

FX

Electronic Trading in the Foreign Exchange Market

Thought-Leadership Roundtable



From left to right: Mark Robson, Chip Lowry, Dan Conte, Laurent Develay, Jeremy Smart, Stephen Aldridge, and Mark Warms

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On August 1, a group of technology leaders in the foreign exchange market gathered in London to look at the challenges facing electronic trading in the FX market and how this booming market is likely to evolve in the future. Participating in the discussion were Stephen Aldridge, head of FX sales Europe, Bloomberg; Dan Conte, global head of trade book transactional and support desk, Bloomberg; Laurent Develay, forex dealer, Fortis Investments; Chip Lowry, senior managing director, Global Link Europe; Mark Robson, chief executive, FXMarketSpace; Jeremy Smart, executive director fixed income, Morgan Stanley; and Mark Warms, general manager Europe, FXall. Adrian Murdoch at *Institutional Investor* served as moderator.

MODERATOR: Is it possible to define what the FX market is or is it more sensible to speak of FX markets?

MARK ROBSON, FXMarketSpace: When I

think of the market, I think of strong customer segmentation. Leveraged funds, CTAs, asset managers, corporates and banks all have differing trading profiles. FX is certainly more homogenous and standardized than the equity markets with so many different stocks, but that doesn't mean that one size fits all.

MODERATOR: What's driving the growth at the moment then?

JEREMY SMART, Morgan Stanley: More than anything in the FX markets, it has been the reduction in barriers to entry for the buy-side. The growth of electronic trading has also driven market volumes forward enormously. Those two things combined have meant huge increases in volumes, and they don't show any great signs of abating.

CHIP LOWRY, Global Link Europe: That's an interesting point because growth has come from people who traditionally have not been actors in the market. If you go to business

school, they tell you specifically that FX is not an asset class, but now you have a generation of people coming in and saying it may not be an asset class, but you can make a lot of money off of it.

STEPHEN ALDRIDGE, Bloomberg: For many years, a small number of banks controlled the market and made a lot of money doing so. The buy-side has gradually realized that it was paying too much. Banks have become more efficient and made it easier for their clients to trade with them, bringing their own electronic systems in. The only reason they've done so is to hang on to as much of the business that they already have. Part of the growth is really just a lot of the hidden business that's finding its way to the surface now.

price to six or seven different anonymous trading platforms in what I think is a reasonable spread for that particular size, and then I get a trade from every single one of those all at the same time, I don't think anonymity is around that. I believe that a lot of genuine clients who want anonymity are being prevented from having that by some of the other players in the market. They are taking advantage of the plethora of platforms on the market, the fragmented liquidity and the ability to trade on that fragmented liquidity anonymously to make money.

CONTE: Both Mark and Jeremy make good points, each client focuses on different aspects of the transactional process. Those who are sensitive to transparency will direct interest to those outlets which provide pure anonymity such as Bloomberg Tradebook

From left to right: Chip Lowry, Global Link Europe; Stephen Aldridge, Bloomberg; and Laurent Develay, Fortis Investments



DAN CONTE, Bloomberg: Technology. The continued evolution of technological advances is leading the way for both suppliers and consumers providing channels to access greater transparency within FX marketplace. Thus, community of market participants from traditional banks, investment houses, brokers, client's (institutional & retail) and software providers have substantially increased which has opened the gateway to broader universe consistently executing FX. As new participants become more familiar with various elements FX market and traditional players enhance technology to support extensions of liquidity & information; many individuals are identifying transactional cost implications and alpha opportunities which exist in FX marketplace.

MODERATOR: Does that impact demands for anonymity?

MARK WARMS, FXall: It's not a question now of being transparent as to where the market is at any given moment in time. It's more that the larger players worry about who knows about what they're doing and whether or not they can capitalize on that information.

SMART: As someone on the bank side, I don't really mind a client saying that they want to be anonymous and they want to go and trade on an anonymous trading platform. But if I'm making a

FX., The need for this element of execution has definitely increased over the last few years with the inception of products like Tradebook and some other venues catering to market segments which look to discretely participate in FX marketplace. On the other hand, banks advancements in technical capacities and risk management have afforded trader's ability to optimize managing anonymous flows. Again, I see this as a general progression of FX transactional space which is becoming more accepted by all participants and will only increase its profile over next few years.

