FEATURE

From desktop to API - meeting new demand for FX Option platforms

By Frances Maguire

With all other instruments traded electronically and with new technology available for trading FX options, interest is now turning to the last bastion of telephone trading, writes Frances Maguire.

Getting the comfort levels to trade the more complex FX products electronically has taken longer than expected but coupled with the recent advancements in trading technology, the time is ripe for a final push towards the e-trading of FX options. Already first generation FX options are being traded on screen and with two new FX options platforms set to launch – one of them bringing an ECN-style platform to the FX options market for the first time – it looks as though a break thorough has been made and one that will even bring new participants to the market.

Increasing demand

Ralf Behnstedt, managing partner of FX Architects International, a team of FX specialists advising on how to strengthen FX business and operations, believes that the increasing global demand for FX options is based on a variety of factors, not least because the financial turmoil and the resulting increase in regulatory requirements is forcing the sell-side to review the business models for providing OTC derivatives. He says: "The focus is shifting clearly towards cash and

plain vanilla products and this is forcing the sell-side to rethink distribution strategies. Ultimately we will see increased hurdles to market structured OTC derivatives and stronger demand to hedge client exposures using the FX cash and plain vanilla product spectrum."

This is because Behnstedt believes the buy side is logically looking for the next asset class on the electronic channel now that simple cash products have been available for more than ten years. He believes that FX options are the next logical step for the buy side as plain vanilla FX options are increasingly becoming commoditised. Furthermore, the opportunities in the FX market are currently outstanding, with huge volatility in some currency pairs and the buy-side want a quick and easy way to take advantage of this.

However, Behnstedt says that a few challenges have still to be addressed on the FX trading platforms to meet buy side requirements and before a distinctive value proposition can be offered to the client base. He says: "First of all, similar to FX cash products, entering and capturing FX options must be simple and easy. Leveraging graphical features to facilitate FX options' trade capture processing is inevitable."

He says that apart from Oanda's box option feature, which marked a new and innovative way to capture two options by drawing a window box on a FX chart, there have been very few solutions that are easy to understand and allow ease of use FX options' trade capture.

Behnstedt says: "Demand is strong and vendors would be well advised to put effort into developing a solution that meets users' expectations. Enabling trade capture FX options using an electronic trading solution is no longer considered 'state of the art' technology. Solution providers have to combine an electronic offering with using portals and mobile solutions. Innovative product and service offerings are required to market FX options via electronic distribution channels. New ways to present data and provide information are required. Solutions cannot just provide the information in tables as it has been done on paper before."

He believes that as technology evolves the opportunities to create superior services to enable traders to view, execute and analyse FX options and their underlying data will grow. "Clients are expecting services like getting information based on pre-defined triggers, e.g. delta of an FX option reaches a pre-

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defined level or an ITM FX option has produced a pre-defined amount of return. All these items are demanded and the demand will continue to grow," he adds.

Capturing, processing and monitoring

Behnstedt also says that solution providers are also increasingly being asked to create packages which help clients in capturing, processing and monitoring FX options during the lifecycle of the trade, using graphical tools, to improve the decision making processes. "Just as in the era of establishing electronic FX cash trading solutions, once the client has made a decision for a specific electronic FX options platform the hurdles for competitors are higher to win that client back," he says.

Unlike the sell-side, Behnstadt believes that the buy-side is looking at their traded products from a portfolio perspective and not from product silos, but the digitisation of FX options, will force the sell-side to rethink and reorganise existing product silos and to interconnect silos within client portfolios. He says: "Clearly, if the client wants to hedge an underlying FX exposure, there are many ways to do so, for example it could be done using cash products or using options. Clients want to see alternative scenarios and compare them in order to make the right decision. Providing these decision-making features electronically, interlinking the silos and making historical trade data as well being part of that process will require serious innovation to create these value propositions."

Finally, Behnstadt says that less is more when it comes to new technology and solutions providers are better off developing fewer products than risking not getting it right. "Establishing the whole business proposition -- from electronic trading, mobile application and portal integration - with just a couple of products is the better strategy than developing the whole FX options spectrum into an electronic trading solution but missing out the mobile application and portal integration. Strong project leadership, management focus, creative business analysts and experienced state of the art development teams are required to get that done."

Impact of Clearing

For David Collins, head of strategic solutions at SuperDerivatives, the various factors affecting FX options trading arena are colliding. Firstly, he says, the need to clear FX options is forcing a pure OTC market to reconsider the way it operates and realise that benefits have been reaped in other markets through clearing platforms and electronic workflow. "This will help level the playing field for many smaller regional banks as credit will play less of a role in price than before," says Collins.

Secondly, legislation may not yet be finalised but potential Swap Execution Facility (SEF) requirements and the need to show best execution, is making end-users reconsider the benefits of some of the banks' direct execution platforms. Thirdly, FX is emerging as an investment asset class and can be traded by people who are used to electronic markets.

Says Collins: "This is all leading to increased interest in electronic execution which many see as a disruption event to the dominance of a few large banks. We are seeing specialist players emerging and wanting to play

a major role in specific currency pairs e.g. Nordics or Emerging Market Currencies, as they see electronic execution platforms as a large channel to market. In addition, as vanilla flows are being commoditised, banks are driven towards electronic execution in order to retain market share and reduce cost per trade."

