

Transparency, efficiency and innovation

uncovering the real benefits of Institutional ECNs and new trading venues for the FX buy-side

The e-FOREX Debate

With Roger Rutherford, Chief Operating Officer, ParFX, John Miesner, Managing Director and Head of Sales at KCG Hotspot and Alan F. Schwarz, CEO of FXSpotStream LLC.

Do you agree with some commentators who believe the ability of many FX market participants to manage risk via electronic platforms has been degraded over the last few years and is therefore not as effective as they would wish?

RR: The global FX market ecology will always be in a constant state of flux and it is incumbent on everyone to keep pace with the changes. As the ecology evolves, market participants have to amend the way they execute and manage risk across all outlets, including electronic trading platforms. Developments over the past few years – such as the opening up of those platforms to different market segments, underpinned by low latency technology and the proliferation of market data products – is clearly causing concern. Hence the market's push for greater equality and fairness, the core tenets of ParFX.

JM: No, I believe that the industry has developed very effective risk management tools that address the challenges posed by a fragmented market structure and specifically the managing of credit in that environment. Prime Brokers have been instrumental in working with the venues to implement these changes. A great example of this is the “kill switch” infrastructure now in place as well and on-going enhancement to further enhance the ability to manage risk.

AS: The ability for FX market participants to manage and mitigate risk is a by-product of the nature of the liquidity and the nature of the transparency in a given venue. Although there are now many tools available such as OMS and EMS to assist in the risk management effort, the nature of the liquidity and transparency has become such that it has impacted the FX market participant's ability to manage risk. Venues that offer greater transparency and access to real

liquidity allow both buy and sell side counterparties in a given venue to manage their risk appropriately.

What do you see as the main drivers which have encouraged providers to create more transparent environments that clients can trade into with trust?

RR: Market commentators have recently been discussing why banks are internalising more of their flow, impacting volumes on electronic trading platforms. It is clear from these discussions that trust is being eroded and the trading experience of interacting with these platforms is degrading to a level that is not profitable or sustainable. This is why we see banks reducing their volumes on these platforms and warehousing that risk. The ParFX model is built on trust. By creating a transparent, fair market where there is intent to trade, you could argue bank internalisation could reduce.

JM: From the onset, Hotspot has been at the forefront of marketplace transparency providing real-time and historical data to clients showing full depth of book while maintaining client anonymity. We routinely work with all of our clients to optimize their experience on the platform. Hotspot's ability to customize the user experience and tailor liquidity to suit their needs has allowed us to build trust and respond quickly to client needs.

AS: We see a desire by counterparties to get back to the basics of trading as one of the main drivers that has encouraged the creation of more transparent trading environments. As a result, we see growth in venues, such as FXSpotStream, that allow participants to exchange risk based on real liquidity, on which they can conduct business in a fully disclosed transparent manner and at the same time preserve and grow the bilateral trading relationship.



Roger Rutherford



John Miesner



Alan F. Schwarz

Transparency, efficiency and innovation



In what ways has the arrival of new trading venues lowered the barriers to entry for a wider variety of buy-side firms looking to access the FX markets?

RR: By providing improved, more cost-effective technology and standardisation of processes and protocols (FIX, for example) – and, by dint of their differentiated business models, by offering a choice in what is very much a buyers' market.

JM: I am not sure it has. The proliferation of new venues has not in any way changed the process by which firms access the broader market. Regardless of the number of venues, clients will still need to have an account with a prime broker or secondary prime broker, and the account opening process still requires the same KYC as it has over the past few years. In fact, it has probably become more difficult for buy-side firms to navigate the number of available platforms

and sift through which venues have adequate liquidity to meet their needs. Until there is greater transparency from all venues as to their trading volumes, this will continue to be a challenge for prospective clients.

AS: The arrival of new trading venues has increased the choices for buy side firms looking to access the market. New venues offering different trading options with different pricing models have made it easier for buy side firms to access the market. Competition between venues has reduced costs and newer/better more accessible functionality has reduced go live times.

What issues have traditionally influenced a buy-side firms choice of FX trading venue and how do you think this may be changing as the global FX market grows and evolves?

JM: That depends on the buy side clients liquidity needs and how they

choose to interact with venues. Hotspot FX gives full order capability to all buy side clients, thus enabling them to retain a good amount of spread retention. All clients are able to act in a passive and/or aggressive capacity at any time as their needs dictate. Additionally, buy side clients can access alternative liquidity that they will not typically get from other venues.

