From conflict to collaboration

how client relationships are changing across the e-FX trading environment

The e-FOREX Debate

With Ty Danco, CEO of Buyside FX, Alan F. Schwarz, CEO of FXSpotstream, David Vincent, CEO of SmartTrade Technologies and Justyn Trenner, Global of Head of Liquidity Optimization at EBS.

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Do you think that despite the clear and demonstrable benefits of electronic trading it may have created certain barriers between some clients and their FX providers and if so, what efforts need to be made to pull these down?

TD: Most barriers created by electronic trading can be dealt with through one simple measure: eschewing anonymity in favour of trading on a fully disclosed basis. LPs routinely give better prices via "relationship pricing." But both buy-side and sell-side benefit by using venues that allow for full information--most importantly, identity.

A way to further enhance communication between the buy- and sell-side is via reports that allow both sides to evaluate the value of FX business done to date. Why shouldn't the buy-side firms simply push a button and send a pre-formatted report to their liquidity providers on a regular basis? This report could show any and all relevant statistics —e.g. percentage of business seen and percentage won by the LP, percent of business put in competition, average distance by the LP from best quote, relative performance by quartile vs. all other dealers, etc.—all specific to that liquidity provider, broken down by currency pair. It's only possible to do this with electronic trading; hence you could argue that electronic trading can create better working relationships than those in the days of trading solely by phone.

DV: Relationships count, people buy from people and companies they like and trust if they are competitive. By replacing somewhat the direct person to person contact banks now have to work harder to keep those direct relationships and client loyalty. To be successful, banks need to provide not only the vanilla services electronically but also other order types, additional asset classes, news, charting and messaging in a format that is attractive for clients. From the clients' perspective the more rounded platform (in terms of services offered) combined with an engaging look and feel reduce the barriers thrown up by older less functional eFX platforms. For some time liquidity providers have been voicing concerns as to how their electronic liquidity is distributed, aggregated, matched and prioritised when it leaves the bank. Some e-solutions have been seen as black box in terms of logic used to match and prioritise who gets orders. This lack of transparency can lead to fears that the market is not always a completely level playing field. One should also remember that some venues and technology providers charge liquidity providers to supply liquidity leading to further potential conflicts of interest as the venue/technology provider stands to make more money if the higher paying LP wins more deals over a lower paying LP.

AS: Electronic trading is not the issue. The question is what does the service - whether electronic or voice - provide to the end user and does the service provider have any conflicts in the provision of the service. FXSpotStream is a

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perfect example of an electronic service that is fully transparent and completely preserves the relationship between the client and the liquidity provider. FXSpotStream's business model is unique in the market and unlike other venues we have no involvement in the terms of the transaction, charge no commissions and derive no revenues from spreads or proprietary trading.

JT: Electronic tools are simply an efficient means for communicating pricing and managing execution. They do not change the importance of differentiating on other aspects of the relationship – execution fulfilment and all the service wrappers associated with foreign exchange. The challenge when building relationships with clients is to provide services that are valued without expending too much cost and effort on the aspects of client service that provide limited differentiation. Some banks have overemphasised the latter and have been slow to address the former.

What issues have traditionally shaped client expectations regarding the way they trade and interact with their FX providers and how has use of the e-channel influenced these?

DV: In its infancy the e-channel was seen more as a tool for convenience and spreads were still high due to poor price knowledge. However eFX was a useful tool for reducing manual processing of vanilla products. In more recent times for many markets price knowledge is easily available; many liquidity providers can be easily compared and swept in milliseconds. As e-channel technology has matured it has allowed clients to drive down spreads first in spot majors then exotics, forwards and swaps etc. Given events of recent years, liquidity provider banks now have an opportunity to compete not just on automation, price, and product offers but also on transparency and best execution, something that in previous years was maybe taken for granted. In response to market demand smartTrade has introduced a number of reports that can, depending upon permissions given, enable both sides in the market to see an abstracted execution report showing the state of the market as the trade is worked and filled. A liquidity provider that can give tight spreads, supply a range of asset classes and prove best execution as a matter of course is not to be discounted.

TD: With phone trading, identity is disclosed and the issue of front-running by HFT firms is not a real concern. The anonymity which was required in v1.0 of e-trading not only undermined relationships, but it also led to predatory practices once identities were shielded. So bad behavior went unpunished. In anonymous, unregulated OTC markets, it's no secret that real money clients often come up on the short end of the stick.

