Liquidity, Independence, Analytics and Transparency

Why some Institutional FX ECNs still stand out from the crowd

Nicholas Pratt explores why Institutional FX ECNs are appealing to increasing numbers of trading firms many of whom value anonymity, low-latency and the ability to use special order types.

In 2015 it was widely considered that FX electronic communication networks (ECNs) were in a sweet spot. The apparent ease of trading offered by ECNs was cited as a crucial contributor to the growth in FX market turnover during the last decade to the plus $5 trillion traded every day. The potential for FX ECNs was seemingly spotted back in 2012 when an unprecedented number of new FX ECNs or trading platforms were launched. Depending on your definition of an ECN, there were as many as eight debuted in the opening half of 2012. The attraction of an ECN is easy to see – primarily there is the independence and flexibility compared to a single dealer or counterparty, an advantage that was all the more apparent following the SNB crash in January 2015. Others will cite the depth of order book on an ECN, the multiple order types, the customised liquidity pools and the trading anonymity. And then there is the technology.

By using an ECN, FX traders can get access to deep and diverse liquidity, aggregation and execution through an ECN rather than having to build this functionality themselves.
But while it is easy to build the case for the ECN against the single dealer platform or against building your own, in-house multibank trading engine, the question is how all of the ECNs will be able to compete against each other. And, as deep as the FX market may be in terms of liquidity, can the market really support so many ECNs in perpetuity?

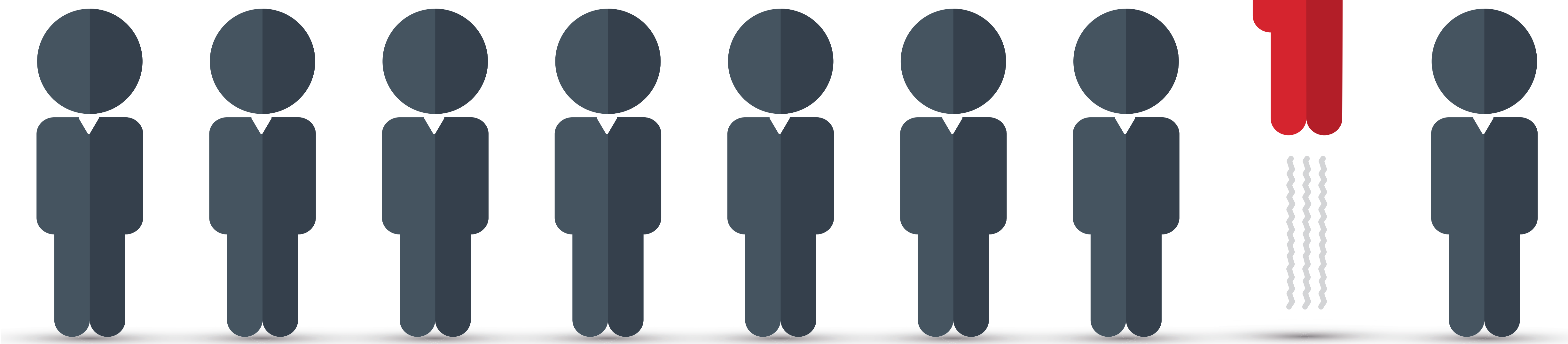
TRANSPARENCY

Use of ECNs has plateaued in recent years and as the market becomes more competitive, the latest battleground is 'transparency', says Tim Cartledge, Head of FX and Product Management, NEX Markets.

"Institutional and real money clients have a fiduciary duty to get best execution so they are more interested in transaction cost analysis, expected cost analysis and optimal ways of netting their portfolios," says Cartledge.

NEX Markets has just launched a new service designed to show more transparency in the netting process to reassure clients that they are not being disadvantaged through this process. The NEX Quant Analytics service is available to clients trading on the EBS platform.

"Through the use of analytics, you can show the true costs of execution," says Cartledge. "That is the theme – analytics, transparency and data. It is the new



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battleground for ECNs and it has been hotting up over the past year. Banks have been using analytics for 15 years or more but our clients are coming to this relatively late."

