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Opportunity Knocks
Searching for a Solution in FX Options

The impending regulation and a desire to grow the FX options market has triggered a shift in the trading platform world. Colin Lambert looks at the different models seeking to tap the market and asks, can the market sustain them?

It is easy to fall into the trap of looking at the current moves in the FX option platform world and seeing parallels with the cash market at the start of the century. A rash of models are coming to market, existing players are seeking to change their model, and each appears to be targeting a particular client segment. That assumption would be wrong, however.

There appear to be underlying issues surrounding the FX options market that are likely to make things different – not least the need to give trades up for clearing, which will involve creating a more "open" trading environment than that which existed during the cash e-trading evolution. The added complexity of FX options also means that the majority of platforms will operate on an RFQ/RFS basis, although there are two models in particular likely to encourage participation by high frequency traders amongst others.

Although the FX options story has been bubbling for some time, a catalyst in bringing it to the forefront of the industry's thinking is the launch of three new platforms, the closure (temporarily) of an existing model, and the subsequent investment in one of the models by two major industry players.

First out of the stalls was Digital Vega, which launched late in 2010 (*Profit & Loss*, December 2010). The firm's platform, Medusa, provides RFQ/FRS trading functionality via a simple GUI, which can operate in any browser, or via an API. Pricing is available in either premium or volatility terms, with or without delta hedge, with real-time execution and confirmation.

The platform delivers reporting tools to both buy- and sell-side participants, allowing them to identify best execution as well as detailed client and provider activity and service levels. It is also integrated to the Traiana Harmony network, which delivers real-time trade notifications and position and exposure management tools.

Although the platform got off to a slow start – it was handling some trades – the model has proven popular amongst bankers, something that may prove invaluable in the months and years ahead. "Of all the models we are being shown, Medusa is probably the most 'bank friendly' without disadvantaging the customer," opines a senior FX options technology manager at a European bank.

This "advantage" may not be popular in the wider world, where bankers still receive a rough reception, but the technology banker believes that FX options, more so than the cash market, will rely upon bank-provided liquidity. "The sheer range and complexity of FX options means that banks will be the key liquidity providers."

This argument does not necessarily find support from at least one of the new players in the industry – although Evgeni Mitkov, CEO of SurfacExchange (which went live at the end of July) does acknowledge the importance of banks. "The options world has gone very vanilla, which means more people are able to market make," he says. "The key to attracting these new market makers is providing them with a venue on which they can place interest easily, which is robust and which operates fairly. That way we can broaden access to FX options and benefit everyone in it. The banks are important to the FX options market but that does not mean that other participants cannot also engage."

New Models…

General access or not, it is clear that the regulatory world – even though it is not yet fully nailed down – will incorporate the operation of swap execution facilities (SEFs) and mandatory clearing for the majority of FX options participants, and that means models have to be looked at. Notwithstanding the importance of being regulatory-compliant in the new world, to succeed the platforms also have to have the lifeblood of any trading venue – liquidity and trading volume.

The early signs are that things will be a struggle, but as all those coming to market are keen to stress it is early days. Work done now, putting key processes in place (especially post-trade) will make attracting liquidity easier when the rest of the industry comes to terms with the "final" regulatory model.

"Waiting for the regulators to explain the new world and then reacting will leave you too far behind the curve – whether you are a technology provider or a liquidity provider," says a European-based e-FX sales manager at a bank. "You have to be moving now, and to be fair we do know 80% of what the landscape is going to look like regarding the execution piece, if you are going to have a chance of success. I think the door is already closing on those who have not started work if they want to be a part of the e-FX options trading landscape."

Putting the work in now obviously costs money and whilst some have doubts over the viability of new models, they are live and they are attracting interest. None more so than Digital Vega which recently announced two pieces of investment from major industry participants (as reported in the July/August issue of *Profit & Loss*).

With Deutsche Börse already onboard, the platform officially unveiled investment from State Street's eExchange business in August. As a result of the investment, both parties are working on integrating and combining their platforms to deliver an FX capability that includes State Street's Currenex and FX Connect platforms with Digital Vega's FX option trading tools. Essentially, Digital Vega customers will be able to trade cash products using Currenex technology and liquidity, while Currenex and FX Connect customers will have access to a suite of FX option pricing and trading tools that will be integrated into their platforms.

The deal is widely seen as beneficial to both parties – Digital Vega gets the obvious boost of a cash injection from credible market participants to help with its development and State Street can overcome the potentially tricky obstacle of rules debarring a single owner of a SEF.

