

DIGITAL MARKETS

THE EXCHANGE DEBATE



MARK ROBSON



SHARK TANK OR DOLPHIN POOL? THE REALITY OF FXMARKETSPACE

Market sources suggest that much of the flow in the early days was generated during North American trading hours, something which could be seen as a positive or a negative for FXMS depending upon which side of the fence one sits. Critics (mainly among rival firms but some bankers continue to express reservations about the model) point to this apparent phenomena and claim it reflects the dominance of the “Chicago” trading firms.

This is an extension of the “shark tank” school of opinion in the industry which claims that FXMS will be too heavily biased in favour of the algorithmic trading firms that typically have their technology based in Chicago, close to the CME Globex hub that is providing the matching engine for FXMS.

This is an argument refuted by FXMS, which points out that just over one quarter of the 36 firms live on the platform (at time of writing) are actually Chicago-based, the balance mainly being spread around the US and UK. It would certainly appear inevitable that Chicago-based firms would be among the leading group to go live on the platform, mainly because so many of them are merely extending their use of the Globex engine that they already use for futures, and also because they already use CME clearing firms – who will be providing the same services to FXMS participants.

“CHICAGO FIRMS WILL INEVITABLY BE AMONG THE FIRST GROUP TO GO LIVE BECAUSE THEY ALREADY HAVE STRONG LINKS WITH CME AND ITS CLEARING FIRMS”

1992 (and probably further back to the telex!)

A slow start is inevitable to a degree as market participants come to terms with the model, a fact that Rick Sears, global head of sales at the firm, acknowledges. “There is an educational hurdle, we cannot assume that everyone in the industry understands the model,” he says. “Once we have cleared that hurdle the central counterparty model removes credit as a constraint on access, which makes it easier to onboard clients. This is a different model – it doesn’t rely upon 10 or so core players, which should mean more diverse flow.”

Further support for FXMS’s refutation of the pro-Chicago argument comes from one trading firm manager spoken to by *Profit & Loss*, who points out that algorithmic firms don’t work US hours – as long as the machine is operating, the firm is potentially trading. True, other trading firms suggest that they were initially cautious when trading started on FXMS, thus they preferred to oversee their machines’ price making operations, which effectively meant they traded US hours, but most of these firms express a greater degree of comfort in providing liquidity now that the model is bedding down.

From a banker’s point of view, an “e-FX strategist” (model trader) at a US bank says that the start has been “quiet”, adding that the bank’s models prefer deeper liquidity than that currently on offer on FXMS. “That said, if the right bid or ask is on FX MarketSpace our machine will hit it,” the e-FX strategist adds.

LOCAL PREFERENCE?

The issue at the heart of the debate over FXMS is, of course, whether the venue is indeed a “shark tank”. The crux of this argument in turn, is whether the “Chicago” firms have an advantage. The trading firm manager argues that the “shark tank” argument does not hold water (no pun intended) because the majority of participants are expressing a view or an interest. “You cannot be latent on something you wish to trade,” the manager asserts. “If such people want to complain that they are being hit in a moving market they need to grow up.”

As far as FXMS itself is concerned, CEO Mark Robson makes a four point argument. “Keyboard users are not adversely affected by the location of a trade matching engine,” he points out. “All platforms actually throttle market access over graphical user interfaces, because human beings are unable to respond quickly enough to benefit from less than 500 millisecond latency. In reality machines will always be advantaged over humans on all platforms if it’s all down to which is quickest on the draw.

“Secondly, for FXMarketSpace customers who use high frequency trading programs but are based outside Chicago, we have an agreement with CME which enables any participating firm to either connect through telecommunication hubs or rent “cage space” at the “LNet” facility,” he continues. “Telecom hubs provide free access with reduced latency for customers around the world. LNet reduces this latency to a minimum, by locating customers’ computers and programs alongside Globex, allowing trades to be generated and confirmed over a very high speed fibre optic circuit. Renting cage space next to a trade matching engine is actually nothing new to the FX industry and other organisations support similar networks, but this does support level playing field access.

“Thirdly, being an attractive venue for the high frequency community makes for very liquid markets, which ultimately benefit all,” he adds. “And fourthly, for customers with prime brokered market access, delay is often introduced when they need to gain approval from the broker’s limit system to trade before their order is accepted. FXMarketSpace adopts a different approach so customers do not need to gain limit pre-approval before entering their orders.”

This all leads, Robson believes, to a truly level playing field, something he accepts is not as simple a concept as it seems. “Providing all participants with access to all prices on the platform is a must and orders should be executed on a simple best price basis backed up by a first-come-first served principle,” he asserts. “Equally, all customers should be free to trade as much as they like no matter how busy the markets get. We have ensured that FXMarketSpace ticks these boxes.”