EBS Direct's analytics service also covers market impact, last look rejection rates, where markets traded, order book arrival times, spreads, liquidity at the top of the book and what clients are paying relative to others that trade through the ECN.

According to NEX Markets, the service is the most comprehensive, community-based analytics tool for its clients. And while banks and other platforms may use similar analytics internally, there has not been a comparable service for analysing data at a market level, the company says.

Size is a factor in such a service, says Cartledge - the bigger the ECN, the better the data, citing the EBS "ecosystem". And while initially clients just wanted a simple and standard set of reports it can very quickly get complicated when more complex requests are made.

For example, it is possible to analyse the market impact for each trade; whether you overpaid or underpaid; of what was paid, how much was used for hedging; and the level of last look rejection rates and the cost of these rejections. Ultimately the service is designed to benefit both liquidity takers and providers by helping to create long-term, sustainable bilateral trading relationships at a time when such relationships are under threat, says Cartledge. "FX is a relationship-driven market where the relationship has all but gone. Some liquidity takers don't care where the prices come from as long as they are the lowest. There is no common language," he states.

RELATIONSHIPS

As electronic trading has increased and the use of aggregation has grown, there has been a tendency for liquidity takers to look solely at price and

Tim Cartledge

"Through the use of analytics, you can show the true costs of execution. It is the new battleground for ECNs and it has been hotting up over the past year," not consider the total cost of trading or to view daily prices in a wider context and within a longer timeframe.

Additionally, the 'relationship' also has to be considered – ie, whether your counterparty will still provide liquidity at times of market stress.

Cartledge says that by providing more transparency, clients and liquidity providers can more easily assess each other's behaviour and the quality of their relationship. "Everyone will hold everyone else to account, not just the LPs but also the clients."

But while the data will tell a story, it will not tell the whole story – it may give an idea of 'what' but not 'why'. To answer that question will ultimately involve a conversation between the liquidity provider and the client.

For example, a client may ask why they are being charged more than the average rate or why are they suffering high market impact. It may be down to the types of currency pairs or the time and manner of trading. Or it may be down to the way the liquidity provider is hedging. "Everything boils down to the transparency and the strength of the relationship," says Cartledge. "You build trust by giving them the same information and not being too prescriptive."

An ECN can also play an important role in maintaining a relationship between counterparties

Transparency is likely to become a more prominent feature for the FX market and the most useful tool for ECNs to address some of the market's concerns that have arisen in recent years, such as trading in their own liquidity pools, artificially higher matching or opaque last look rejection policies.

But while most ECNs should have the capability to offer more transparency, not all may have the willingness, says Cartledge – either they may be embarrassed by the extent of their rejection rates or they may not be willing to divulge the extent of order routing in their own liquidity pools.

Consequently, the level of transparency offered by ECNs through the availability of analytics may become an important differentiator and, as Cartledge says, the best way to encourage good behaviour and long-lasting relationships between market participants.

DIRECT ACCESS

When a market becomes more competitive, it can lead to consolidation and acquisitions. Cboe FX may be a relatively new name on the FX ECN market but its offering is one of the most established platforms. Back in February 2017 CBOE Holdings spent $3.4bn on the acquisition of Bats Global Markets which had itself acquired the institutional FX ECN Hotspot back in March 2015.

"Trading via an ECN allows for true price competition among a diverse pool of participants and the ability to see – in one centralised location – the full depth of book," says Bryan Harkins, Head of U.S. Equities and Global FX at Cboe Global Markets. "A growing segment of the FX market now sees the value of being able to access the FX marketplace directly via an ECN, rather than just accessing liquidity through multiple single bank relationships."