"Currenex and FX Connect have a huge franchise in the cash markets and as there is increasing interest from a range of clients in the options market, it makes logical sense to incorporate an options capability into their offering," agrees Mark Suter, CEO of Digital Vega. "Simultaneously we have a very strong options product but haven't really focused on the cash element; it hasn't been a critical part for us. Now however, we will have the ability to deliver a complete solution.

"We provide option trading capability and liquidity and in return, they deliver spot and forward trading capability and liquidity. We complement each other perfectly, it's a natural fit," he says, adding that he expects the integration to be completed by the end of Q3.

"From the outset of the Digital Vega project, we knew that in order to compete on the global stage, we would need strategic partners, and with this investment the final piece of that plan is in place," says Suter. "With investment and support from two such important institutions as Deutsche Börse and State Street, our ability to leverage the complementary strengths of both firms ensures that we are now ideally situated to rapidly deliver a range of market leading products and services to a huge and diverse global customer audience."

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Evgeni Mitkov, SurfacExchange

A not-insignificant aspect of the deal for Digital Vega is that one of the two deals provides the company with a strong, well-established clearinghouse operator. "We still don't know what the final iteration of regulations is going to be, particularly the regulation of options and NDFs, but the unique partnerships with Deutsche Börse and State Street will allow us to adapt quickly and efficiently to upcoming changes," says Suter.

Although its launch came some months after Digital Vega, there is a similar sense of optimism at SurfacExchange. "There are plenty of new players coming into the FX options market that have good technological capabilities," says Mitkov. "We are very interested in making the platform open to all players, be they banks at all levels or non-bank organisations.

"We think this is a very opportune time to be launching Surface because there is demand for more market makers that we can facilitate," he adds. "It is important to be able to place interest in the market to attract interest and by doing so we think we are broadening industry access."

Whereas Digital Vega is based very much around the request for quote/request for stream process, SurfacExchange, as hinted at by the name, has more of an ECN feel to it, and while it operates a multi-participant, open access model, it has elements of a single-bank platform in its look and feel.

"We believe in a fair process, where anyone can trade with anyone, there is no price inversion," explains Mitkov. "Clients can express an influence in specific products, and everything is transparent in terms of price. We have a central limit order book for FX options that is open because it is important that everyone can access all of the interest. We are seeking to embrace both vol and premium traders' interest and deliver a price in a single fashion. It is no easy undertaking, but we believe it is important that it is delivered that way."

A third new entrant is likely to be the joint venture formed late in 2010 between retail FX broker FXCM and technology vendor SuperDerivatives. The DealX platform seeks to maintain client anonymity whilst allowing clients to request prices from all liquidity providers, a model very much along the lines of Digital Vega's Medusa, although with added anonymity. Market participants express an interest in the model, mainly, they tell *Profit & Loss* because of the presence of SuperDerivatives which has built a solid reputation for the accuracy of its pricing. Any customer of the vendor will have access to the live pricing, sources say, meaning liq-

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uidity providers are expecting to have a line of customers ready to trade.

The firms say that every DealX user can see all the current interests and participate by submitting bids and offers and the depth of each bid and offer price is published.

They also stress that clients are no longer only able to deal with banks they have credit relationships with. This in turn mirrors the central counterparty role played by Citi on SurfacExchange.

…And Existing

It is not only new entrants that are causing a buzz in the FX options market. Alongside the existing voice/electronic hybrid models, inter-dealer broker GFI Group has launched an electronic platform for trading FX options. Elsewhere, Thomson Reuters was due to close its Matching for FX Options trading platform at the start of September.

At face value, the decision to close the platform seems strange, but both interbank traders and senior sources within the firm have told *Profit & Loss* that volumes and revenues were not only stagnant, but also declining. In a world in which SEF-compliance is all important, *Profit & Loss* understands that Thomson Reuters is working on a new model – in association with Tradeweb (in which it holds a majority shareholding), therefore the decision is based on taking the business forward rather than maintaining a status quo or retrenching.

Whilst the decision is understood by market participants, the senior options technology manager warns that a new solution has to be readily available. "If it [Matching for FX options] isn't working, by all means shut it down, but be ready with a new model, otherwise you could be left behind."

At GFI, the launch of ForexMatch comes some years after an abortive attempt to get the platform off the ground by SurfacExchange's Mitkov (among others) that led to him establishing the start up. ForexMatch is used by the inter-dealer broking side of GFI's business, but Paul Millward, head of FX e-commerce at GFI, accepts that access to the platform is a sensitive issue. "We acknowledge that some people are trying to act like banks in the market," he says. "But if you have an electronic platform you need carefully defined rules to make sure it is fair for all and that inter-dealer broker customers can actually get business done."

