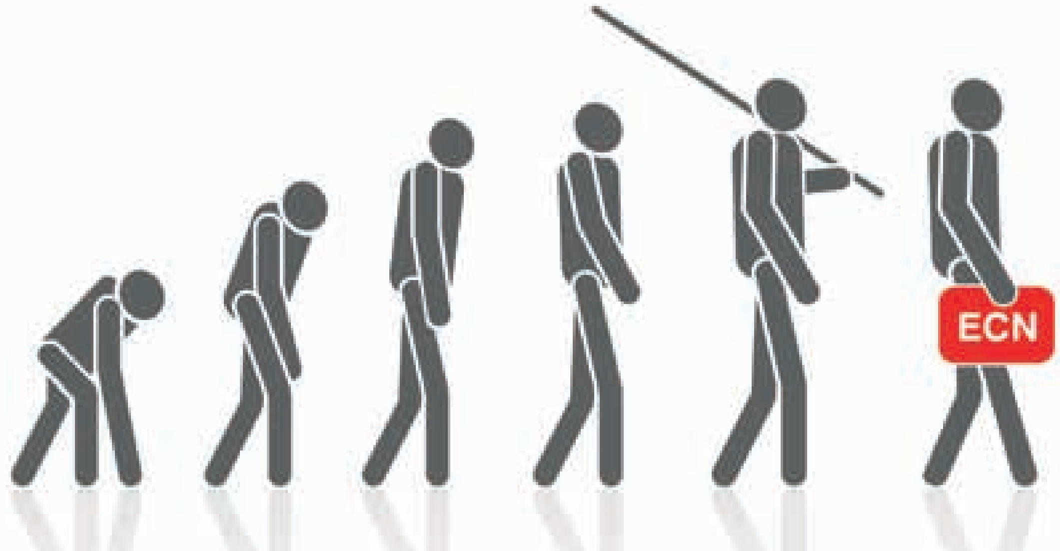

Survival of the Fittest – what's coming next in the evolution of FX ECNs?

Electronic communication networks may be in the FX market sweet spot right now but Richard Willshire sets out to discover whether they can all survive.

Institutional FX ECNs seem to meet most market participants' needs. Some ECN executives suggest that the doubling in FX market turnover in the years 2005 to 2010 and the redoubling in the five years to the $5 trillion a day to date is in no small measure due to the ease of trading that ECNs deliver. Every ECN will argue that they are the best, most effective, most efficient, low cost offering but in the fight for volume, better players will clearly survive while other will inevitably fall by the wayside. So what is the fundamental appeal of the ECN model?

WHY ECNS?

"As a general trend, trading across most major asset classes is moving towards anonymised, lower-latency trading," says Bill Goodbody, Jr. Senior Vice President, Foreign Exchange at BATS, since March this year owners of the Hotspot FX platform. "This is most obvious in the equities market, which is now fully-automated, but it's also increasingly the case in the global foreign exchange market. Here, electronic trading lends itself to trading highly-liquid, concentrated pairs across fragmented markets in a 24-hour trading day – and lower-latency and greater levels of anonymity are by-products of that."

"Customers appreciate the independence that ECNs represent," adds David Newns, Global Head of Currenex. "They are not dependent on a single counterparty to provide liquidity and execution technology. This requirement was highlighted this year in the SNB move. Dependence on a single provider is a perilous position to be in. ECNs provide a breadth and depth of reliable liquidity."

Moreover the recent regulatory censure and fines meted out to banks operating in the FX market has hastened the move of both market makers and takers to ECNs.

"The behaviour of banks has highlighted the sense of purpose for ECNs in the marketplace. And how integral we are at times of stress to the market," comments Darryl Hooker Head of EBS Market. "We saw some dramatic and traumatic events on 15th January with the Swiss Franc and also the spike on the Euro. This has helped to remind the market of the need for a central utility. A primary source of reference, price discovery and execution. Moreover looking at the number of elections coming up in 2015 / 2016, events around the Euro and the US we would expect to see a number of other disruptive events to occur. What happened with the SNB could be replicated in Copenhagen or in Hong Kong, with any pegged currency in fact. It reminds people that they do need to come to one point. And also for the regulators and central banks it is very important for them to be able to understand how the market ecology works through those events and they need visibility and transparency."

