Tradition

Market Structure Evolution – Helping the Market Create Solutions

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As 7,000 of the great and the good from across the financial services industry descended on Boston in September for the annual SIBOS conference, one theme above all dominated the speeches, panels and bar conversation: The three 'Rs' of regulation, regulation, regulation.

"Why can't they coordinate their reforms together?" opined one senior fund manager.

"We're having to report transactions to multiple bodies and it is costing us millions. How many ways can you report the same information to different entities?"

Much of the focus has been on regulation and attempting to increase oversight in financial markets – a mammoth task that spans multiple sectors, asset classes and jurisdictions. It hasn't always been a seamless process – despite the best efforts of international regulators to coordinate and shape financial reform – but if you talk to market participants today, few would disagree that regulators have made significant steps towards their aim of introducing more transparency and better risk management.

The need for regulators to produce a coordinated approach that resulted in timely, globally harmonised regulation was echoed time and time again in the panel debates. While it may be fair to question the regulators' methods, and the lack of consistent regulatory change on a global scale, the industry should also be asking what it could do to assist them in their task.

Certainty and confidence is the lifeblood of our industry, and a common bugbear that negatively impacts core requirements and causes continued frustration with a cross-section of the market is the lack of regulatory harmonisation and global coordination. The regional discrepancy of rules in particular has resulted in numerous unintended consequences, such as fragmentation of liquidity, inefficient trading, higher costs and a theoretical increase of global systemic risk.

However, the reality is that, while financial markets are global in nature, regulators by necessity must maintain a regional or jurisdictional focus. Although this adds numerous challenges and complexities that need to be overcome in the regulatory reform process, it leaves a gap in the market. Individual firms that are globally operational have the opportunity to take the initiative to shape a new trading mentality underscored by best practice and technological innovation.

A recent report from the Financial Stability Board (FSB) highlighted the benefits of the industry developing its own solutions[1]. In recent years, Tradition, one of the world's largest and most diverse interdealer brokers, has worked in tandem with the industry to reinvent trading in both OTC derivatives and foreign exchange – markets that have come under intense scrutiny in recent years. By recognising early on that the regulatory vacuum and inefficient structure that had become prevalent needed to be addressed, Tradition tapped into its global network and resources to implement collaborative, industry-backed solutions that

[1] FSB Report on Foreign Exchange Benchmarks, September 2014

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did away with regional borders – providing the global standard for boosting transparency and fairness, eradicating improper behaviour, and ultimately, creating a level playing field that applies to all participants globally.

By drawing on the two biggest assets of the financial services industry – people and technology – and marrying the two together with intelligence, coordination and creativity, Tradition has delivered industry-led solutions designed in collaboration with the market that not only complied with, but exceeded the requirements of regulators while meeting the needs of participants. The impact to date has been tremendous, and as noted by the FSB earlier this year[2], such solutions can prove to be more effective than hard regulation and prescribed laws.

Finding the sweet spot in foreign exchange

The global foreign exchange market is worth $5.3 trillion per day[3] and underpins the stability of the whole financial industry. As one of the largest and most liquid markets in the world, it is integral to the function of other markets, and more importantly, the underlying global economy. It is therefore critical that it continues to operate efficiently.

In recent years, the market landscape has changed. The electronification of spot FX markets, in moving with the times, has undoubtedly benefitted the industry significantly, enabling more effective risk management, wider participation and deeper liquidity. However, it has also brought with it a new set of challenges – whilst the migration towards electronic trading has increased transparency, there are concerns that the focus on certain strategies that rely on high-speed technology has played a part in creating an imbalanced and fragmented market.

Some participants have taken advantage of low latency technology and used it to develop trading strategies and engage in behaviour that has distorted and disrupted the markets. This worked on two fronts: first, the use of these disruptive trading strategies to execute orders relied critically on having access to the most advanced low-latency technology, so any instructions were executed into the market as fast as possible. This in turn, drove the need to source faster and faster market data to feed those engines to gain a millisecond advantage.

