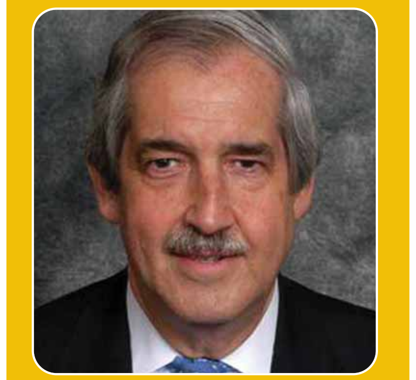
Detection and access:

Tackling key liquidity considerations in the new FX trading landscape



Jim Leman

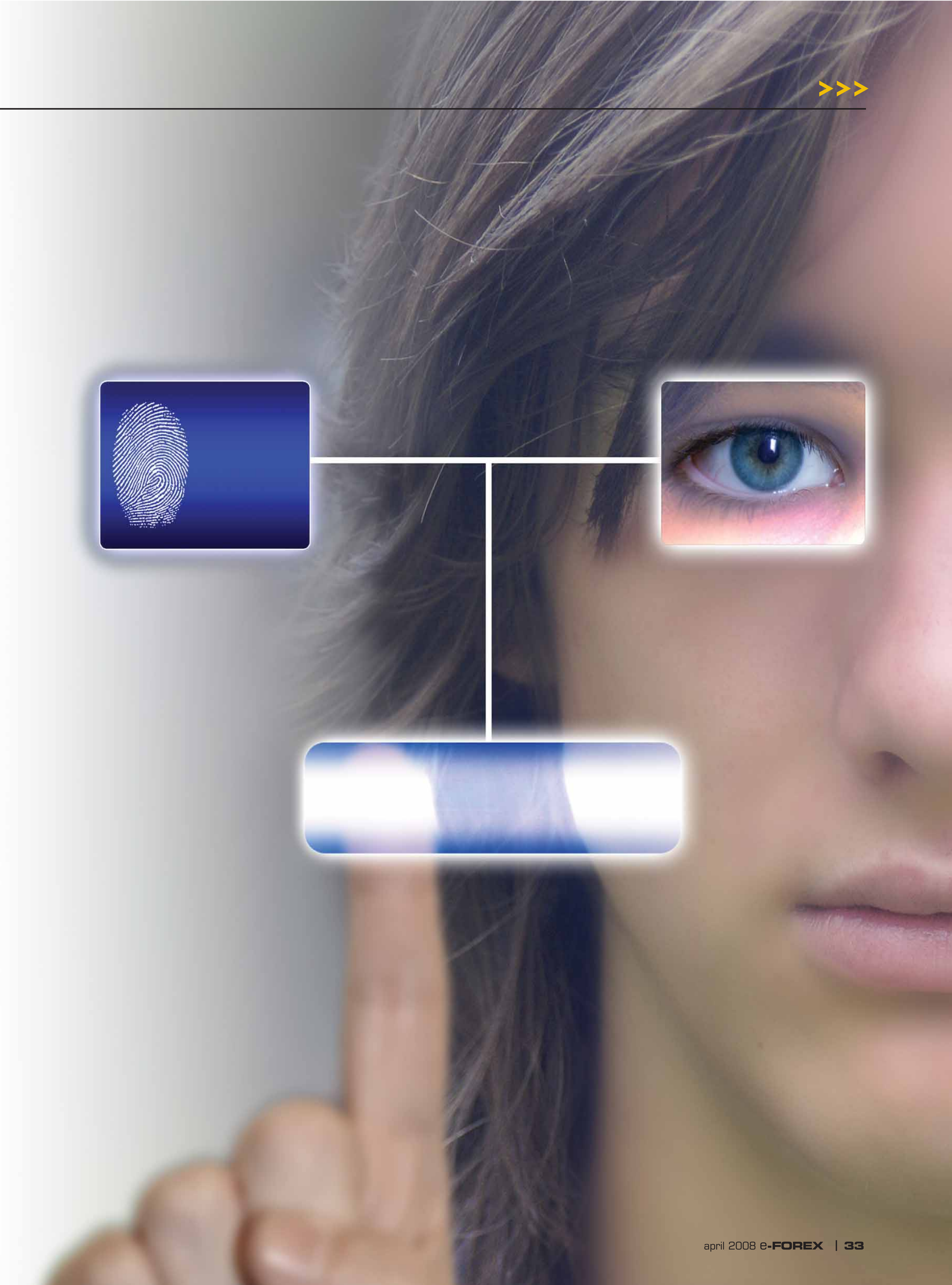
Ravi Manchi

Jim Leman and Ravi Manchi, co-Principals of Westwater Corp. examine the factors making the detection of and access to liquidity complex in the FX trading environment