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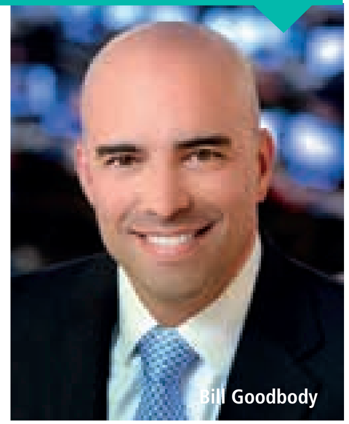


If this then is the *raison d'être* for ECNs, what do market participants gain in terms of practical advantages from signing up with one? John Miesner, Global Head of Sales at GTX, GAIN Capital's ECN, summarises them succinctly, "Anonymity, depth of book liquidity, multiple order types and the ability to have customised liquidity pools are all advantages to using an ECN such as GTX. But most importantly, no one client is subjected to trading on a specific bid-ask spread. Every GTX client has the option of placing limit and market orders."

Ryan Gagne responsible for otcXchange in the US for Divisa Capital, places these benefits in historical context. "E-FX is a 15 year-old business. The thing with it is that if market participants don't use an ECN they have to go out and buy or build a new system of their own but they can acquire this for little or no cost from an ECN. A decade ago you had to spend $250,000 to put in a connection to get a single price feed. Now you don't even buy the connection, you see it right on the screen. E-FX has been around for some time but more and more clients are now looking to get unbiased, multi-provider pricing. People come to us for example because they feel that the market is true. They don't feel that the deck is stacked against them. They are looking to level the playing field. And the bigger the playing field in terms of market participants, the more likely it is that the market itself will be true in reflecting a wide range of available information."

MARKET DIVERSITY

"Having a mix of clients that are all trading currencies for their own reasons and as part of their respective strategies, with the end game being an executed transaction, is the best possible outcome for all parties involved" suggests John Miesner at GTX. "In addition, the natural depth of book that is created by client diversity enables orders to be executed in a much more expeditious fashion."

"Any ECN is looking to create a virtuous circle," says Currenex' David Newns. "A differentiated, rich liquidity ecology is a robust one. As a platform you want to nurture as diverse a client base as possible so that their differing requirements ensure that the activity in your market has as little correlation as possible. The less correlation your marketplace has the more attractive it is to others who want to join that pool in that virtuous circle. Our pool includes our white label brokers, banks and hedge funds and asset managers who are makers and takers; so the pool is extremely diverse."


David Newns

"Dependence on a single provider is a perilous position to be in. ECNs provide a breadth and depth of reliable liquidity."

At EBS Market Darryl Hooker tells a similar story, "The size of our community and the diversification of it is very useful. We are always able to offer a number liquidity providers. And there will always be a consistent level of service coming through the EBS Direct channel as well for those who prefer to trade disclosed rather than anonymously. On EBS Market we have that great spread of buy-side and sell-side institutions. So we are giving strength, visibility and price compression to our pricing and it is very hard to compete with that. Moreover within ICAP we have the options of both electronic and voice broking all in one house."

While competitive pricing is vital, it is by no means the whole story. Now, as never before, clients seek the best, most suitable outcome from their engagement on a platform.

BEST EXECUTION

"Best execution is in the eye of the beholder," according to Ryan Gagne. "It is about what is important to each individual firm. An ECN gives them the tools. Does every trade need to be done on an ECN? No because it defies best execution. Best execution in my view is to get the best price, at the least cost with the least amount of market impact. It all depends whether you are dealing 200,000, 2 million or 2 billion of base currency. It varies depending on what you are trying to do."

"In a fragmented market, ECNs enable customers to execute against multiple providers and that's an important aspect of best execution," explains David Newns. "We at Currenex pull together the broadest range of liquidity to meet the customer's needs. It's essential to be able to leverage credit lines as effectively as possible to access to the broadest, deepest liquidity available to you, and have the confidence in the strength and breadth of your trading platform to ensure that it's always there when you need it. And as a platform provider we have to be able to prove this to the customer and so sophisticated reporting both for ourselves internally and for our customers is crucial. Customers are becoming more sophisticated in analysing total cost and the market impact of their trading activity in being able to show how they are going about achieving best execution. But it's not just about Executable Streaming Prices (ESP), Request For Quotation (RFQ), anonymity, lower latency, diversity, hidden orders, disclosed and undisclosed liquidity, advanced order types or technology and transparency

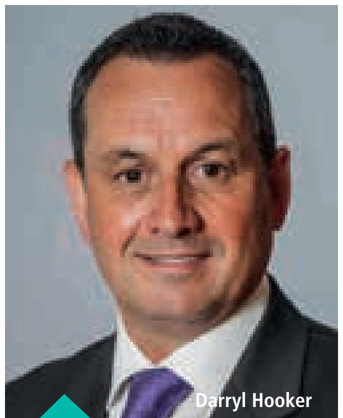
– these are all tools that help the customer to achieve best execution."