This model has tainted the efficiency of the market and created a new revenue stream for some trading platforms where direct, low-latency market data feeds were sold to firms seeking an advantage – sometimes at costs of tens of thousands of dollars a month. Marketed as 'live' or 'proprietary' data feeds, the toxic combination of direct and often multiple global co-located application programing interface (API) access, combined with superfast data streams, degraded and distorted the trading environment.

This emphasis on speed, rather than skill, was causing participants to lose faith in the integrity of the market, and created negative knock-on effects. To many, the

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[2] FSB Report on Foreign Exchange Benchmarks, September 2014

[3] BIS Triennial Central Bank Survey, April 2013

focus had shifted away from trading as a result of necessity (such as risk management, currency hedging and ensuring global flow of payments) and had become a technology arms race, with a competition underway to invest in the fastest low-latency technology and secure discounts with platform providers based on volumes traded.

Brokers and money managers became disillusioned with this unfair trading environment – the spectre of what became commonly known as a 'liquidity mirage' developed, and many were unable to guarantee certainty of trade or best execution. In addition, signal risk had grown significantly and many with genuine intent to trade were consistently 'pipped' by low latency-based trading strategies. As a result, many were forced to internalise their trades and banks preferred to hold onto unnecessary risk. This mass internalisation has been widely cited as one of the key reasons for the decline in institutional FX flow in recent years and has introduced the potential threat of systemic market risk.

A select part of the trading community, known as high frequency traders, or HFTs, has been unfairly blamed for this distortion of the market. This is inaccurate and short-sighted – high frequency trading is a natural evolution of electronic trading and is not bad in itself; in fact, it has provided enormous benefits and played an important role in creating liquidity, reducing spreads and lowering the cost of trading. Therefore, it is unfair to paint all those who engage in HFT with the same 'dark arts' brush. Rather, it is the intent and behaviour behind certain trading strategies, often based on extreme low latency, that need to be questioned and addressed.

The high costs of low latency technology and high speed market data began pricing some firms out of the market and participants were rapidly losing confidence in the spot FX markets. Incumbent FX platform providers have inconsistent opaque and asymmetric charging models, meaning firms are unable to see what others are paying on both a frictional and fractional basis per trade. This is a prevalent factor that continues to contribute to an unfair trading environment.

It became a race to the bottom, and the market knew it had to act. Rather than a potentially ineffective and expensive 'cure' in the form of legislation, which could take years to implement, a significant cross-section of the FX market recognised the need for a proactive preventative solution and went about designing an innovative and unique solution - ParFX.

The logic of ParFX's 14 founders – which include the world's largest spot FX trading institutions – was simple and clear: spot FX had to be reformed so participants could operate and compete with each other in a fair and transparent environment where all firms – regardless of size, technological sophistication, financial clout or volumes traded – are treated equally and play by the same rules. They wanted an efficient trading environment for those that needed to exchange FX spot risk and service their clients. As a result, disruptive trading behaviour in any form is effectively negated by key ParFX features: transparency, trade matching efficiency, market data equality and minimal peripheral trading costs.

In the same way that it is the drivers caught speeding that are held responsible for their actions, as opposed to the cars they drive, the focus needed to be on eradicating disruptive trading behaviour and the intent behind it, rather than the technology.

There was significant demand for a fair and equal trading platform where everyone could trade on a level playing field. ParFX was created in collaboration with the industry to combat disruptive trading behaviour and establish a fair, low cost and efficient trading environment. Together with the industry, ParFX pioneered a number of features to meet the requirements of the market and ensure a level playing field for all participants.

It was the first to introduce a randomised order entry mechanism to its matching engine that delays all order submissions, amendments and cancellations by between 20-80 milliseconds, thus nullifying any advantages gained by low-latency trading strategies. This puts an end to 'first in, first out' trading, which gives an unfair advantage to the fastest computers and which was one of the underlying reasons for the unnecessary and costly rise of signal risk.

