WHY ALL FX TRADING NETWORKS AREN'T THE SAME

We look at issues around connectivity and why partnering might be the right solution rather than relying on a single vendor forced to build out dozens or hundreds of connections

The foreign exchange market is frequently described as the world's largest and most active. With more than $5.1 trillion in value changing hands every day, there's an incredible amount of value exchanged.

However, describing FX as a single market belies the complex web of connections that underpin the exchange. Foreign exchange transactions are executed through a combination of direct, voice and electronic methods. Recent reforms since the Financial Crisis have had the effect of further splintering the market. This means that creating a new provider isn't as simple as purchasing a single connection to a main "market" – the process is much more akin to creating one with hundreds of individual connections between major providers. This article examines why more flexible models are emerging along with some of their advantages.

The vast majority of foreign exchange trading happens through three primary data centers – NY4 in New York, LD4 in London and TY3 in Tokyo. Connections are made here between different sides of the trading. Speed is key – even a thousandth of a second can be the difference between getting the expected price for execution or being front run.

Execution is more important than ever. Revised regulations such as the Mifid II's Best Execution mandate mean that asset managers have an ever increased responsibility to ensure they are getting the best possible price for their transactions. Counterparty relationships and selection criteria are key. Things that were once uncommon in the industry such as algorithmic execution are now getting more common as regulation increases. This gives a leg up to specialist providers, who have had more time and focus to develop products. These companies also have additional analytics and metrics to validate their approach to market liquidity.

Specialist providers tend to be better equipped to deal with different types of flow. Increased use of data and post trade analytics allow liquidity providers to make better informed decisions. The provision of liquidity is not only manageed by adjusting spreads, but also the ability to decide whether to quote and cover, or to warehouse the position.

Providers with a series of single and somewhat narrow connections into the market are ill-equipped to handle these sorts of challenges. Being able to identify the profile of each client's flow is critical to optimizing the liquidity function.

This ultimately allows the specialist provider to find the "sweet spot" between giving their clients the best price, whilst also providing the necessary protections to the liquidity providers. The benefits of this model goes both ways, since foreign exchange specialists can create a multi-asset trading model by partnering with experts in other areas.

Currently, this model of partnering with specialty providers is rare in the industry, but we believe as more people see the benefits of this approach, it will spread. The foreign exchange market is vast, but it can be navigated with the right assistance. We see a future where managers and traders think to themselves "we don't want to worry about connections and liquidity, that's already being handled by an industry leader".