

# Skipping the middle man will you be joining the FX ECN party?

Nicholas Pratt explores why increasing numbers of both Retail and Institutional FX traders are being attracted to the transparency, speed, as well as trade execution and cost benefits of ECN trading platforms.

Electronic communications networks (ECNs) have been a prominent part of the foreign exchange market ever since electronic trading started to make an impression back towards the end of the Millennium when new entrants such as Currenex, Hotspot FX and the short-lived Matchbook FX emerged to challenge the market dominance of EBS and Reuters which had in turn developed as an alternative to the closed shop that was the inter bank FX market.

The proposed benefits offered by ECNs have not changed in that time and were a combination of advancements in technology (particularly web-based tools) and the growing demand of buy-side firms to have greater access to the market. ECNs offered such access and the chance to be a price maker as well as a price taker along with less expensive execution and greater transparency. Since then the ECN model has continued to flourish in the FX world and the early forerunners such as Currenex and

Hotspot have been joined by a host of new ventures targeting both the retail and institutional markets.

## Retail versus Institutional

Dukascopy Bank is a Swiss-based ECN that offers direct access to the Swiss foreign exchange marketplace and serves both institutional and retail clients. "The ECN model works almost identically in both retail and institutional trading environments, trades on the same datafeed but could benefit from different post trade services," says Dmitry Kukel, Chief Broker Officer of Dukascopy Bank. "Clients can execute their trading needs on a competitive price stream with just one means of access. The bank charges a commission for this service. The difference lies in the counterparty

risk and settlement of the executed trades: While institutions may face a prime brokerage bank, retail clients will settle with Dukascopy Bank directly.”

An increasing number of both retail and institutional FX traders are likely to be attracted to the ECN model because of the benefits of transparency and cost, says Kukel. “Pricing conditions have long been a major factor in choosing an executor, with the rise of electronic trading and processing speed has grown in importance for professional participants. Complying with the clients need for transparency is simply the next logical step to grow market share.”

*“A stable and liquid trading environment, customer support and especially in the institutional business, efficient post-trade handling are all important considerations.”*



Dmitry Kukel

There are several factors, in addition to transparency and cost, which should influence a trader's choice of FX ECN marketplace to use, for both retail and institutional traders, says Kukel. “A stable and liquid trading environment, customer support and, especially in the institutional business, efficient post-trade handling are all important considerations. Added values such as charting, news, research and easy access come next.”

As the ECN market for both retail and institutional traders grows, these benefits will become important means of differentiation, says Kukel. “For retail clients the trading interface, the reporting tools and technical support are key areas. Software developments need to cater for a large field of requests and it can be tricky to increase functionality while preserving ease of use. Institutions require flexibility in post trade handling at the lowest possible costs. A lot of the new liquidity comes from funds and algo-traders that are trying to step in between brokers and banks. This works well in calm markets but it seems to have accentuated the risks during price spikes.”

The retail and institutional ECN offerings are currently separate but as providers look to the functions and features that will make up the next generation of platforms, is there a prospect that the two sectors will converge? Kukel thinks this is likely. “The retail and institution will converge as more and more solutions are available for post trades activities, such as Netlink. There are hardly any key functions that do not exist today. Minor additions for the user's comfort can always be added, as long as it does not complicate trading.”

#### More efficient marketplace

Gain GTX is a US-based independent ECN which is designed for hedge funds, high frequency traders and other buy-side financial institutions. According to Chief Operating Officer Vincent Sangiovanni, FX ECNs are helping to make the FX market more efficient by giving institutional traders more control over trade execution and position management as well as the ability to trade against prices made by ‘natural sellers’ or ‘natural buyers’, enabling buyers and sellers to meet at natural spreads. “The FX ECN model is maturing and gaining wide acceptance not only in the buy-side community, but the sell-side community as well. Banks are realizing the value of ‘client to client’ trading possible in the ECN model, leading to greater interest

in the speculative community, which leads to more demand for bank price making, which helps everyone's bottom line.”

This efficiency is an obvious benefit for FX traders who are being increasingly attracted to the ECN trading model says Sangiovanni. “The more efficient a marketplace and the more efficient the exchange of pricing information between buyers and sellers, the more amenable the marketplace becomes to the ECN model and the attraction it offers traders in way of applying their strategies. ECNs that provide a combination of reliable price makers and a diverse pool of participants will differentiate themselves and attract more liquidity and more volume.”