Long known as one of the deepest and most actively traded products in the world, foreign currencies have, over the last several years, attained unanticipated attention for a variety of reasons. While the reality of substantial increases in trade finance have grown as the global nature of import and export activities have mushroomed worldwide, the emphasis on more refined cash and treasury management has pressed for greater use of electronic methods to meet growing transaction needs. Similar in some ways to the equity markets in how the use of technology evolved in the methods of how trading was accomplished, the foreign exchange markets saw the emergence of the "click and deal" form of technology as the first and prominent way of technology presenting itself.

The growth of investments in international fixed income and equity markets has fueled greatly increased transaction levels in the foreign exchange markets. This reality, combined with the growing desire on the institutional buy side to retain the spreads that brokers had previously reaped while trading for clients in the foreign exchange markets, led them to retrieve their prerogative from their custodial banks to control the disposition of foreign exchange activities. They thereby reaped the benefits of more competitive rates and netting of offsetting transactions in the larger institutions. Hedge funds for their part also began to refine their techniques of working with their prime brokers to leverage their currency positions and trading strategies as part of their overall financing creativity.

As the interest in foreign exchange grew as an asset class to the long only buy side and then the hedge fund community, the number and variety of single entity currency trading portals grew with streaming executable quotes replacing other earlier quotation methods. While foreign exchange for some asset managers remained a secondary event associated with trades in other asset class transactions, there was a distinct



group of asset managers and hedge funds who adopted more quantitatively oriented tools and trading strategies that began to count much more on frequent trading and greater speed of order delivery. The growth of a diverse group of listed derivative instruments also offered a more consistent and prolific stream of pricing information that could be used in context with other pricing information that enabled more quantitatively based strategies to be set in motion at a pace that the buy side found acceptable.

In today's markets the buy side player has a wide variety of liquidity points to choose from in executing his or her trades. A large and growing group of single provider solutions are available with new and improved versions being introduced on a regular basis. While these have existed for some time, they were joined by multi broker or bank portals a number of years ago as an attempt was made to consolidate the number of places a buy side player would need to look for quotes. Thereafter, ECNs began to present themselves to provide a new wrinkle to the institutional and then retail investor populations that promised more transparent pricing and a way for different sized transactions to be executed. While equity players were motivated to embrace ECN mechanisms to detect liquidity not otherwise easily accessible, in foreign markets where substantial size has generally been the norm finding hidden liquidity in size would not prove to be the primary motivator. Greater transparency of quotes, the ability to spread orders to a variety of execution points quickly and greater focus on minimizing market impact began to factor more significantly into the style of trading. In that respect the experience of asset managers and broker/dealers who transact with them paralleled equity experience.

Key liquidity access and detection challenges

As with most universes of customers they come in all shapes and sizes or more precisely with all manner of investment strategies, trading strategies, trading tools, algorithms, and needs which guide the way they approach the market.

For classic clients with business or trade related needs in the foreign exchange space the method of interaction has increasingly embraced technology and innovation but much more from the perspective of gaining efficiencies to cope with business related growth or the appetite for verifiable competitiveness in rates while maintaining traditional or historical relationships with broker and bank providers.

Clients who are pursuing foreign exchange as an asset class play do not have the same historical context with their counterparties. Moreover, they are, in many cases, seeking to adopt methods of interaction and dealing that put them more clearly on a footing they enjoy with broker or banks in other asset classes. Compounding this trend is the reality that the variety of strategies being explored and implemented has grown significantly as the availability of quantitative tools provided by vendors proliferates. Again as with equities the availability of more data and application of technology is consistent with the equity experience. Additionally, the emergence of retail oriented day trading operations and the growth of individual interest in trading currencies has changed trading patterns and attracted the attention of various providers of service in the marketplace.

As the returns in other asset classes become more difficult to realize, the pursuit of improved returns by use of currency overlays, outright trading of derivative instruments and the trading of currencies as their own asset class are finding favor across a wide variety of asset managers and hedge funds. With the overall growth of the global economy and the individual country economies and the attendant growth in asset management trading activity, the buy side has more trades to be carried out and an appetite to execute them more quickly. Moreover the concept of quality of execution was also growing and was borrowed from other assets being managed. These realities then give rise to selecting tools to be used in adopting strategies, determination of destinations for order flow and what services can be expected in terms of price competitiveness, speed of

execution and transparency of transactions when gauged against prior experience with other asset classes.