AS: Cost, pricing, time to market, reliability, and transparency have traditionally been the primary influences for buy side firms when choosing a trading venue and those are all areas that differentiate FXSpotStream's no fee service from other venues in the market. We think all those factors will continue to remain important. Buy side firms will seek out FX trading venues that can create efficiencies, offer access to better pricing, reduce/eliminate transaction costs and that can minimize the go live time while providing a stable venue for trading.

Is the application of technology, for example to develop new matching methodologies or pricing mechanisms, the most effective solution for creating more fairness and transparency within electronic marketplaces for FX?

RR: Technology absolutely has a role to play. ParFX's unique matching mechanism, for example, really does level the playing field by making it impossible to gain advantage by any means. Much better to prevent the crime than allowing the crime to occur then applying the rule or law.

JM: Applying technology to create a better marketplace is something that Hotspot has done since it was launched and continues to do to this day. Several years ago, Hotspot introduced new technology that allowed for customization around client requirements, allowing us to

Transparency, efficiency and innovation

deploy multiple market structures to different client segments all while remaining completely open with the client and providing a fair and satisfying experience. Technology has made this possible and at Hotspot it is a constant process of always making improvements for the benefit of our clients. In the end it's all about the ability to meet the needs of each client which from our experience is very hard to meet through a one-size-fits-all approach to market structure.

AS: The application of technology certainly plays a role in creating more fairness and transparency within FX electronic marketplaces. But, technology is only one component. Venues tend to overlook the importance of the relationship with the client and support provided to clients relying instead on technology as the sole value proposition. Ensuring the client is properly supported is key to any venue's success and having and maintaining a relationship with the client is key. Clients need to have trust in the venue they are trading on and that trust is, in part, the by-product of a fair and transparent marketplace.

How hard is it or buy-side firms to determine the relative merits of cost reduction versus execution efficiency when it comes to assessing the benefits of FX trading venues and is making this key judgement more important for some client sectors rather than others?

JM: For all clients, the key most important factor to evaluate when looking at trading venues is the ability to get your trade done in the most efficient manner possible with little to no slippage. This can only be achieved when there is an adequate pool of liquidity available to absorb the client's interest. Furthermore, the ability to act in a passive capacity with exposure to a large pool of participants provides the opportunity



for tremendous cost savings for a client. These factors far outweigh the cost structure or commission structure that a particular venue may have. If you can't get your trade done, it really doesn't matter if the brokerage cost may have been \$1 per million less than at another venue where you were able to get your trade filled.

AS: The judgement of the cost reduction versus execution efficiency question differs between client sectors. Some clients are more sensitive to costs based on their trading style and others are more sensitive to managing and exchanging risk. Ultimately, however, all venues need to ensure that the client can easily understand the costs incurred, the nature of the liquidity available and the manner in which execution takes place in the given venue. Transparency again comes into play. Of course, the advantage and benefit of trading

via a service like FXSpotStream that doesn't charge any commissions versus a platform that does is fairly obvious and clients can then concentrate on execution efficiency.

In what ways can platforms which provide deeper STP and increased functionality across the entire trade lifecycle deliver a more powerful value proposition?

JM: In the current state of the FX market for any platform to succeed it must be tightly integrated with STP processes and be able to deliver data and trade information to support the entire trade life cycle. Platforms that are not able to deliver in this area will not be able to survive in the long run.

AS: The more functionality and trade processing support a venue can offer its clients the stronger the value proposition for the client. But,

Transparency, efficiency and innovation

clients need to assess the cost of the enhanced functionality in a given venue since added functionality comes at a price in terms of the cost of execution and the price at which the execution takes place. Clients need to determine functionality that is critical to the seamless execution and functionality that adds cost but no value.

What opportunities exist for platforms and trading venues to differentiate themselves by helping buy-side clients to meet the growing challenges of Best Execution as well as new regulatory obligations involving clearing and reporting?

RR: As it is already doing for the sell-side, ParFX will deliver a fair trading environment for best execution for the buy-side. The guiding principles of fairness and transparency that apply to the sell-side will apply equally to the buy-side. With Prime Brokers' control of their clients increasingly under the microscope,

ParFX Prime will be both different and relevant and provide enhanced, more elegant controls, such as net rather than gross credit and control switch, as well as full disclosure of both the EB and Prime Client name post-trade.

JM: Hotspot specializes in tailoring liquidity for both buy- and sell-side clients to create an optimized trading environment where all participants can have a positive experience. The system is built on a flexible foundation that allows us to provide this unique and valuable service, something not all venues can do.