Given the breadth of definition for best execution there needs to be close communication between client and platform to ensure that the client can explain their needs. Consequently a consultative approach is inextricably linked with best execution and this is also an area where individual platforms can differentiate their service from that of their competitors.

CONSULTATION AND DIFFERENTIATION

"It's one of the benefits customers are getting when they are coming to otcXchange," says Ryan Gagne. "If they tell us what their trading style is and what their definition of best execution is, we can help find the right liquidity for them. Some ECNs have one big pool, it may be segregated but essentially you are getting all of it. We can define certain regions within our pool and create sub-pools or pools of pools. So we could cater towards high frequency traders (HFT) or a larger ticket type trader. We have general pools, pools that have last look or re-pricing. We put those with similar or complementary trading styles together. Market makers will say that they like to price to these types of clients. So they are working with us to service their chosen client types. We also say to buy side clients, "Do you want us to improve you execution quality, find liquidity that makes sense for you to trade with?" If they say, "show us everything and we'll filter it ourselves," then we do that. They may have the tools to do that but those tools cost money and we can do this for them at no cost, so there is benefit for them there."

The natural depth of book that is created by client diversity enables orders to be executed in a much more expeditious fashion



Darryl Hooker

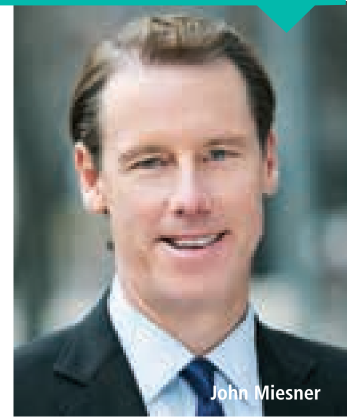
"On EBS Market we have that great spread of buy-side and sell-side institutions. So we are giving strength, visibility and price compression to our pricing and it is very hard to compete with that."

David Newns says Currenex performs a similar role. "We've always supported a consultative approach to customer services as a result of our extensive white label business. As markets and customer requirements become more sophisticated there has to be a more consultative approach to customer and liquidity management. Our integration and support team works closely with the customer to determine their preferred execution mode, their preferred order types so they work with liquidity providers and takers to make sure that the customers' requirements can be met."

Other platforms we spoke with for this article also argued that their consultative approach was what differentiated their services in the market place. This poses a conundrum to potential clients when choosing a provider from among platforms that have broadly similar offerings.

"It is unwise to paint all ECNs with the same brush," says Ryan Gagne. "They do not all deliver the same services and those are the major differentiators and the reason to get an ECN in addition to one someone may already have. The one they already have may cater for particular types of customer, type of orders or geographical area. You may want a second to service other particular needs that you may have."

"At the core of any sustainable ECN offering must be the ability to meet each individual client's specific trading needs, along with cutting edge technology and order management capabilities"



John Miesner

The key for potential customers is to carefully analyse each platform and gauge which approach most closely matches their precise requirements. Those requirements will very often revolve around regulatory demands, particularly for banks and other regulated businesses. However technology may be an important selection criterion as well. Joining a network with technology that is either likely to date or which is incompatible with in-house systems will likely be disruptive to install or will not keep pace with systems as they are upgraded. Not surprisingly ECNs are quick to talk about their technology edge.

TECHNOLOGY

"Equity traders have been putting more transactions on ECNs for decades," continues Ryan Gagne. "More liquidity, non-bank or non traditional market maker activity, the client has the ability to work their own orders instead of going through a trading desk. They can use more technology for smarter order types. Some of that innovation is in play on some ECNs like ours with enhanced order types. We utilise not only FIX 4.2, which is the standard but also FIX 4.4 and we support over 30 order types."