Brokers for their part grapple with the varying needs of their client bases and the costs that exist for them to attract and maintain the different segments of their client universe. Brokers need to refine the information they gather on the trading needs of their clients and how those clients profitability measures up against new and emerging clients who demand a different level of service. Brokers, who previously enabled clients to "click and trade" through their proprietarily provided front end or phone messaging now needs to consider how many different portals or multi broker/bank sites they want to deliver quotes to throughout the day. Now enabling streaming actionable quotes via one of the ECNs available from third parties or individual entities raises issues for how quickly the broker or bank needs to be to stay competitive as the universe of users grow. With the advent of the Fix protocol we now have brokers and banks enabling API access by selected clients. In this world the entry of trades is not gated by the keyboard of the user but instead by the computer model the client is using and the speed of the associated trading engine powered by millisecond tick data. Brokers now have clients no longer gated by their keyboards. This in turn forces broker/dealers to compensate with faster auto quote and auto execution software that must be in place along with real time risk management.

Crossing of block sized trades as a practice in equities arose from the buy side clients' desire to execute large blocks without experiencing information leakage. The desire to minimize leakage continues today. Now through the wonders of technology, the existence of reserve orders, which show part of an order to the market but keep a portion out of sight, and the development of dark pools, which allow orders to rest out of sight without a displayed quote, permit clients large and small as well as broker/dealers to discretely access liquidity without creating noticeable market impact while still receiving a representative execution price based on public market trading. As pricing of trading fosters more transparency either by business imperative or regulatory fiat the need or desire not to show entire order quantities will increase. Currently large foreign exchange trades occur regularly however new and different strategies are becoming more common and as dark pools have helped equities cross blocks and harness offsetting trades I believe we will see some mechanisms created specifically in the foreign exchange market to test similar principles. We can expect that technology will play a role so that execution opportunities are not missed.

The equities world saw this arms race occur once and it appears we have begun to see it manifest itself again in foreign currencies as more clients using an ever growing number of tools are trading more and more actively attempting to extract the variances presented by actions in the market. After the 1987 equity market crash, the role of being a registered market maker carried a burden that required a market maker to participate in a mandatory execution process where those who were slow to change their quotes were locked into trades launched by sophisticated clients. The lesson was now clear. Speed was an essential component and human keyboard reaction was no longer enough if you were making markets. That may be clear now for many in the foreign exchange market it may well be a mandatory element of all players' sets of tools in the future in order to achieve representative execution performance in a market where various algorithmic trading tools and blinding order delivery speed is prevalent. Algorithmic execution strategies are the primary reality of this trend where the number of transactions taking place may increase but the value of the currencies involved remains substantially at the same levels.

The new FX trading landscape

Liquidity guidance solution?

The perspective of the players in the market is guided by the way they use the market largely dictate the adequacy of the mechanisms in place that allow them to achieve what they need to do to carry out their duties and keep their clients satisfied. For certain classes of clients that trade infrequently and have relationships with brokers or banks that meet their needs, the mechanisms available to them may be entirely adequate. For clients in a role of managing other people's money or serving clients who have that role, the need for continuous pursuit of the very best rate at the fastest pace possible can fuel an appetite where speed of execution, speed of price change information and a wide variety of liquidity points is an absolute necessity. Anonymity and pursuing the absolutely best price at any point in time would call for demanding criteria to gain business. Strategies that base profitability on very thin margins on very large positions create a challenging environment for brokers or banks choosing to court such business. Maintaining competitive dealer capabilities and dealing with such demanding clients require those brokers to be equally adept at managing their quotes and positions as well as maintaining a variety of liquidity options that will enable them to manage their risk at a speed needed to match their fastest clients and competitors.

Acting in a dealing capacity for clients whose appetites and strategies are global in nature call for commitments to trade their books on an around the clock basis especially where these clients wish to continuously coordinate either linked underlying equity or fixed income trades to their currency components or those whose currency trading hinges on a globally managed book of business and who fields his or her own team of personnel.

For the most demanding clients whose strategies are predicated on model following quantitative techniques, one can expect that use of API capable solutions are a necessity. Moreover that class of user will want multiple liquidity point access that will grant the full range of order types available and consistent speed of execution that will enable an order generated by the strategy to aggregate the quote data from these sources and use a smart routing capability that can slice or segment an overall order in a variety of fashions needed to carry out the strategy rapidly with no single counterparty able to form a complete picture of what has just occurred in the market.