On ForexMatch, users are able to generate a specific interest that will go out to all participants on the platform and it will be available via FIX API or on a GUI. "There is a lot of interest to connect up to the platform," says Millward. "As an industry and as a firm there is a desire to move voice processes to electronic, because the industry and our clients are recognising a need to enhance efficiency. Traders want to see all the information in a single channel so they can generate a price back.

"There is a lot of work involved in this, especially in the messaging and workflow, that is the key," he adds. "It is not as simple as it sounds because you need to attract people to trade electronically with GFI. In order for that, we can enhance the workflow and solve client issues."

GFI also rolled out Fenics Trader earlier this year (see *Profit & Loss*, April 2011), a bilateral RFQ-based platform that allows clients of the firm's Fenics Professional service to access liquidity from their preferred provider.

Other platforms continue to circle the e-FX options question. TFS-Icap has the Volbroker platform, which has been around for more than a decade, and other inter-dealer brokers are believed to be developing enhanced e-trading capabilities. All are keen to stress that the voice broker has a role to play, especially with more exotic products. Equally there is a general understanding that the vanilla end of the market is going to go fully electronic at some stage.

Given the focus on clearing in the Dodd-Frank Act, circumstances are driving the market towards at least one existing model in CME Group. Volumes have been on the rise at CME for some time – and not just because of the push from the evolving regulatory environment. Craig LeVeille, director, FX products at CME says that market participants were looking at the benefit of a cleared model already. "What we are hearing from a broad range of market participants is that the mandate for clearing is still unknown," he muses. "But that has not stopped people being attracted to the CME model, because there is a tremendous amount of interest in clearing OTC options without the regulation."

There are some concerns over the potential cost of clearing, but LeVeille, while accepting that it could be an added cost: "I caution though that, that remains to be seen." LeVeille is a firm believer that if efficiencies can be realised, they often justify a cost.

CME stands apart as an options trading venue purely because it is an exchange – a model that many expect the industry to evolve towards over time. LeVeille sees CME's strength as offering standardised products in a very flexible environment. "Much of our growth has been generated from electronic trading on Globex," he says. "But we have such a broad base of clients that our floor trading is still an active venue for those who prefer dealing through brokers in the open outcry, and we also have seen growth in block trading where two counterparties trade on a bilateral basis and, following some basic reporting rules, novate the trades into CME clearing."

The development of additional functionality has been central to CME's push into options, some of which has been successful in winning over previous sceptics. "There were those who had concerns over the expiry process, specific to the exchange," says LeVeille. "We established processes for auto-expiry at the fix so everyone knows what options are going to be exercised. By making this an efficient and transparent process we have been able to overcome some scepticism and gain confidence from risk managers. This has helped bring new participants to CME."

A New Market?

So what are the challenges and opportunities facing providers in the FX options market? Obviously regulation is a massive issue and is yet to be fully resolved and projects to enable firms like CME and LCH.Clearnet to clear FX options are at different stages of development.

For FX options e-trading providers opportunity knocks, if, and it is a big 'if', they get the model right and attract sufficient liquidity. So what makes a successful venture? Opinions, as ever, are divided. "Regulation is clearly driving a lot of development," says GFI's Millward. "But clients are also demanding electronic execution more than they were. If you can improve your clients' ability to price their clients and manage their own risk, you will be successful."

SurfacExchange's Mitkov believes success will come, in part (all interviewees acknowledge the importance of efficient, fair *modus operandi*) by enabling more traders to participate in the bigger trades. "A five billion ticket needs to be split if it is to achieve best execution," he says. "No one is happy with a five yard trade, the client or the price maker. If you can split this trade and work it over several hours, picking up liquidity and pricing from a range of interest from multiple counterparties – and then aggregate it into one ticket – you have a powerful proposition.

"Ticket sizes will come down, but volumes will go higher," he adds.

FXall is taking a different approach currently, preferring to work with regulators to shape future regulation and then provide a solution to meet that environment. The firm has interest in pre-trade provider Finteract and was mooted to be an investor in Digital Vega earlier this year before negotiations reportedly broke down.

Phil Weisberg, CEO of FXall and a veteran of the FX options market is pragmatic, noting that "whatever the rules are, that is what we will have to do if we are going to be a SEF".

He is also pondering the possibility that FX options could be the first non-homogenous FX market in that there will be different people trading under different rules, in different parts of the world. "The initial focus is not about execution, because that is not the majority of the work," he says. "The prime focus should be working out how to operate as a regulated entity in a segment that is not yet regulated, that will determine who succeeds.