The key attributes for an FX ECN are anonymity, deep liquidity, solid market quality and cutting-edge technology via a single and cost-effective connection, says Harkins. And from a technology perspective, it is also important for an ECN to provide liquidity aggregation, thereby eliminating the need for institutional FX traders to maintain numerous direct connections to multiple liquidity providers. Furthermore, an ECN should also allow participants to add liquidity to the book, joining the bid/offer and avoid paying the spread. To this end, Cboe FX provides pegged orders to its clients, says Harkins.

And from a liquidity perspective, it is important for an ECN to have a broad array of participants, says Harkins. "It is the diversity of order flow and a competitive environment that improves market quality for all participants. Bringing together different types of customer flow provides greater opportunities to access best prices across an otherwise fragmented global marketplace."

"We want the market to be more robust, open, liquid, and transparent so that it better serves the investing and trading objectives of all participants,"

Bryan Harkins

As FX is a decentralized and OTC market, it can be more complex than exchange-based markets, says Harkins. "An ECN can be leveraged by participants to outsource much of that complexity (both technology and execution complexity), and we welcome our customers' appetite to do so."

He also recognises the need for ECNs to manage the overall trading experience for its clients by offering customized liquidity and improving the quality of fills. "Today Cboe FX manages the liquidity profiles of both market makers and takers. For takers, Cboe FX has introduced and published market maker standards to ensure that the liquidity its customers interact with is accessible and real. For makers, we can measure the quality of order flow they interact with to ensure all trading is mutually beneficial."

Just as NEX Markets has placed more importance on the use of analytics, one of the core areas of focus for Cboe FX has been building out their liquidity management and analysis capabilities. "Our liquidity management team works closely with clients to review analytics and helps instruct them on how they can execute their orders to improve execution quality. Because Cboe FX is an anonymous platform, we are able to share anonymous data with clients to help them understand the impact or opportunities that exist if they execute an order in a certain manner," says Harkins.

While there are many factors for clients to consider before partnering with an ECN – from access and connectivity, securing credit lines, market

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quality, technology prowess, and operating standards, to name a few – Harkins also feels that transparency will be an increasingly important area for clients. “That is why we have put in place operating procedures and market maker standards, so participants know exactly how our marketplace operates and what the expectations are of our participants.”

As FX is a decentralized and OTC market so it can be more complex than exchange-based markets

The focus on transparency can hopefully enable ECNs to combat some of the previous issues of concern raised by some market participants, such as trading in their own liquidity pools, offering asymmetric slippage rules and creating artificially higher matching rates.

“Transparency is a core part of our business and we have always been focused on the highest standards of disclosure and fairness. We are able to maintain a transparent marketplace with full depth of book, guided by a straightforward set of rules made available to all participants. Additionally, on Cboe FX customers have complete anonymity throughout the trading process from pre- to post-trade, which we believe is critical to creating a fair marketplace. Our matching logic is transparent, with all orders on Cboe FX prioritized by price/time, with firm orders taking precedence over non-firm. Our clients have complete control as to who they interact with on the platform. We want the market to be more robust, open, liquid, and transparent so that it better serves the investing and trading objectives of all participants,” says Harkins.

The other battleground for FX ECNs, in addition to transparency, remains technology and its ability to enhance capacity, improve performance and reduce latency. Harkins says that Cboe FX has managed to halve its ACK times (an important measure of throughput) in the last 12 months – and plans to reduce these further before the year-end.

Cboe FX has also looked at ways to address latency issues on their clients' side. “While our platform is well-engineered to handle a very high capacity, our end users aren't always equipped to absorb that level of quote traffic and access that liquidity in an efficient manner. To that end, we have worked to provide solutions so that customers can absorb increasing peak message rates by introducing features like a top-of-book feed, limited depth-of-

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> "ECNs have long been a utility service. They need to evolve to span the breadth and depth of offerings needed across complete FX lifecycle,"

Vikram Srinivasan

book feed and QuoteModify, which reduces quote traffic," says Harkins.