AS: Fairness in pricing, cost of execution, and above all transparency are paramount to clients when deciding what venue to use to do their business. Our success is based on those core principles which our liquidity

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providers share in their longstanding relationship with our mutual clients.

JT: Clients continue to value the quality of service and relationships for things such as pre-trade insight, credit provision and direct relationships. But e-trading allows them to be much more precise in putting a price on these and transparency has reduced the cost of some pre-trade services, such as research, market data and market move advice. However, differentiation still matters. Banks that place too much faith in execution-based relationships risk seeing that flow move away the moment another bank is able to offer better execution completion rates on a consistent basis.

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Do you believe that bringing more transparency into the FX trading life-cycle can make a significant difference towards improving relationships and if so why?

TD: Yes, although this is a many-layered questions that begs a definition for what is meant by "transparency" at each stage of the trading life cycle. For instance, we are often surprised how many managers actually want to remain blissfully ignorant of the true costs of "free" services. Generally, we endorse initiatives such as EBS's white paper on aggregation best practices, with disclosure leading to more trusted relationships. For buy-side clients who feel burned by market behavior, the best response is to establish a "trust but verify" practice through better, near real-time benchmarking. Just as the sell-side monitors the profitability of customer business, now the buyside is beginning to sharpen its diagnostics, not just on algo orders but on all trades. Benchmarking and profit analysis for both sides will lead to improved trading behavior all around, which in turn leads to better, more-trusted markets.

AS: Absolutely. When a liquidity provider is able to maintain a transparent bilateral trading relationship with its counterparty both sides will benefit as pricing can be made with more confidence and tailored specifically to the needs of the client. The shift we are seeing away from anonymous execution is evidence of the importance market participants place on transparency.

DV: The innovators in the industry have a great opportunity to build relationships and win more business by proving themselves whiter than white in their dealings with clients (B2B or B2C). Unlike other technology vendors, smartTrade provides you with a unique ability to share abstracted execution reports directly with clients, showing the full liquidity landscape, sweeping process and liquidity provider responses. This allows banks to prove best execution to clients without requiring any additional resources. Transparency is not just a subject for banks but also for their technology vendors. smartTrade is uniquely placed in not charging liquidity providers to supply clients using our software. We feel use of this often 'hidden' double brokerage model (charging both flow and liquidity) by software vendors creates market distortions and conflicts of interests between how vendors develop and promote clients' route trades between A/B books.

JT: Clear electronic pricing, execution completion statistics and comparisons with other FX providers shine a very harsh light on an FX provider's performance and allow a client to make a very clear assessment of the value added by a provider, and to document this.

There is an argument that this can decay the relationship – or at least define it very simply as price and execution. But overall, it leads to a clearer definition that allows both provider and client to benefit from more efficient service, focused where the client values it.

Is there a danger that initiatives that set out to improve trading conditions for some specific client sectors, for example by assisting buyside firms who are only looking to exchange risk and not trading for investment or other purposes, might damage relationships with others and, if so, does this matter?

JT: One of the great strengths of the foreign exchange market is the variety of participants, all trading for different reasons, not just alpha generation. This allows room for different trading models and services to suit each user type. This plurality is a huge strength and reduces the danger caused by unintentionally correlated risk seen in other markets. However, that doesn't mean that heedless provision of service to one group might not disadvantage another. At EBS, we pay constant attention, through our Market Surveillance function, to the dangers of unintended consequences of well-intentioned market improvements.

TD: Any changes to a market that benefit one party generally means less benefits for another party. But that's always been the case. Like any relationship, the key is being honest and open.

AS: Maintaining strong relationships with a diverse client base is essential to a successful business and improving trading conditions for all clients should be the ultimate goal. A fair and open venue that allows all clients and liquidity providers to exchange risk in a transparent manner with all participants understanding the rules is the best approach.

Do you believe that all FX market participants (sell-side firms, trading venues, etc) share an equal responsibility to identify problem areas and ways to improve client relations or should that burden fall more on some rather than others?

AS: The burden for identifying any problem areas should be the responsibility of all participants. The market operates on several levels and at some point participants can be both a provider or consumer of liquidity. Relying on only one side to offer solutions is never the answer.

TD: I'm not sure that any party bears responsibility, but firms that are "long-term not short-term greedy" will embrace ways to improve and promote better business practices across the board. Those vendors and sell-side companies offering the best solutions create the happiest clients, benefiting both sides.