In addition, spot FX market data is distributed to all participants in parallel and the cost is included in the connection fee, meaning that no participant can buy trading advantage with faster or enriched market data.

Uniform and transparent brokerage fees also ensure that all participants operate on an equal level – nobody is able to negotiate a special deal. These innovations were necessary to address the root causes of disorderly behaviour that had damaged the spot FX market for so long.

The fundamental principles of ParFX include open access and equality; any firm can trade on the platform but they will be subject to the unique system parameters that discriminate against behaviour not entity. There has been significant interest from a wide range of participants, including many buy-side firms that are keen to operate and trade in the trading ecology that the market designed and Tradition implemented and now manages.

What effect has this had on the spot FX market? For one, incumbents have recognised the shift in trading mentality and introduced models somewhat mimicking the randomised pause – thereby further validating the ParFX model and signalling that the industry is moving towards meaningful change.

ParFX is an example of the industry coming together to improve the market environment, delivering a global solution to a problem that is underpinned by fairness, transparency and equality. It satisfies some of the concerns raised by regulators, harmonises trading rules across borders and provides a beacon model that demonstrates the success of industry cooperation.

As one global head of e-commerce at a European bank stated: "The values and ethos of ParFX resonate strongly with us. Its very concept is rooted in

transparency, which we believe is a major step towards truly levelling the FX playing field.”

Future-proofing the OTC derivatives market

The 2008 financial crisis prompted a global upheaval of the over-the-counter (OTC) derivatives markets and led to the introduction of new legislation such as the Dodd-Frank Act and MiFID II, which aimed to reform the derivatives market. Due to its nature and make up, OTC derivatives were traditionally voice-traded and somewhat opaque, but an onslaught of new regulation has precipitated a move towards regulated venues in a bid to bring more transparency, efficiency and fairness to the derivatives markets.

As one of the world’s largest interdealer brokers, Tradition has long been at the heart of the derivatives industry, facilitating liquidity and execution globally across a wide range of asset classes such as interest rates, foreign exchange, commodities, equities and credit.

As with spot FX, there were a number of underlying issues that needed to be addressed. Moving to utilisation of a more electronically-traded market presented a number of challenges. Ever since its inception, the OTC derivatives market was voice-traded for good reason – it often involved complex high-value multi-leg transactions with varying degrees of liquidity and participation, which were often tailored and carefully negotiated according to the needs of individual investors, and avoided signal risk. Spot FX in comparison was relatively vanilla and standardised with many more participants, hence the prevalence of electronic trading as a suitable form of execution.

Replicating OTC derivatives trading electronically was by no means a straight-forward process, but recognising the sea change that was about to get underway, Tradition identified and worked with the industry to ensure the market was able to benefit from the best of both worlds, and that trading utilising hybrid electronic solutions could become the new normal in the regulatory environment spearheaded by the Commodities Futures Trading Commission (CFTC) in the United States and other international regulators.

Anticipation of regulatory reform by Tradition and the industry resulted in the creation in 2011 of Trad-X. Trad-X is an industry-backed trading platform for OTC derivatives that utilises the hybrid nature of both voice and electronic trading and uniquely offers a reference page based solely on irrefutable and executable prices from a populated central limit order book (CLOB), streamed by at least twelve of the largest banks in the world. It differentiates itself by the depth and purity of its liquidity and the fact that it operates on a hybrid basis, meaning that voice and electronic liquidity are combined and operate on a seamless and symbiotic basis. In real terms this means that participants have the choice of direct execution on the platform via click-and-trade screens or they can use Tradition’s voice brokers to act on their behalf to execute on the screen, operate on a voice RFQ basis (as defined and required by US regulation) or increase the size and/or participation immediately after a screen trade by voice interaction.