DEGREES OF SUCCESS

When measuring the success or otherwise of a trading platform, liquidity is all important. Without liquidity, a trading venue can have the best functionality in the world and it will count for nothing. Given most people’s expectations of reasonable liquidity on FXMS, the next challenge to the company becomes access and cost of trading.

Two types of membership have been created for the new platform – the first is simply an extension of membership of the CME Clearing House wherein existing CME firms can use FXMS for no extra charge. The second type of membership allows non-CME member firms to put up the economic equivalent of CME membership without having to own CME stock. Under the new membership criteria, these firms will be able to trade on FXMS or guarantee clients on it – effectively be the latter’s prime broker.

It is more difficult ascertaining how competitive FXMS’s pricing is given the huge variety of volume discounts available on most of the major platforms, however industry sources suggest that from a passive trading perspective it is “very slightly cheaper” than many of its rivals. The firm has also ensured that its clearing firms or prime brokers pay no monthly membership fees and all customers receive market data for free. When a firm posts net collateral to the Clearing House, it can receive real time market data with an average latency, FXMS says, of 7.2 milliseconds.

The real cost to be considered is the total operational cost, something that is incredibly difficult to measure. For those firms already active on CME, one would imagine

the operational benefits to be considerable, including risk offsets between futures and cash positions. The real operational saving would come, however, if FXMS is able to convince CLS Bank of the merit of accepting pre-settlement netted trades. Discussions continue between the two organisations, but it must surely raise the heat on CLS that EBS, the platform many see as FXMS’s main target, has (re)launched a netting service (see *Profit & Loss*, January 2007).

Exactly how successful FXMS will be remains to be seen, but the company would appear to have most of the foundations in place. The critical difference between this and other models that have failed to achieve a significant penetration of the market is that FXMS does actually evolve the model. To this can be added the fact that aside from the API participants, and this is a crucial difference to EBS given the latter’s continued resistance to allowing non-bank participants a keypad, players can access FXMS via the GUI on their Reuters’ desktop. This could well prove to be a boon not only to FXMS in its drive for liquidity and breadth of participants, but it could also help maintain Reuters’ position in the desktop market.

How can one actually measure the success of FXMS? As a regulated institution the company declines to make its own criteria public, but it is reasonable to suggest that before it celebrates its first anniversary it should be seeing greater volumes than the second tier of ECNs such as Hotspot FXi and

participants. Although FXMS itself is quick to stress that its success does not rely upon the banking industry as so many others have in the past, the reality is that for it to achieve considerable or meaningful success, the banks are going to have to be involved.

For the API traders, especially the Chicago-based firms, the die is cast, and given FXMS’s insistence that its provisions for other API clients level the playing field, it should have no problem attracting other trading firms from around the world.

For the banks, it is more of a mixed bag, but it is noticeable that more and more banks are creating their own proprietary, API-based trading models – especially the US investment banks – and as such they should be playing on FXMS on equal terms. For banks that are behind in the trading technology arms race, a greater effort to catch up is required, and it is clear that some banks are going to be content to, as one senior e-FX banker puts, “look after the customers on our own platform and let the rest play elsewhere.”

This means that the reality behind FXMS is that it is not a “shark tank” as some would have it, but neither is it a swim with the dolphins. It is, in fact, a different approach to the evolving foreign exchange market, one that reflects the wider industry’s increasing reliance on technology. In such a world, speed is everything, meaning that while there will be a degree of advantage in being a “Chicago” firm, there is nothing to stop any other participant taking advantage of the same benefits.

“FXMS IS A HIGHLY PUBLIC FORUM...THERE IS NO PLACE FOR PHANTOM LIQUIDITY”

Currenex (probably around the \$30-40 billion per day mark). Tremendous success would see FXMS seeing average daily turnover close to its parent organisations and above those on FX Connect and FXall (both of which, Accelor notwithstanding, are different models).

Either way, the firm should be praised for following the example of at least one of its owners in pledging to release volume data. Understandably it wishes to settle down before releasing data that will inevitably be pounced upon by proponents and antagonists, but as the year progresses the industry will be able to gauge the level of support for the venture.

DANGEROUS WATERS?

To achieve the aforementioned benchmarks of success, the new platform is going to have to create a comfortable environment for all

Ultimately, what a successful FXMS will achieve is another raising of the bar in technology terms – banks in particular, will have to raise their performance – perhaps evolve their own models a little further or even create a new, stand alone model to handle the challenges of the modern day foreign exchange market.

For FXMS itself, it needs to hope that the banks are up to the challenge and, more importantly, that the trading firms seeking to provide liquidity adapt well to the unfamiliar position of being the major liquidity providers on the platform. Make no mistake FXMS is a highly public forum for these firms to test their strategies and price making abilities – there is no place for “phantom liquidity” which means that ultimately the argument between banks and trading firms over whether the latter’s liquidity is “real” should be settled once and for all. ■