JT: All participants have responsibilities but they are not all the same. For example, as a significant liquidity venue, EBS takes issues of fairness, consistency and monitoring behaviour very seriously. We do this both because it is right and because it ensures the long-term health of the markets we enable. We believe that all market participants need to balance their short-term economic interest with the long-term objective of creating a sustainable and trustworthy market ecosystem.

In what ways do you think better communications and education can play a more important and valuable role in helping FX providers to engage with their clients?

TD: The easiest example where education helps is in algos. For most buy-side accounts, giving an agency order for an algo is essentially an act of faith forged by a relationship. It's unlikely that a trader can distinguish between, say, many of the similar strategies offered by his preferred dealers. We have heard from our friends on the buy-side, however, that they prefer to do business with those agents that take the effort to show what is going on under the hood, offering not only the best pre-trade education but also dashboards within their SDPs that show the current status of the algo in process. These same dealers can differentiate themselves further via comprehensive transaction cost analysis of the order. Once again, participants "do well by doing good."

DV: Being aware of what kind of solutions can help LPs and clients engage better actually helps. We try to explain our role of technology enablers to both sides so they can actually see the advantages of technology. Clients can feel they have no control on what they are getting from the LPs and LPs can feel like some technology providers are taking something away from them. Once again, showing transparency is possible and explaining how technology can concretely support healthy relationships is how we contribute on this subject.

JT: Clients need to understand how the electronic evolution of the market will affect them. At the same time, the pace of regulatory change and its implications for trading mechanisms and liquidity are very important and operators, vendors and FX providers need to be prepared to collaborate with their clients on these issues.

Does the nature of the huge and fragmented FX market make it harder for all of its participants to work with each other in ways that perhaps are possible in other markets and what lessons in managing relationships can be learned from the way these operate?

JT: In fact, the foreign exchange market is relatively simple. Although pricing is available on many venues, there is a limited number of underlying providers and pools. Accessing these is becoming simpler and cheaper so participants only need to decide which of these offer the best value. When we look at other markets, exchange-traded and equities in particular, there are lessons to be learned. Some of these are things not to do – the unintended negative consequences of Reg NMS are well documented.

TD: OTC markets are tough to navigate, period. The best model for us comes not from OTC markets like fixed income, but instead from the regulated and more advanced equity markets. Smart order routers, machine learning, and automation in general lessen the market fragmentation problem from a high-tech angle, while good old-fashioned high-touch salesman/client communication also helps. In the end, traders are looking for simple solutions to get their work done as effectively as possible. Since no single approach works best across all markets all the time, the holy grail is to find an approach, based on data and not intuition, that helps traders determine which strategies to use when. And since the correct answers keep changing, the approach taken needs to be dynamic. This type of pre-trade analysis is where we think the most value can be gained, and firms which can offer this are likely to have the strongest client relationships.

AS: Market participants are very savvy and are more than able to manage multiple relationships. Ultimately, market participants gravitate to venues that offer the best experience in terms of pricing, cost, transparency, reliability and service. FXSpotStream's focus on ensuring we address all those criteria accounts for our success.

DV: Fragmentation means more choice for market takers and makers, more possibilities to source and offload liquidity but it also

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requires more effort to search out the right venues in which to make or take liquidity. It also means that liquidity can be spread thinly so having a technology partner to efficiently abstract aggregation multiple liquidity sources or distribute liquidity to multiple end points is becoming ever more critical. Today we offer connectivity to over 45 liquidity Providers (ECNs, bank and non Bank feeds for liquidity taking) as well as connectivity to many multi and single bank platforms for making pricing to clients. We find that using an experienced technology partner who can build and maintain connectivity allows participants to take the best of each market and focus on core competences like pricing, risk and relationship management.

Looking to the future it is not always clear if the market will continue to fragment. The actual number of large market markers in the industry is still small and even within that group we see significant flows moving to bank led consortiums like FXSpotStream who recently just launched their new 4XIBOX product to supply clients with aggregated bank liquidity and a ready-made pricing and distribution platform.

As FX grows and attracts more participants with differing trading objectives do you think more formalised rulesets and best practice guidelines are increasingly going to be required to ensure that the interests of clients and providers are more closely aligned?

TD: There seems to be two flavors of exchanges and/or aggregators cropping up. On one side are the markets that promote the interests of the largest volume traders (which may feature last looks, requirements for prime brokerage and anonymity, etc.), generally geared towards price-makers. The other variety is those protecting the interests of the price-takers, which generally means the buy-side. Those two divisions clearly require different rulesets. What is important and often missing is having the transparency to know what those rules are, what happens to the trade (including who might see that information), who bears which costs and who gains which benefits.