There are some bridging questions for brokers and traders to address in terms of improving connectivity to ECN platforms. And when bypassing bank dealing desks and connecting directly to ECNs, a trader or broker might be concerned they are losing something, says Sangiovanni. “First, for most ECNs, participants are responsible for maintaining sufficient credit with all eligible counterparties on those ECNs. But GTX is able to perform pre-trade credit checks because GTX tracks available credit between the central clearers, prime brokers, and client firms in real time.

“Second, liquidity in FX is fragmented not only across traditional ECNs but also across internal pools at banks and other institutions. Simple aggregators are not able to distinguish liquidity providers that have natural interest from those that are in turn reflecting liquidity from yet another pool. GTX solves the problem because it is a hybrid of firm, anonymous ECN liquidity, side-by-side with external liquidity providers backed by unique pools.”

There are a number of different fee and commission structures available from different ECNs including per-million fees, flat fees or having fees “baked in” to the price, depending on the participant's specific accounting, budgeting and reporting requirements. But the primary differentiators for ECNs will always be speed, ease of execution, currency pairs offered and credit availability says Sangiovanni.

The trading technology and architecture within an ECN platform is also a way to attract more market share, says Sangiovanni, particularly if they



Vincent Sangiovanni

*“ECNs that provide a combination of reliable price makers and a diverse pool of participants will differentiate themselves and attract more liquidity and more volume.”*

are able to facilitate best execution. “GAIN GTX's aggregation and credit engine represents a new ECN-hybrid architecture which acknowledges that FX is a relationship business, and while often you may need to deal many small tickets into a pool of ECN liquidity, you may also need to preserve your direct/disclosed counterparty relationships in a healthy, sustainable dealing environment. You should not have to carve out your credit and set up multiple circuits and GUIs and APIs just to execute your business in these various ways. It goes without saying that an ECN-linked aggregation service should offer all the fundamental order types and market data protocols including full

order depth-of-book (as well as quote “tiers” when those are appropriate) as well as GTC resting limit orders, IOC orders, stop and OCO types.”

As for how the next generation of ECNs will develop, Sangiovanni believes that they will be multi asset class with high levels of credit so that a prime broker can see the exposure of any particular client in both pre and post-trade stages. “This will ease credit issues for the prime brokers and allow them to extend and control credit more readily than is available currently. Ultimately a merging of retail and institutional platforms will happen, but the issues for both are completely different so again credit will be the key differentiator.”

### Transparency

MB Trading is one of the few ECNs to combine both retail and institutional traders on its platform. “Our routing technology works the same for \$1 as it does for the largest institutional orders,” says MB Trading chief executive Ross Ditlove. “We analyse an order when it arrives. If it is a marketable order we route that order to the destination. If it is not a marketable order, we display that limit trade on our ECN for all others to see. We believe the idea that there needs to be a separation between retail and institutional is outdated and archaic.”

Ditlove believes that free markets seek efficiency by their very nature and once sufficient information and a level playing field exist, participants’ confidence in the market grows. “Our clients have come to learn that no one is holding their order off to the side for their own benefit, waiting for a chance to make money between the order and the market. This is critical to a fully transparent marketplace and exactly why our client orders are posted so they may interact fairly with one another.”

Ditlove refers to what he calls ‘the test’ as the basis of the platform’s trading model. “We ask traders to place a limit order to ‘buy’ between the ‘bid’ and ‘ask’ of their broker. A trader should see their order become the new bid immediately with no delay and reduce the spread of the market place for all traders on that system to see. This means that the broker is not playing any games with your order. With our platform not only does the order display but you would get paid a fee for putting up that limit order once it is filled.”

He goes on, “Since a true ECN/STP broker shows the quotes provided by their liquidity providers, they



Ross Ditlove

*“..true ECN technology with incentives for traders to post their liquidity in the form of limit orders will bring more retail volume to the market place and reduce spreads to 1/10th of a pip for all pairs.”*

don’t rely just on mark-ups in the spread like a deal desk does. That means that those brokers charge a commission or fee for the trade routing process. At MB Trading, we’ve recently sparked a change in the industry by paying customers to display their limit orders while charging a routing fee to those that take liquidity off our ECN. That is a significant change which we believe will have far-reaching ramifications in the coming years.”

According to Ditlove, as traders begin to realise the benefits of having their orders interact immediately and directly with the rest of the market, the truly transparent ECN model will become dominant. But there will be an education process involved. “The Old Guards of fixed spreads and lack of transparency are not going to easily hand over the FX market to

efficiency because we say so. If you look at what happened in the equity markets in the 1990s, the arrival of true ECNs brought faster executions and new pricing models but most important it brought true transparency and tight spreads. We believe that the FX market is heading in the same direction and that true ECN technology with incentives for traders to post their liquidity in the form of limit orders will bring more retail volume to the market place and reduce spreads to 1/10th of a pip for all pairs.”