AS: Venues that can provide clients the tools required to satisfy best execution and other regulatory obligations fill a need and, therefore, can differentiate themselves from the competition. Clients tend to migrate towards trading venues that provide the easiest, most seamless and headache free experience. If a client can press a button and know that a

deal is done, confirmed, cleared and reported they will continue to use that venue. That venue will have an advantage over those that can't or can only supply part of the solution.

Do you think innovation in the business models of FX trading platforms has now reached a limit and is unlikely be furthered anymore by altering the way dealing rules are written?

RR: The FX market and its participants will continue to evolve and innovate. ParFX is an example where true innovation was achieved at a far more fundamental level than rewriting the rule book.

JM: No I don't think so. FX is always evolving and Hotspot has been no different. Our marketplace today is very different and much more sophisticated than the one that was launched over 10 years ago, we fully expect to continue to adapt and introduce new innovations to meet the ever changing needs of a diverse global client base. It is a process that is never complete and if you think that you have the perfect model for the market, you will quickly become bypassed by others.

AS: Innovation in the business models of FX trading platforms have come a long way in the last 10 years. FXSpotStream, for example, was created and evolved from the belief that the market was looking for something different; a venue that was transparent, offered no fee trading and that preserved the bilateral trading relationship. We expect the market and venues in the market will continue to evolve and innovate.

Do you believe the popularity of disclosed relationship-based FX trading will continue to grow in the future as electronic FX execution spreads further around the world?

"..we see growth in venues that allow participants to exchange risk based on real liquidity, on which they can conduct business in a fully disclosed transparent manner and at the same time preserve and grow the bilateral trading relationship."

Alan F. Schwarz

Transparency, efficiency and innovation

RR: The network model of disclosed relationship-based trading will continue to grow. We must remember, though, that this model is completely different from the centralised markets for trading which are mechanisms for price discovery. Network models can only price their relationships effectively if they have a trusted source of price discovery and a trusted ecology to offset the associated client risk. They go hand in hand.

JM: Yes. In fact, over the last several years, we have seen an increase in the desire by clients to trade with each other on the Hotspot platform on a more disclosed basis. Within our marketplace we have many clients trading within disclosed pools or even on a direct point-to-point basis with one specific liquidity provider, leveraging Hotspot connectivity and technology.

AS: Yes, we see the popularity of disclosed relationships continuing to grow and we see that in the growth experienced by FXSpotStream, which has recently celebrated the 2nd anniversary of the company's formation. There has been a shift in disclosed versus non disclosed trading and we expect the interest in transparency and the ability to exchange real risk will apply just the same as markets evolve in other parts of the world. Of course, there's a place for non-disclosed trading between market participants so we certainly see both models remaining part of the trading options available and demanded by the market.

Is it truly possible to ever fully align the interests of FX marketplaces with their users?

JM: No platform can be everything for everyone. For most clients, the key is determining what factors are most important to them: liquidity, price, spread, participants, rules, etc and then finding the venue that can best meet their requirements.

Our aim is to create an environment where we can bring buyers and sellers together and both walk away happy and come back to trade again. This is achieved through open communication with our clients and a constant process of working to enhance the experience of all parties on the platform.

AS: The foreign exchange market functions properly when users have interests that are generally aligned with other market participants. One of the main reasons foreign exchange trading, as an asset class, has succeeded has been the broad diversity and make-up of the participants. But with that diversity there will always be an entity not able to maximize potential. Increases in transparency and speed of information have made it easier for all participants to use and to obtain the tools to access the market for their own needs.

Have we now reached a turning point in the way buy-side clients are likely to engage electronically with the FX market in the future?

RR: At ParFX we have yet to meet anyone who disagrees with our philosophy of equality and fairness, and that includes the buy-side.

The people we speak to say they have trading strategies that will be effective in a fair and equal market and that they have nothing to hide. The fact that they are embracing our fully transparent model is, to me, a turning point.

JM: It is an exciting time to be in the FX market. There are huge opportunities out there as more segments of the buy-side take a more active view of their FX trading, usually leading them to electronic venues. There is still more education that needs to be done for the Asset Manager community, for example, but the rest of the market has embraced electronic trading and has not looked back.

AS: Clients are always seeking new ways to engage the market. They have embraced the technological advances and will continue to do so. In 2000 the first live streaming internet based interface was introduced. Clients were lining up even though the quickest delivery available was via a 14.4k modem. Now you're looking at micro second delivery speed and access via any number of devices. Clients will always be looking for an edge in trading, so when the latest advance is released they will utilize it.