JT: We certainly see the advantages of applying clear rules of participation impartially to all participants. That's why we have, and review regularly, our dealing rules and aggregation best practice guidelines. It's important that all participants understand the rules of the game in each venue and that the venues are transparent and enforce their own rules. This protects both the integrity of our market and our entitlement to remain unregulated or low touch.

AS: An active and diverse FX marketplace consisting of a wide variety of trading styles, objectives and timeframes has historically been the force behind the dynamic growth in FX trading. Greater transparency in the markets and stronger bilateral relationships is an important part in ensuring the interests of clients and providers is closely aligned.

Do you see any threats to a future of improved FX buy-side and sell-side relationships with the increasing use of technology and new trading styles such as automated and algorithmic execution?

DV: At smartTrade we do not feel these are new issues for the industry. There have always been people with better technology and alternative trading styles. The key is to choose an experienced technology partner that understands the potential problems that may arise in terms of technology, connectivity, hosting vs onsite, aggregation, internalisation and distribution. The smartTrade client base includes tier 1 & 2 banks, brokers and buy-side clients. We have strong experience in all sides of the market combined with 15 years of experience across multiple asset classes. We often hear that the transparency that our system provides, advanced price and order management and the fact that we do not charge liquidity providers, all help to play an important role in maintain the quality of the relationships despite the changing market conditions. The main threat is getting into a new market without an experienced technology partner!

TD: Any threat isn't a function of the medium, but of the nature of the actors involved. Buy-side clients who allocate agency orders to the Street are valued by the sell-side, and those orders are the result, not the cause, of solid pre-existing relationships. Those managers that use their own internal algorithms and trade anonymously via any exchange most likely are valued more by their prime brokers rather than by liquidity providers. Those buyside managers that value good relationships keep their LPs up to date via good feedback, keep careful controls over how they allocate business, and understand the relative importance of their flows to those dealers. And vice versa--dealers know who their best customers are, and they price accordingly whether trades are done electronically, via phone, or carrier pigeon. This simply isn't a technology issue.

AS: Technology should not be seen as a threat. Automated and algorithmic execution tools have been part of the market for some time and they play a role in the functioning of the marketplace.

JT: The challenge for participants is to understand the benefits the technology brings and how they can protect themselves. The risk is when technology becomes the end goal – this can drive up costs through overspending by market participants without any corresponding improvement in execution or liquidity provision. Market participants need to resist the urge to compete on technology rather than on relationships and risk management. The development of third party technology providers and more dynamic solutions should reduce this in time, allowing market participants to focus on client relationship management and value added service provision.

In what ways could regulatory reform provide a catalyst for enhancing trading relationships amongst a wider group of FX market participants?

TD: I'm not hopeful that external regulation helps. For every dangerous door closed, two more loopholes open; for proof just look at the effect of Reg NMS in equities.

One positive exception is in mandated trade reporting. What may be a short term nuisance eventually will become automated, and in time therefore painless. Having a broad, discoverable database of prices can only improve dialogue, which improves relationships.

AS: Effective regulatory reform promoting openness and full disclosure could help to broaden trading relationships amongst FX market participants. Improved transparency and a level playing field for all participants could help to offset the rapid developments and applications of new technology, which coupled with the ever-increasing complexity and speed of financial trading have made it harder for some market participants to keep pace.

JT: Regulatory reform is evolving and unclear but the likely outcomes will probably result in increased reporting burdens on participants. Supporting clients as they navigate these changes should offer FX providers an opportunity to enhance their client relationships.

Do you think FX is always likely to remain a relationship driven market and if so why?

JT: There is no doubt that FX is at core a relationship-driven market. What changes is the structure of these relationships. As price and execution diminish in importance as differentiators because of technology, the other wrapper issues become more, not less, important.

TD: Yes. The rationale is not "because traders are human." Increasingly, we will have automated trading happening on both sides for the bulk of transactions. In the end, however, the volume, pricing and nature of business done is always dependent upon the quality of the relationship between the two parties.

AS: As FXSpotStream's success has demonstrated, the most successful trading relationships are bilateral, transparent, predictable and built on trust. No matter the business model, at all levels the nature of the relationship between a client, liquidity provider, technology or service provider will always be important. Bringing technology to the equation does not mean the end of relationships.