CREDIT FACILITATION

Facilitating credit (access and mitigation) is also an important feature of an ECN, says Vikram Srinivasan, Global Head of Spot FX at 360T. "An ECN is a marketplace that brings together participant interests through varied credit facilitation mechanisms, under different disclosure models. Low latent trading infrastructure and options for risk exchange (such as trading protocols, order types) are 'hygiene' factors that in itself does not guarantee success of the marketplace, but rather enable participation. Anonymity is merely a bi-product of Sponsored Access credit facilitation, and in itself is not a driver of participation in an ECN."

The 360T ECN has targeted participants who were challenged for market access due to the limited number of credit counterparties, says Srinivasan. "By decoupling credit from provision of liquidity, such participants have been able to leverage their credit counterparties for access to quality liquidity from a wide range of liquidity providers."

The real value of an ECN stems from an efficient credit facilitation framework that can ensure maximum interconnectivity of participant interests, says Srinivasan. "Fragmentation of credit results in fragmentation of liquidity and hence hinders efficient risk exchange. Which is why, a participant on 360T can, through a single credit line, gain access to an entire portfolio of order flow for liquidity providers, or gains access to all liquidity on the venue for traders. In an era of constrained credit, consolidation of lines culminates in their efficient usage and facilitates unhindered access to deep, tight liquidity. The beauty of an effective credit facilitation framework is that it takes relatively little effort to enrich or extend the mechanisms for risk exchange, to better match participant intent with liquidity, enabled by data and technology."

Newer ECNs such as 360T also have an advantage over some of the older, more traditional ECNs in terms of a more diverse range of participants, says Srinivasan. "Traditional ECNs started as such, as they offered a simple path to scale the marketplace. As a result, they lack the breadth and diversity of participants. Primary marketplaces and ECNs are considered neutral venues for price discovery. However, fragmentation resulting from inefficient credit facilitation and the lack of real unique order flow dilutes this value."

In contrast, a venue with a diverse client base brings unique order flow which translates into more accurate view of the interests in the market and hence more effective price discovery. This diversity also facilitates risk exchange between participants who may not be able to otherwise come together, such as two traditional buy-side participants passively exchanging interest, says Srinivasan.

BEST EXECUTION

ECNs have also become the most effective way for clients to achieve best execution, say the ECN operators. "A market operator is uniquely positioned to observe participant intentions and liquidity quality of service," says Srinivasan. "In an undisclosed marketplace, it is the market operator's responsibility to bring these interests together for risk exchange transaction that is beneficial for both parties. The venue can tailor and curate the liquidity and trading mechanisms to the participant's execution style and desired outcomes, be it large-sized Immediate or Cancel (IOC) executions at best price, or full amount risk transfer, or passive risk offsets."

Despite the anonymous nature of the execution, an ECN can also play an important role in maintaining a relationship between counterparties if it takes on a more consultative role, says Srinivasan. "The lack of a relationship between trading participants is bridged by the market operator assuming the role of a liquidity manager to guide liquidity counterparties to tailor liquidity and price to be competitive, and attract profitable order flow. The market operator also stands to advise the trading counterparties on directing order flow into appropriate liquidity pools through effective execution styles to achieve the desired trading outcomes, be it best price, fill ratio, market impact, or any combination of these. 360T delivers superior analytics across all of these dimensions to enable effective matching of participant interests"

And just as with other ECNs, Srinivasan also believes that transparency is a crucial element in helping ECNs to counter any concerns about trading behaviour, execution inconsistency or liquidity manipulation. "360T fundamentally believes in transparency and allows clients complete discretion in managing the parameters driving the execution algorithms. The client is then provided transparent reporting on how each order was handled, what the market conditions were, how the algorithm behaved in accordance with the user defined strategy, and what were the outcomes in terms of execution quality and transaction cost. 360T is regulated by the German Federal Financial Supervisory Authority (Bafin) and adheres to the highest standards of transparency for an OTC marketplace," he says.