Once Trad-X had reached a level of maturity as to the consistency of traded volume and as a result of the constant depth and quality of liquidity, Tradition took the bold step of deciding to link its USD and EUR reference pages to Trad-X.

Having a reference page based entirely on real, electronic prices that are tradable, rather than indicative, is a significant and notable step forward for the market.

The Trad-X reference page is based entirely on prices submitted in to the platform and displays real-time tradable best bid and offer prices from at least twelve of the largest banks in the world. The market makers stream two-way prices on a continuous basis via the Trad-X platform, offering a quality of liquidity and subsequent market data that was not previously conceivable. Trad-X is able to provide full charting capability, audit trails and liquidity analysis based on irrefutable firm pricing at any point in time. Put simply, it is a far superior, transparent and more validly created form of price verification and discovery than previous indicative methods, which effectively rely on market perception rather than necessarily reality.

More recently, there were question marks over the accuracy and calculation methodology of a long-standing interest rate swaps (IRS) benchmark widely used in the global derivatives market – ISDAfix. As the primary benchmark in the OTC interest rate swaps market, it was calculated using indicative pricing collected historically by contacting dealers directly by phone, or referenced to an indicative page. This left room for improper behaviour to take place, and there was agreement from across the industry that the calculation process had to be improved.

Uniquely at the time, Trad-X offered a reference page based solely on irrefutable and executable prices from a populated central limit order book (CLOB) streamed by at least 12 of the largest banks in the world.

Having a reference page based entirely on prices submitted to the electronic platform that were tradable, rather than indicative, was a significant and notable step forward for the market. By displaying real-time best bid and offer prices, it offered a far superior and transparent form of liquidity, market data, price verification and discovery to what had been possible.

The International Swaps and Derivatives Association, the owner of ISDAfix, saw that provision of the benchmark could regain credibility and trust within the market by basing it on firm, irrefutable electronic pricing - a concept that Trad-X had embraced several years earlier. Such a move validates the existence of a platform like Trad-X, which is taking part in the move to aggregated submission of pricing to create the "new" ISDAFix.

As one Head of EMEA Delta Trading commented after the launch: "Tradition appears to have taken a lead in the development of regulatory-compliant IRS trading platforms by managing to partner with a broad range of liquidity providers. As a result the liquidity available to trade on Trad-X is truly impressive

and is reflected in the large volumes that have gone through the platform in the first few weeks."

The catalyst for change

The financial crisis of 2007/08 may seem like a long time ago, but the industry continues to suffer from the effects. However, adversity can often bring out the best in people, and the same is true for the industry's largest trading organisations, which have demonstrated time and time again their ability to take a lead in reforming and adapting to the new market landscape with innovative technological solutions.

In the previous decade, there were tremendous benefits derived from their support and use of industry-backed initiatives, such as credit risk mitigation from CLS and the transparency and clearing benefits from CCPs. The same is true post-crisis. Now, more than ever before, financial markets need forward-looking companies to show the leadership urgently required to solve the underlying problems relating to regulation and market structure. In a shifting regulatory landscape, Trad-X and ParFX present global future-proofed models of trading for all participants that return to the core principles of efficient trading with a model designed to prevent malfeasance.

When it comes to international regulation, the objectives of regulators are similar; however, it is the approach that tends to differ. Tradition and its industry-wide partners recognised early on that globally-harmonised regulatory solutions remained several years away, and their success is a reminder, if any were needed, of what can be achieved by demonstrating visionary leadership, international cooperation and technological investment.

Given that the recommendations from the recent FSB report presented to G-20 leaders included a call for solutions to key market issues to come from the industry itself, rather than regulators, the time is now ripe for regulators to embrace and endorse such industry innovation. Tradition and its partners worked together and drew on their market intelligence, technology, global presence, networks and resources to help fill the regulatory and operational gaps in the markets in which they operate. It's now time for international regulators to do the same.

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