As a result, clients will expect brokers and dealers to be able to provide software that can absorb multiple provider quotes, understand the various order types available and enable clients to access this capability via the broker's trading personnel. As had occurred in the equity market, direct market access (DMA) by clients evolved from single exchange decisions to multiple destination capable software where the human trader still selected the destination. Given the growth in activity levels the speed of trading present and the need to manage scarce resources, the development of smart routers will be the next eventuality.

Broker quality of execution will be closely monitored and the flow of trades committed to those demonstrating competitive quotes, adequate depth, speedy execution and the ability to take on high volume activity levels. Brokers for their part will definitely need the same tools in terms of routing decisions and speed of trading to be comfortable making quotes in an increasingly active and demanding market.

As more asset managers embrace currencies as an asset class or pension plans commit resources to currency positions, the creation of new and varied strategies will be created to win the right to trade these new waves of assets. Technology trading improvements and quantitatively oriented solutions, many times created by brokers or vendors, will abound creating a crowded field where competition will translate into more competitive execution costs and other measures of competitiveness. Access to dark flow or more properly captive flow will most probably prove attractive to those who value anonymity highly. Additionally, smart router experience will become a marketing element of a broker or dealer's capabilities and performance tracking will be essential to obtaining and keeping business.

Again, trying to assess how the foreign exchange model may mimic equities could prove less than a direct replication. Using ECNs, algorithmic execution

strategies and crossing venues most likely do not hold the same promise in foreign exchange that they did in equities. The proliferation of algorithmic trading strategies, the number of ECN providers and dark pool or "alternative liquidity providers" may not grow in the same way. In fact, with regulation guiding much of the equity game, the absence of regulatory intervention leads one to believe market pressures from the buy side and the adequacy of how their needs are met by the dealer community seems much more the force to be reckoned with in foreign exchange transactions.

The future?

All in all, as the markets move into a more completely electronic mode the tone of the markets will change. With the expected growth in assets dedicated to this class along with the growth in international trade the number of players in the game and the complexity of the strategies being undertaken will be accompanied by more quantitative models. That phenomenon call for more quotes and data points provided instantaneously as they are produced. Crunching this data and acting in sub second response time will be a compelling necessity along with access to the widest variety of order destinations available with documented experience the judge of who continues to see flow.

As the various client segments are outfitted with more sophisticated trading tools and broker dealers offer Fix connections, the variety of options the buy side has to move around trading activity will make it disarmingly easy to move flow if a client is disappointed in any way by a broker/dealer. After basic connectivity is established, the need for aggregation software will be evident as the machines, following transaction events or quote changes, will be able to redirect or shift flow instantly.

Over time brokers and dealers will seek to demonstrate the capabilities of the technology and networks they have assembled to serve their clients. This situation can occur where their appetites for taking the other side of these transactions becomes taxed they have the ability to access liquidity at extremely competitive prices.

They will seek to satisfy their clients need for segregation of execution activity so clients can mask their activities. Hedge funds may be particularly interested in this dimension of the business. Eventually pricing at less than a pip may become a demanded feature the largest clients' request of their primary group of counter parties as a prerequisite of continuing to do business at the size and frequency they enjoy. This eventuality may be brought forward by competitive pressures by new entrants. It may be the way price improvement as experienced by the equity market presents itself to foreign exchange and it may happen in an internal crossing mechanism administered by certain players who operate on a scale few can match. Nevertheless, the level of business the foreign exchange markets continue to attract will occasion intervention by new players, new strategies from existing players and greater capabilities to personalize and customize solutions for the buy and sell side users.

Buy and sell side interests including retail trade flow will be explored as a way to reduce market impact, create price improvement results and even to reduce transaction costs to some degree. The ability of existing or new players on both the buy and sell side to ratchet up their game through the accelerating use of technology will create compensating pressures to offset either pure balance sheet brawn or involvement in historical segments of others in the foreign exchange business. The continuing expansion of asset managers and hedge funds into foreign exchange and into international markets will make trading foreign currencies a much more complex and challenging business. Growing pools of dedicated assets to established and emerging market currencies, pricing pressures on transaction costs, unendingly higher volume levels compounded by the need for greater velocity of trading will drive both the buy and the sell side to explore and experiment with new techniques and trading tools. Where it will end or how long it will take to get there is not clear. However, we can count on technology, quantitative techniques, higher trading volume, faster execution delivery and lower rates to remain constants in that newer globally oriented world.