"We are working on what is effectively a moving target, for example, how will surveillance operate in the regulatory regime? How will we report? How will execution work, what will the rules be?" he continues. "There will a lot of adapting necessary on the part of technology and service providers; establishing the reporting and post-trade functionality and process; not to mention ensuring the trading protocol works effectively."

Weisberg neatly encapsulates the fluid nature of the FX options market currently when he observes, "There is still a lot to be nailed down by the CFTC. We are pragmatic enough to know that some customers are going to be restricted by the new regulatory environment, but also that others will have more freedom to grow their activities."

The sense of uncertainty is further heightened when he adds,

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Craig LeVeille, CME

"We could conceivably have regulated and un-regulated platforms operating in the same market. That means we would have to build a framework that allows them to co-exist."

CME's LeVeille sees success for the industry in a happy confluence of OTC and clearing services – and keeping things simple. "Electronic execution can bring about real volume growth, but that is only really possible in vanilla products. There has to be a degree of standardisation," he says. "E-trading also makes it more efficient to build a straight-through process to clearing and other post-trade services.

"Initially we may not see tremendous value from the separate initiatives, but if you assume, from what market participants are telling us, that the SEFs will be online maybe a year after the clearing mandate comes into force, that will be a very important time for the market. It is at this point that I think the value will really be realised and the market will experience serious growth," he adds.

Although most options players agree with LeVeille's sentiments regarding vanilla products, to an extent it does depend upon what one calls vanilla products. For many years, products that were once seen as exotic drifted into the vanilla space in the minds of market participants, but the events of the past three years have served to better delineate exotic and vanilla products. Some providers, like SuperDerivatives, believe that trading exotic options is a distinct possibility, especially in an RFQ environment, and indeed the company could have that space to itself. "SuperD has a good reputation in pricing exotics so it may be easy for it to add a 'trade here' button," says a senior FX options trader. "But I doubt if anyone else can be bothered to build the technology to handle a few trades a day."

A Hurdle Race

There are those who have long believed that the path to success in FX options is simple – replicate what went on, and goes on, in the spot FX market. This opinion gets short shrift from options technology providers who point to the more complex nature of derivatives.

Probably the biggest hurdle to overcome has surrounded the expiration process, exercising large numbers of options involves heavy Pin risk, not to mention the sheer mayhem of managing multiple trades, across multiple venues, with multiple counterparties – all of which are maturing at the same time.

Millward believes that the key challenge in a cleared world is managing exercise risk. "It is one thing to exercise against a sin-

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Paul Millward, GFI

gle counterparty on one platform, but it is quite another to build something that works across multiple central counterparties on different platforms," he explains. "We need an industry solution for this."

CME's LeVeille agrees, and also believes that a solution that allows all trades, not just exchange-originated trades, to be auto-exercised will add tremendous value to the industry. "The exercise process has to evolve," he agrees. "It is an integral part of offering a successful options trading venture. I am a huge proponent of OTC markets because they meet the needs of certain customers, and if we can successfully improve the process for cleared OTC trades where possible, we will provide a tremendous boost to the options market."

The complexities around the expiry process are highlighted by the fact that some seven years after it first launched an auto-expiry product for its FX options platform, Deutsche Bank is still the only bank offering the service on its single-dealer platform. In the multi-dealer space, it is coming but it is not a straight-line advance. On SurfaceExchange for example, Mitkov says the firm has established a fully electronic process around expiries, but it remains complex because there are potentially five parties to every trade, the two end clients, possibly two prime brokers and the central counterparty. "We have gone fully electronic on expiries through an automated notification process," he explains. "It doesn't completely eliminate expiration risk but it makes the process a whole deal more efficient, and can revolutionise the business. Any time we can avoid people picking up the phone in the process we are improving market efficiency."

He also has another idea for improving market efficiency and helping to build volumes. "In a centrally cleared world you could novate trades, that would improve market efficiency tremendously," he says.

Segmentation

Although it can easily be accepted that the FX options amrket is not blindly following events in the cash world, there is a sense that, at a high industry level, we are witnessing a replay of events in the cash market a decade previously. Although all parties involved are keen to stress their commitment to expanding their value proposition to a wider client base it is hard not to bucket them.

As one close observer of the industry points out, "Digital Vega looks very much like the FXall of FX options – and may have the 'real thing' to contend with soon. GFI and Thomson Reuters are very much targeting the inter-dealer space. And CME and Surface seem content to provide access to anyone, but also seem to be embracing the high frequency community rather more."

For firms like GFI and TFS-Icap, moving beyond the inter-dealer community could be difficult because of pushback from their core client base – the banks. The latter seem to be exhibiting a "once bitten – twice shy" attitude to mixing with high frequency, hedge funds and other clients in anything other than a specific, request for quote environment.