Srinivasan also believes that an ECN's history of operating a transparent and regulated marketplace is one of many factors that should be considered by institutional participants before partnering with one. Other considerations include 'hygiene' factors such as connectivity, maintenance, execution quality and the value added by the ECN comes from longer term reduction in cost per transaction "When the market interaction intentions do not match the appropriate quality of service of liquidity, the longer term result would be increase in transaction costs

Solid FX – an ECN built from the ground up

The Solid FX ECN launched eight years ago in the Netherlands and was founded by Diego and José Baptista, two brothers with a background in FX and equity trading.

"Technology is our day to day job. We build our ECN completely in house, so we are not dependent on third parties."

They believed that the business model of existing FX ECNs could be improved by focusing on tailored liquidity – spot FX and metals only – and investing in relationships with clients and partners.

"To us, the relationships with our clients and LPs are at least as important as performance and price competition," says Marco Westerman, Solid FX's Head of Relationship and Liquidity Management. "We invest a lot in analysing and managing LP-client matches. It is not always easy to keep everybody satisfied, but we always aim for long term business success for all parties involved."

"Another important aspect of our relationship management is good customer support. Our operations team is very knowledgeable about the technical side as well as the trading side of our business. Oftentimes, the quality of support suffers as a company grows larger: clients have to wait longer, get referred to different people and deal with a lot of red tape. That is not how we would want to be treated, so we take care to do it right for our customers."

Solid FX is essentially an IT company. Westerman: "Technology is our day to day job. We build our ECN completely in house, so we are not dependent on third parties. That give us an edge over the competition and allows us to be flexible in our infrastructure choices. It also means that the quality of the Solid FX platform is in our own hands, so the IT guys really have to be on top of the curve."

Solid FX continues to grow. Not only has the workforce doubled in size in the last two years, the company is set to launch a trading hub in TY3 (Tokyo) in addition to their existing hubs in London and New York.

"We invested a lot recently in new, faster and more robust hardware," says Westerman. "And we are expanding, as we see demand for our services in Asia."

When asked about the client base, Westerman replies: "Years ago, it was mostly broker/dealers and trading houses. But now the client base is much more institutional – asset managers and regional banks – and much more global. These clients have different requirements, for example, our liquidity managers are now very focused on keeping the rejection rates as low as possible."

Westerman agrees that transparency is an issue in the market. "Transparency is paramount at Solid FX: there are no unexpected or hidden costs after the fact. On the technical side, clients can connect to our interface directly or use our trading GUI. It is not necessary to use a third party infrastructure provider, so our clients don't have to pay additionally for infrastructure either. All of this keeps our pricing structure very clear.

"And finally, we send our clients monthly reports with their trading results. Though the counterparties remain anonymous, as is the nature of an ECN, the client is able to analyse their performance and go into specifics with our liquidity managers. The FX business is complicated enough, so we try to keep it as simple as possible for all involved."

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(by virtue of deterioration in spreads, longer hold times, market impact) and much worse, loss of depth. To ensure a sustainable outcome in the longer term, the market operator needs to actively steer participants," says Srinivasan.

A good ECN should also invest in new technology to ensure performance, improve capacity, reduce latency and enhance their core value propositions. But, says Srinivasan, the real differentiation with an ECN comes in terms of their ability to possess unique sticky order flow, and non-discretionally (through data and analytics) match participant intentions to appropriate liquidity pools through optimal execution strategies. "For example, anyone with technology can run a matcher, or a mid-book, but without unique order flow, it will merely be a recycled pool from other markets. On the other hand, possession of real order flow creates unique liquidity in itself can be channelized into new market models for execution," he says.

And when it comes to positioning themselves for future growth, ECNs need to expand their focus to cover more services within the FX trading world, says Srinivasan. "ECNs have long been a utility service. They need to evolve to span the breadth and depth of offerings needed across complete FX lifecycle. And by looking at the complete lifecycle, opportunities are presented in addressing challenges in the marketplace that far exceed simple execution management. And only by solving such challenges can clients reduce the total transaction cost beyond simple execution cost savings. Those venues that do address the big picture will see their client base grow in both size and loyalty," he concludes.