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Direct Edge Surpasses Nasdaq in Routed Flow to NYSE Euronext

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Direct Edge ECN now routes more flow to NYSE Euronext than Nasdaq does. January was the second month that Direct Edge surpassed Nasdaq's routing volume to the Big Board and its sister markets.

The rise in Direct Edge's routing profile is part of the ECN's growth strategy, according to William O'Brien, CEO of Direct Edge. "Routed volume is an asset," O'Brien said. "We've been able to consistently convert that into matched share over time. That's revenue and profit for us, and value for our customers over time." Direct Edge's matched market share last month was 7.9 percent.

As a router, Direct Edge overtook Nasdaq in December. That month, Direct Edge accounted for 3.7 percent of broker volume on NYSE Euronext's three markets, while Nasdaq was 3.6 percent. In January, Direct Edge had inched up to 4.0 percent, compared to Nasdaq's 3.8 percent. Direct Edge became a NYSE member in July of last year. Prior to that, it routed through Merrill Lynch's Broadcort, its clearing broker.

NYSE Euronext doesn't break down its broker volume figures for each of its three markets. But according to O'Brien, his market center routed an average of 144 million shares daily to the NYSE in January, and 101 million shares daily to Arca. Direct Edge is now the sixth-largest NYSE member firm, based on broker volume. The biggest is Getco, followed by Goldman Sachs and Wedbush Morgan Securities. Nasdaq Execution Services, Nasdaq's broker-dealer, is No. 8.

Still, the key headline number for market centers and broker-dealers making routing decisions is matched market share. "The game is about matched volume," said Rich Repetto, an analyst at Sandler O'Neill & Partners. He added that "some firms have used routed volume to grow their liquidity and get a first look at routed volume." Both Arca, before the NYSE acquired it, and Nasdaq employed that strategy. "The hope in routing out was that the internal match rate would increase over time," Repetto said.

Despite Direct Edge's focus on routing, the firm's new position as the market center with the industry's dominant routing strategy isn't an upset for Nasdaq. Indeed, Nasdaq quietly changed its approach to routing last fall. In 2006, after NYSE altered its transaction fees and a fee cap that had been in place for brokers (which it subsequently eliminated), Nasdaq pitched itself as a NYSE-customer-friendly venue with several routing options to the New York. The goal was to offer routing services to NYSE customers to help lower their costs and, in the process, to increase its own match rate in NYSE names for those orders that chose to go through Nasdaq's book before heading to New York.

The strategy worked. Nasdaq gradually upped its matched market share in Tape A (NYSE-listed) names. Then, this past October, Nasdaq put the kibosh on its DOTD order type, which enabled customers to route orders directly to the New York, without passing through Nasdaq's book. Now, all customers must first check Nasdaq's book before their orders are routed out. That has decreased some of the exchange's routed flow to the NYSE.

"We made a strategic decision to stop routing orders to the NYSE that did not pass through our book first," said Brian Hyndman, a senior vice president in Nasdaq transaction services. "When we were at 2 percent [Tape A] market share, that strategy [of routing to the NYSE] was very effective. Now that we have over 20 percent market share, we feel that we give our customers a superior venue to trade. We are more focused on matching trades on our system rather than being a DOT pipe to the floor of the NYSE."

Direct Edge, a much smaller market, is now counting on its routing strategy to draw liquidity its way and increase its matched market share. The ECN has two markets, called EDGA and EDGX, which appeal, respectively, to liquidity takers and liquidity posters. The majority of Direct Edge's routed flow comes from EDGA. EDGA has a 0-0 pricing model, in which it pays no rebate to liquidity providers and charges no fee to liquidity takers. That market is used by firms that "are not microsecond-time-sensitive and who want to get free executions a portion of the time," O'Brien said. EDGX, in contrast, has a more traditional 25-26 pricing model for most customers.

It is EDGA's pricing model, O'Brien said, that could be particularly appealing to liquidity-taking customers in the wake of NYSE's new pricing. Earlier this week, NYSE said it would increase its take fee and rebate to 10 cents and 18 cents per 100 shares, respectively, starting in March. The Big Board currently gives customers no rebate and charges them 8 cents per 100 shares for removing liquidity. Net liquidity takers will therefore pay more for executions at the NYSE.

O'Brien noted that EDGA has an internal match rate of 43.4 percent in Tape A names. O'Brien acknowledges that that internal match rate is much lower than the rate in other market centers, but it represents, he said, a potential savings for customers routing to NYSE. "If we're matching orders [internally] 43 percent of the time, that's a cost savings for customers of 43 percent," he said. However, EDGA's matched market share in Tape A names is still small. It was just 2.7 percent in January, while Direct Edge's overall Tape A matched market share was 7.5 percent.

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