The problem for these firms could very much be seen as convincing the banks that crossing the spread is occasionally a good idea.

Digital Vega's model very much appeals to the "real economy" users of the market in corporates and asset managers, and may benefit from a simplification of the process of trading and managing option exposures. "Currently corporates and asset managers only trade FX options when they really have to," says CME's LeVeille. "As the industry improves its technology value proposition, it naturally makes it cheaper and easier for these customers to trade options and once it does I think they will come back to the market."

CME looks in good shape, especially as more efficiencies, such as margin offsets between clearing and OTC trading venues grows. It also offers, as LeVeille notes, a different product, but one that CME is keen to build out. "Our product and execution methodology are unlikely to be the same as other venues," he says. "But we are part of a globalising market, which can only be good for volumes."

CME and Surface are attractive to the Alpha-chasers because they are focused on short dated options, which typically have fewer second and third order effects. This makes them easier to manage and provide liquidity in for non-banks.

FXall remains an intriguing proposition regarding a potential target audience for its offering. Weisberg acknowledges that it is natural for the firm's solution to target the "risk transfer" segment of the market. "The RFQ, collaborative solution is, we believe, a good protocol and we are working hard to convince the regulators of the strengths of this approach," he says. "We could and possibly will, expand beyond the risk transfer segment of the market, but only if our customers are demanding it. At the moment, the inter-dealer brokers are doing a very good job servicing the large options books that are the banks, for example."

Looking at the cash market again, there has been a distinct shift in recent years towards a homogenous model where all can effectively trade with all. This has, as has been witnessed in these pages several times, created an air of tension between the banks on one side, non-bank liquidity providers on the other, with the platforms in the middle. Ultimately a platform's lifeblood is volume and as such if there is enough from the high frequency community (to use one example) to justify a platform embracing it to the *de facto* exclusion of the major banks, then a platform may choose to do so.

This, and what some would term the bordering paranoia of the banks regarding high frequency trading firms entering the FX options market, could mean that segmentation stays in the FX options world much longer than it did spot. Certainly there is opportunity for bringing the world together after the trade, but beforehand? That seems a much tougher 'ask'.

Onwards and Upwards?

So what are the prospects for the FX options market? Understandably, most providers in the space are upbeat, but some are realistic enough to know that the volume data may not look especially good for a while yet. As FXall's Weisberg notes, "There is a lot of noise in this space at the moment, but it is not just about printing the first ticket – there is so much more to do after that."

Several interviewees spoken to for this article believe that the latter half of 2012 is potentially the time when volumes really start to grow, but all also accept it could easily be well into 2013 before that growth is witnessed.

A driver of that growth could be wider access to technology. "There are currently a very limited number of banks that are able to quote e-FX options," points out Millward. "There are others with the interest but without the capability currently, but that will change.

"If the market is to grow it will not do so through the existing players, it can only be achieved through new players entering the market," he continues. "And that means technology firms developing solutions that can be adopted by second and third tier banks."

LeVeille agrees; "We are seeing a number of ISVs [Independent Software Vendors] building out functionality to enable customers to trade on CME's futures on options market," he says. "The more accessible we can make our platform for customers with decent electronic capabilities, the easier it will be for these customers to trade increased volumes with us."

The adoption of order management tools and other algorithmic technology could also help improve volumes, especially if these solutions can be used to mask business. "Greater transparency can lead to lower volumes," points out a senior options market participant. "It makes people more reluctant to place interest in the market for fear of influencing the price."

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Mark Suter, Digital Vega

Ultimately then, the FX options industry remains in a state of flux regarding electronic trading. It is difficult to find an industry insider who believes the landscape will not change further – and significantly. The chances of the eight or more providers currently in existence still being about in two years' time are seen as very remote. Some will drift into obscurity and then wither and die, others will be swallowed up by larger – or richer – brethren.

One key to success could be operating a model alongside an equally successful NDF trading model, an opinion with which Millward agrees. "I think options can go the same way as NDFs, since we rolled out NDFs in Latin America on ForexMatch the interest and growth in volume has been very sucessful."

Notwithstanding the role of NDFs in making a platform successful, some of the current crop of providers will continue to exist. For whatever the regulators have to say ultimately, this market is – finally – heading towards greater automation. Barriers are being broken down by the day as more and more participants come to realise what some have known for some time now. The FX options market is going electronic and the rewards are potentially great. The only minor fly in the ointment is selecting the right model. ■

Kirsten Hyde also contributed to this article.