GTX is similarly active in forging ahead on the technology side as John Miesner explains. "Over the past six months GTX has decreased acknowledgement times by 60 per cent, thus greatly decreasing latency and improving performance. Additionally, we have rolled out a "blocking by currency pair" feature, which is a core component of the strategy for many of our market making clients. GTX will also be providing a streaming market data feed that will run in parallel to our existing FIX market data feed. Providing streaming data will greatly improve fill ratios for GTX's data sensitive clients."

So too at Hotspot which is working on a number of initiatives. These include the planned launch of a London-based matching engine in London's LD4 data centre as well as the planned migration of its New York-area matching engine to the same New Jersey data centre where the five BATS U.S. markets are located. "One of the leading benefits of joining with BATS is the company's long time focus on creating proprietary technology which helps to optimise trading for participants in various asset classes," says Bill Goodbody.

Considering the commitment that ECNs are making to technology development it is far from easy to pick the winners and the losers in the battle for ECN market share of global FX trading.

Competitiveness between platforms is intense in this space

Ryan Gagne

"It is unwise to paint all ECNs with the same brush. They do not all deliver the same services..."

FAST FORWARD

Researchers at the AITE Group recently stated, "E-FX market fragmentation will remain as exchanges take greater interest in OTC FX and banks relinquish their market-making role. The FX marketplace will continue to evolve and become recognised as a stand-alone asset class, yet it remains both fragmented and dynamic. Since 2013, volume at Bloomberg's FXGO business and FXall has sharply risen. Meanwhile, a number of emerging players managed to grow their books of business despite a soft spot FX market."

So what do providers say?

"From GTX's perspective, says John Miesner, "our ability to provide tailored liquidity solutions for our "taking" clients and optimizing flow for our "making" clients is the reason we have seen such significant user and volume growth in recent years."

At Currenex David Newns view is that competitiveness between platforms is intense and that innovation is key to survival in this space and this and technical capability is in the DNA of his business. "In 5 years time there may be more consolidation. Bear in mind that increasing demands are being placed on platforms in terms of regulatory overhead, which we are certainly experiencing in the US with Dodd Frank. In Europe new rules coming into play with MiFid II also place significant demands on a platform and we expect EMIR will be demanding too. So it is questionable whether all of the ECNs that are currently extant will be able to mange their businesses with such demands being placed upon them by the regulators. Becoming a multilateral trading facility (MTF) is not a trivial exercise. This could be a factor in driving consolidation or perhaps, failure."

"We believe Hotspot is well positioned to reach our goal of becoming the #1 FX ECN," says Bill Goodbody. "We offer award-winning technology, aggressive pricing, leading customer service and are now backed by a BATS team which boasts the #1 stock exchange in Europe, the #2 U.S. market and the fastest-growing U.S. options exchange. The ECNs who fall short will be those who are unable to scale and forget to put their customers first."


Jeff Ward

> "Some of the ECNs are now 10 years old and their technology could be vulnerable to new disruptive technologies that come in and provide a broader or better offering."

Ryan Gagne of Divisa Capital says, "Some platforms will fail, they will go away. If they don't evolve with the client, the client will find the next evolutionary thing. And fortunately our clients are evolving. Our competitive advantage is that our platform was built by innovators in the equities ECN space, people that had been doing this for more than a decade. So we took that quantum leap on day one. And we continue to take from the equity space what makes sense in the FX space."

Finally, at EBS Jeff Ward, Head of EBS Direct adds, "I think we'll see a couple of strong market players. There will be niche players. Some will survive, others will probably be acquired. I think there could be a place for niche brokers, niche ECNs but I think it is going to gravitate towards the larger entities. They've got the ability, knowledge and the reputation. Also some of the ECNs are now 10 years old and their technology could be vulnerable to new disruptive technologies that come in and provide a broader or better offering. It will be more difficult for a marginal player to make the new investment. So I think there will be shake out that will happen over the next 5 years and we've seen signs of that already post January 15th."

CONCLUSION

In conclusion, there seems little doubt that ECNs are going to garner the lion's share of global e-FX turnover. Single bank platforms will run in parallel while the ECNs will offer the additional routes to market.

Regulatory requirements and audits of best execution will bolster the ECNs proposition, yet the question remains as to how many ECNs the market can support. An alternative question is: will it be viable for ECNs to survive in their current form in an unconsolidated market, given the costs of supporting and innovating their platforms against a background of price compression? Every platform is determined to fight its corner in the market however and the outcome looks certain to benefit market participants in the long run.