WARMS: While I understand a hedge fund wanting to remain anonymous to protect their trading strategy, they must recognize that in today's markets, banks will figure out pretty quickly when they are trading simultaneously across multiple venues. Jeremy pointed out how they can recognize this activity and you can be sure that there are 10 other banks who can figure it out as well. To maximize their performance, the more experienced funds have learned how to work with banks and marketplaces to ensure uninterrupted access to liquidity.

LOWRY: Anonymity, is important but I don't think we should overlay it too much. Hedge funds, for example, are not homogenous. Some hedge funds are trading foreign exchange as an asset

class, many aren't. If you're following a statistical arbitrage strategy, you may not be trading foreign exchanges and asset class, and those people may not even want anonymity. There are plenty of people out there that say: "I want my counterparty to know who I am." And that goes across the players in the market.

LAURENT DEVELAY, Fortis Investments: As a real money player, we want the banks that we're trading with to know who we are and that we're asking a price in that kind of currency. This is the area that has the biggest potential to develop right now, because the real money side is not as integrated as a hedge from the industry for the moment. The hedge fund is at the top of the business, there's no question of that. They're the biggest liquidity providers. Most development is going to come from real money, and there are not that many players that are completely integrated right now.

LOWRY: Every part of this market is growing. Is growth all going to come from real money managers or hedge funds? You know, when you see a three-person shop turning over \$300 million a day

MODERATOR: How will that be implemented when it comes in, in November? How does the directive define best price and best execution?

WARMS: We researched MiFID and its implications for the FX market. What we learned is that MiFID requires each institution to develop their own policies and definitions for best execution. It is our understanding that as long as the institution can demonstrate that it has followed its established best execution policy, then it will be meeting MiFID requirements.

DEVELAY: Our definition of MiFID when you're using a multi-bank platform, is to pick the best price from the five quotes you have asked for. And then to advise your clients that you have been picking the best price.

ROBSON: I like that definition, but there isn't one answer to this. There'll be a lot of interpretation and different customers will have a fiduciary responsibility, others will have much more scope for interpretation around what's best execution or best price. From an FXMarketSpace point of view, we take the exchange view of the world on this and start with a model that means you're guaranteed, no matter who you are or where you are, to trade on the best bid or best offer.

DEVELAY: If anonymity is meeting wide spreads, that's not so attractive.

CONTE: Taking a step back, all of us are alluding to components of the execution workflow while building some continuity to this process. As stated previously, "Best Execution" practices will be defined differently by clients based on interpretations of what they reasonably decide represents "Best EX" policies. Therefore, one might feel comfortable meeting such obligations by seeking out three sets of prices over portal while others

might believe executing over aggregated marketplace fulfills need to seek out best price. No matter how clients choose to define such measures our job as technology providers is to help shape products which integrate client's transactional workflow requirements offering comfort that they are complying with both internal and market practices. One's technology must be flexible enough to evolve with market and client dynamics as they continue to refine variables which influence their overall business needs.

ROBSON: None of us is going to say that there's one monolithic definition of best execution or best price. It's all about what different types of customers need, and by and large, they understand what they want. They won't go for a theoretical best model if it doesn't deliver the right execution results.

MODERATOR: Algorithmic trading is still very young to the market. How do you see that maturing?

ROBSON: What has been interesting over the last 12 to 18



From left to right: Mark Robson, FXMarketSpace; and Jeremy Smart, Morgan Stanley

in foreign exchange volume, there's a lot of growth there. The most explosive growth I think will come, in percentage terms, from the retail market. But will that be as large a portion of the market as hedge funds are or corporates or the real money space? I'm more skeptical here.

