution performance, the need for clean data provision as well as strong analytics is paramount. The growth of real-time analytical tools will allow buy-side traders to ensure that they access the right flow at the right time on the right venue.

The full outcome of the growing plethora of European regulation still has to play out. Continuing fragmentation creates an ever-vicious cycle, more automation creating more passivity, leading to yet more fragmentation. In this environment, greater emphasis on accessing smarter algorithms, monitoring fills and routing logic will become critical to achieving optimum execution.

Execution performance will be the essential benchmark for other services. From the IT low-latency business agility technology provider to the niche research specialist, the switch in clients, products and services will continue. The precarious balance between global technology and local expertise will escalate as the buy side looks for trading partnerships for increasingly challenging executions.

To date, financial industry participants have focused on fighting change, however there has been a recent shift in attitude. Market participants now appear ready to embrace change, evolve with the regulation and establish new rules of engagement. Those who choose to ignore the warning signs may well be maneuvered out of the game.

About

TABB Group

TABB Group is a financial markets research and strategic advisory firm focused exclusively on capital markets. Founded in 2003 and based on the methodology of "first-person knowledge," TABB Group analyses and quantifies the investing value chain from the fiduciary, investment manager, broker, exchange and custodian. Our goal is to help senior business leaders gain a truer understanding of financial markets issues and trends so they can grow their businesses. TABB Group members are regularly cited in the press and speak at industry conferences. For more information about TABB Group, go to www.tabbgroup.com.

The Author

Rebecca Healey

Rebecca joined TABB Group in March 2011, bringing more than 15 years' experience in e-trading and financial services. Rebecca has held various sales and trading positions with Bankers Trust, Goldman Sachs, and most recently Credit Suisse, where as Vice President she was instrumental in launching the successful AES product to hedge funds from its inception in 2002 until 2008. Prior to this she was the first electronic trader at Credit Suisse to be registered for all electronic European cash equity markets and covered sales trading into Asia and then Europe between 1997 and 2000. More recently, Rebecca was based in the Middle East from 2008 to 2010. There she was employed by the British Embassy in Bahrain, where she successfully launched the UK Government's financial services strategy and set up the Bahrain Financial Services Roundtable, which remains a key source of information for the UK Government today, especially in relation to Islamic finance. Rebecca holds a Bachelor of Arts degree in Spanish & Latin American History & Politics from the University of London. At TABB Group, Rebecca has authored *FX in Transition: Taking The Quantum Leap; MiFID II and Fixed-Income Price Transparency: Panacea or Problem?; Market Surveillance in Europe: Under Starter's Orders; European Equity Trading 2011/12: Looking for Allies in the Face of Adversity;* and *European Algorithms: The Evolution; and Trading in the Middle East: the Road to Mecca.*

TABB GROUP

www.tabbgroup.com

New York
+ 1.646.722.7800

Westborough, MA
+ 1.508.836.2031

London
+ 44 (0) 203 207 9397