### Unresolved issues

Fair Trading Technology is a company offering a connectivity bridge between the Metatrading world of home broking solutions and the ECN trading model. As far as McLean Van Cleve, the company’s chief systems engineer, is concerned there are still some

*“If you’re transparent you have nothing to hide and if you’re showing everything, it had better be good.”*



McLean Van Cleve

issues to be resolved in terms of how the ECN model operates in the retail environment. “The outcry for an ECN model in the FX retail space has its roots in the quest for lower spreads and traders not wanting their brokers trading against them. But it has been introduced with a capital requirement that is often out of the reach of the average guy looking to get into the market.

“Brokers have a very good reason for wanting to be the middle man in the retail world in that they quite simply want a cut of the business from the 90% or so of retail traders that are going to lose money but there are very few brokers out there offering true ECN liquidity and pricing to everyone, regardless of their account balance. There are some, as we are discussing in this article, but if the ECN model is going to succeed in the retail market, this is the direction in which it has to head.”

The retail ECN model will also have to provide the transparency that is so sought after in the retail market. On the retail side, traders tend to view brokers as a necessary evil, says Van Cleve. “Whether it is a legitimate accusation is anyone’s guess,” he says. “What I do know however is that through transparency, one can prove that the standards they brokers advertise are either legitimate or not. If you’re willing to put your money where your mouth is, there’s nothing to hide behind and conversely if you don’t have anything to hide, why not be transparent?”

Recent statistics from US-based FX rates service Oanda show that more transparent liquidity providers and brokerages have a higher percentage of profitable traders, says Van Cleve. “So it’s not hard to connect the dots between these two glaring obvious facts and traders all over the world are drawing the same conclusions. If you’re transparent you have nothing to hide and if you’re showing everything, it had better be good. When your facts are out there for the world to see, they’d better be good and therefore a company will strive to make it so.”

### More complexity

The institutional side, however, is functioning as it always has, says Van Cleve, but there are more complex algorithms coming into play and more complex routes to liquidity being found. “This is a very cutting edge market that is blending software and hardware in the quest for microsecond execution speeds.” Speed is becoming an increasing factor in the

## Paying for Limit Orders

MB Trading has begun paying 1.95 per 100,000 in currency traded for Forex Limit orders posted that add liquidity to its FOREX ECN. The company consolidates quotes from major bank liquidity providers and customers, displaying them in a fully transparent retail order book. Currently, customers pay 2.95 per 100,000 in currency executed on the MB Trading system. This significant change gives traders further incentive to post their Limit entries and exits on the FX ECN for all other retail participants to see.

"This is the next logical step for our FX ECN," states CEO Ross Ditlove. "Paying for Limit orders continues the drive to a fully transparent and efficient retail FOREX market place. It rewards our retail clients with lower trading costs and deeper liquidity." He says the response to Pay For Limits has been a mix of surprise and excitement and that MB Trading's technology is uniquely designed for this new way of handling orders.

choice of ECN for traders, says Van Cleve. "Speed is cost. If I take a trade at 3504, I've decided that 3504 is the right price for me. In a fast-moving market, any negative deviation from that price will cost me money and speed of execution is the cure for that."

In terms of providing connectivity to ECNs, innovation is key says Van Cleve. "The initial concepts that were employed when building the first retail platform to ECN bridges are archaic at this point. Technology evolves fast. If you're not thinking, planning and developing the future bridging technology today, someone else is. Another key concept that technology providers have to get away from is the one-size-fits-all bridge. For a proper seamless integration that idea is just silly. A proper

bridge integration is not one-size-fits-all, it is far closer to one-size-fits-one."

Van Cleve says that Fair Trade Technology's approach to providing connectivity services and developing bridges is based on quality not quantity. "We're not cranking out a million of these a week. We'd rather produce one a year and have it revered than have a mediocre product and be recognised as such. When it comes to the technology of it all, I say let the tech guys do what the tech guys do. As a trader I do get involved in the technological side in the sense that I say 'traders need this' or 'this would really help a lot of traders'. In the end though the technology company that keeps its ear to the ground and listens to traders needs is the company that will always rise to the top in this business."