SMART: I do believe as transaction costs have come down, that a lot of strategies which were once unprofitable are now profitable and can be traded. General access to data, computing power and so on just make strategy generation for pure speculative gain much easier to do. One of the reasons why I think that the real money space isn't so highly evolved from an electronic standpoint is that we don't get, from a sell-side point of view, a clear message from all of the participants how they would like it to develop. We try to take a straw poll of real money managers from time to time, to figure out where we should go from a product standpoint, but it's difficult because we get a lot of varied answers. It can be difficult to focus investment. That said, one of the big drivers on the buy-side will be MiFID [the Markets in Financial Instruments Directive].

months is the question about what is driving growth. There have been questions about the extent to which high frequency algorithmic trading is driving it; how much of it is retail; or how much of it is cross border asset investment. One of the key reasons for establishing FXMarketSpace was to provide for the algorithmic community, so you won't be surprised to hear that I believe this has been the main reason for growth in the market and will continue to drive further growth as it matures.

SMART: The market is primed for huge growth, but we should make a distinction between algorithmic trading and algorithmic execution. The former is using a computer to make a decision to, say, buy ten dollar yen. The latter is asking what is the best way to buy ten dollar yen. I see the second piece growing enormously.

LOWRY: Everyone is trying to shoehorn the algorithmic functionality that exists in the equity market into the foreign

SMART: I disagree. If I'm selling a client an algorithm, I'm not going to say that they're getting a better execution than they would get through a trader. I'm going to say they're getting a rules-based execution which works to certain parameters which I've agreed with the client upfront. What we are guaranteeing is that those parameters will be the ones which we use to execute. We will then report that fact back to the client, to show him that we did what we said we were going to do and to make clear their performance versus the market.

DEVELAY: MiFID is going to accelerate the development of algorithmic trading. And not because algorithms are used in the equities, but because when you're leaving an order to be executed by a trader, you will have the detailed execution levels for each piece of the trade.

SMART: Bridges will be built between sell-side institutions to share liquidity at certain points within algorithms. It's likely that that will just lead to increasing complexity in the market and slightly less transparency, although it probably goes hand-in-hand with a better execution... at least in theory.

LOWRY: It may also lead to fewer liquidity providing players in the market.

SMART: It will lead to fewer players in the market. You need to show that you have a reasonable market share to show that the client has a reasonable chance of benefiting algorithmically from you not just executing everything on the street. A client would like to believe that you're keeping as much of their order in-house as you possibly can. The challenge for me as a sell-side organization is to prove to my client that I'm giving him something approaching the best liquidity.

And I'm able to give him the best execution because I have access to a deep pool of liquidity.

MODERATOR: Speed and best execution in liquidity used to be entries to market. What will the drivers be in the future?

SMART: If you don't have speed and the capability to manage risk, you're not in the game at all. However, the key piece remains client service, because ultimately clients will pay you for value that you add to their business.

DEVELAY: What clients are looking for is an electronic trading system that can easily be integrated within their internal system and that allows them to do as much things as possible. From the real money side we are working with ten, fifteen different banks. We need to have one access point to all those banks. This is why the multi-portal system is the only option for us.

ALDRIDGE: The plan at the moment is to go after the Holy Grail, which is to continue to develop the product that tries to meet the needs of the very different participants in the FX marketplace. ●



From left to right: Mark Warms, FXall; and Dan Conte, Bloomberg

exchange market. Will people actually use them? I don't know. People are saying they want to try them but, at the end of the day, if a client wants to give a bank a big order to trade, they're giving it to the bank because that bank has the skill to trade that order in the market. Whether or not that bank uses just a trader to do it or tries to replicate the trader by using algorithm to do it is part of the service the bank provides.

WARMS: The trend we are seeing is for banks to provide algorithms directly to their clients rather than clients developing their own. Regardless of who developed it, algorithms are increasingly being employed to execute orders. What's new is when a client chooses to access the algorithm supplied by a bank, typically there is a fee involved. If the bank manages this risk as traditional, there is no explicit fee.

LOWRY: What you're saying to a client is: "You can leave your large block order with me, and I'll have a human trade it, but I'll get you a better result if we let our super secret algorithmic trade it for you. Oh and by the way, I'll charge you a fee for using my algorithm." I'm not sure clients are going to buy that.