

Moving Forward in FX



By Harry Gozlan, Founder and CEO, smartTrade

The last decade has seen dynamic and fundamental change in the world's largest and most liquid financial marketplace. Foreign exchange trading was dominated by the banks, providing quotes to customers and trading between themselves through the inter-bank market. Consider a major bank currency trading room, circa 2000—traders were centre stage, telephones in hand as they negotiated with clients and the inter-bank market, and between each other. Screens were in evidence, largely reflecting inter-bank pricing and activity but major market movements resulted in an uproar of activity as traders dealt with customers and proprietary positions.

In the last decade the FX market has grown inexorably, with record volumes being posted in 2010 - \$4,000 billion now being traded on a daily basis, according to Bank of International Settlements statistics. However, today's FX trading room (and it is not necessarily a bank's trading room) is a very different place. Gone is the frenzy of trader activity, replaced by the hum of multiple screens supervised by attentive traders.

Change has been driven by the emergence of currency as an asset class in its own right. Previously regarded by institutional investors as an adjunct to equity or fixed income asset classes, currency is now a major source of alpha for traditional asset managers as well as hedge funds. At the same time, automation has driven a transformation of the currency markets. Originating with single dealer (bank) portals, largely replicating the telephonic client-dealer trading process, electronic trading introduced exchange-like Electronic Communication Networks (ECNs) and algorithmic trading to the FX markets.

With the emergence of ECNs and of algorithmic trading in FX, new market participants have

entered the currency markets – specialist high frequency trading (HFT) firms and hedge funds have become major players in FX. It is estimated that HFTs generate as much as 25% of current market volume. Major banks have responded to the incursion of new market participants through deployment of increasingly sophisticated trading technologies, while buy-side firms are themselves beginning to deploy advanced algorithms designed to generate alpha from short-term arbitrage opportunities.

For all that, the fundamentals of the currency markets have not changed. The essence remains to find enough liquidity in all currency pairs to complete required transactions at the best price and on time, whether those transactions relate to hedging currency exposure or arbitrage generated by proprietary algorithms. In an environment of shrinking margins and limitations on overall market growth, the location of competitively priced liquidity has never been a greater challenge: no longer is liquidity routinely available from any large or medium sized market-maker or prime broker, directly or through white-label electronic platforms. Like any scarce resource, the use of liquidity must be carefully optimised; major market participants need to concentrate as much quote power internally as possible, in order to serve their largest clients in their biggest transactions. Major participants have to decide to whom they will make available liquidity and at what price levels. The days of an open liquidity tap are long gone. For Tier II participants the key is intelligent sourcing of liquidity- this means developing sustainable links with larger firms to guarantee provisioning of all currency pairs necessary to serve their clients as it is now close to impossible for smaller players to themselves support the levels of market-making and risk across

all currencies demanded by their clients.

Fundamental to success in this demanding and fast moving environment is a full recognition of the critical importance and value of liquidity, the raw “natural resource” of the market, and the deployment of an advanced liquidity management system. The strategic imperative is full control over liquidity: advanced liquidity management within the firm and intelligent interaction with external clients and liquidity sources. Every participant in the FX market needs to be able to measure and to control at the micro-level the quotes shown to each client and the risk/return relevant to transactions generated by the quotes. This advanced level of liquidity management represents a significant upgrading from market participants’ existing infrastructures.

At smartTrade, we view liquidity management as comprising five distinct but integrated components. Together these five components provide the basis for effective liquidity management in FX and other financial markets.

First, Aggregation. In today’s complex currency markets liquidity may be available from a broad range of sources, both internal and external. Liquidity may take a number of forms, including orders, prices, requests and quotes. Intelligent aggregation across all relevant sources of liquidity is essential to determining and applying rules relevant to crossing, order routing and best execution. Optimisation of internal flows and the application of advanced algorithm-driven auto hedging techniques are now critical to maximising the value of liquidity. Aggregation is at the heart of liquidity management and needs to be flexible, agile and intelligent, providing full control of flows and execution decisions.

Second, Distribution. Long gone are the days when market intermediaries could operate with a two or three tier pricing system for their client and counterparty base. Today’s competitive FX markets require that customised pricing be applied on a client specific basis. Distribution may be required on an internal and external basis and may encompass market data, trading limits information as well as price or spread data. Scalability is a fundamental requirement for the distribution engine.

Third, Matching Engine. An advanced matching engine capability is central to liquidity management. Depending on user needs, a matching engine must be able to support a wide range of order types and execution criteria. A matching engine must support crossing, internalisation and dark pool environments and be both fast and scalable. It is critical that a firm has the ability to monitor, withhold and control its own liquidity before offering liquidity to clients or other market participants.

Fourth, Order Routing Capability. Given the range of execution venues in today’s FX market, from banks to ECNs to HFTs, smart order routing (SOR) capability is a fundamental requirement. Flexibility and full order lifecycle management are prerequisites for SORs.

Fifth, Connectivity. A Trading Connectivity platform provides a seamless linkage to execution venues and other sources of liquidity. In the FX market connectivity is required across a range of banks, ECNs, HFTs and buy-side institutions.

In an increasingly complex and demanding FX market, banks, ECNs, HFTs and buy-side firms face a build or buy technology dilemma in relation to liquidity management. smartTrade’s experience is that firms are questioning the expensive and resource hungry internal development route in favour of vendor software components which can be customised to suit specific client requirements. Open application programming interfaces ensure that the components can be readily integrated with existing and future applications and can be implemented relatively quickly. smartTrade is moving with the user interface trend and we have rebuilt the front end of our liquidity management system using Microsoft’s Silverlight development platform. Our technology is not prescriptive and can be used as a base on which clients can build their own sophisticated, but not too expensive, user interfaces.

At smartTrade, we welcome the complexity, dynamism and ongoing innovation of the FX market and look forward to our continuing involvement. Next time you visit a currency trading floor, remember that beneath that calm exterior an advanced liquidity management system is hard at work.