### Next generation ECNs

And what are his predictions for the future? What developments are there in the market in terms of new fee structures, new sources of liquidity and what will the next generation of ECN platforms look like? "In my opinion, the next generation of ECN platforms will include something resembling a level 2 quote system complete with counterparties," says Van Cleve. "Although, the fact that there is no centralised exchange in the FX market may make this a nightmare to implement. To some extent this is a concept that is more applicable to the large banks but I envisage that in the future this will be something available to all traders in the forex markets."

Although there are some structural issues to overcome in terms of developing the next generation of platforms, ECNs are the way of the future, says Van Cleve. "Traders want liquidity, naturally, but don't want their broker providing it or being the



counterparty as this poses a conflict of interest. Pooling liquidity providers ensures trade execution at or near the requested price and naturally larger pools and faster trade execution times get them closer to the goal."

Regulation can also be an inhibitor of progress but Van Cleve believes that a lot of the regulatory proposals (particularly those stressing the need for the greater use of central counterparties) would have fallen by the wayside if the ECN model had been more widely adopted earlier on. "I believe regulations were imposed due to some of the unscrupulous behaviour of the typical market maker, closed

loop brokerage model that exists in the majority of brokerages today. While it's doubtful that any of these regulations will be repealed by a market going to an ECN model, this is the route it must take if it is to survive. The ECN model is a fair model and provides incentive for sustainable trading."

### Differentiation in the Institutional space

Hotspot FX is an ECN for the institutional FX market and is focused on buy-side participants that connect to the platform via a prime broker. Along with EBS, Reuters and Currenex, it is one of the main, multi-participant, electronic trading platforms in the institutional space. Whereas EBS and Reuters have their roots in the interbank space and are now recruiting more buy-side users, Hotspot's evolution is more the other way round, where it is now welcoming an increasing number of small and mid-sized banks to the platform, trading in the same way as the buy-side firms and larger banks that have traditionally utilized the ECN.

Historically, the biggest interest in the Hotspot FX platform though has come from hedge funds and high frequency traders, says Bill Goodbody, business manager at Hotspot FX. "We are seeing more interest from a wider range of market participants, including banks and other buy and sell side institutions who are increasing their presence in the FX space. They are



Bill Goodbody

*"I think this makes it an exciting time to be in the ECN space – it is a dynamic environment and the push towards more regulation is part of the general trend we are seeing of the market's acceptance of the ECN model,"*

looking for platforms that are not just single book but multi-contributor and with transparent pricing. This is being somewhat driven by some of the regulatory developments that we are seeing and what might come out of Dodd-Frank in terms of Swap Execution Facilities or SEFs, and how those rules may impact the FX Market – even if not spot directly. And this is what an ECN provides – an anonymous platform with multiple pricing from a wide range of market participants, that is well positioned to meet any SEF requirement that may come forward."

In addition to the type of market participants and the liquidity available on the platforms, another way for the ECNs in the institutional space to differentiate themselves is through pricing models and transaction fees.

"We have similar pricing structures for transaction fees as the other ECNs but we try to absorb as much of the other costs – such as connectivity charges,

technology charges and market data charges. We try to create as little friction as possible in terms of getting clients on board but the issue of charges and fees and incorporating them in our business model is something we constantly look at,” adds Goodbody.

Another aspect of the platform that is constantly assessed is the operational side. “There is always room for improvement,” says John Miesner, head of sales at Hotspot FX. “A lot of the work that we do is what the clients don’t see, in the back office, so that the platform operates as efficiently as possible. In terms of the front-end, continual improvement is important but perhaps not as important as it is in equities ECNs. For example, transaction cost analysis (TCA) is becoming a much sought-after service for the buy-side in the equities markets due to the increased regulatory focus on best execution requirements. And while ensuring that all avenues of available liquidity are explored in the execution process is still something that is pursued in FX, it is not yet mandated to the same extent as in equities.”

## Conclusion

The regulatory landscape is likely to change in FX as it has elsewhere in the financial world and these changes could impact on the adoption of the ECN model, says Goodbody. “There is still a lot to be determined as FX products are brought more in line with other asset classes. For example, while the FX spot market may not be directly impacted by the Dodd Frank Act, there are sure to be many spill over effects that will touch all parts of the FX market. And it is clear that the multi-participant, electronic platforms are what the regulators would like to see more widely adopted by the market,” he says. “Voice-based dealing and single bank platforms are still essentially over-the-counter in nature and the regulators would like to see a more exchange-like environment. And there is also a growing demand for best execution and a more transparent and electronic record of trading activity. I think this makes it an exciting time to be in the ECN space – it is a dynamic environment and the push towards more regulation is part of the general trend we are seeing of the market’s acceptance of the ECN model,” concludes Goodbody.