He believes that it is too early to tell whether, and how, users will be able to further leverage the trading metrics generated by their e-platforms for use in other applications. He says: "It will take time for the platforms to gain the traction they need; we see this as the start of a journey of transition and do not expect it to be a big bang."

He does believe, however, that FX will continue to grow in use as an investment asset class and there is still much to learn from the equity markets. "We think there will be continued growth in high frequency and algorithmic trading in FX and that this may spread into the options market but we believe that the pattern will track the equity markets," he adds.

Innovation not emulation

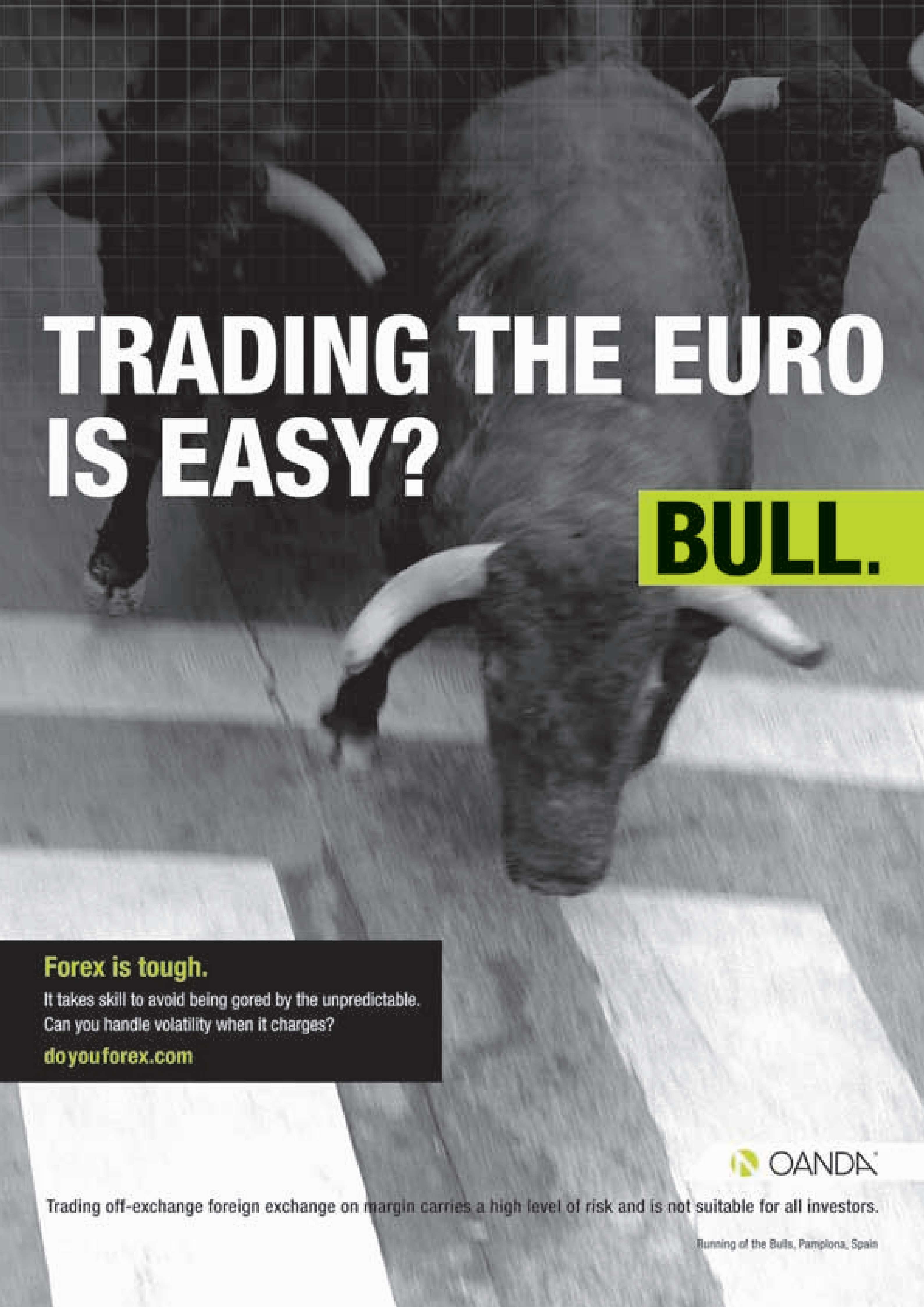
For Collins the most successful strategies for delivering next-generation e-services will be the ones that innovate. He says: "Technology that just emulates the existing OTC markets on a point to point basis will bring little to the market; the future lies in one or many platforms that bring a new dimension to the OTC markets."

The possible introduction of SEFs and clearing for FX options will have a huge impact on the market and will change forever how FX options are traded. "Execution through anonymous platforms will change relationships with bankers and brokers. Some of these relationships could be replaced by social media and specialist service providers will have a chance to enter a broader market, offering advice and research that is independent of brokerage and trading positions," says Collins.

Stephen Best, CEO of FX Bridge Technologies, believes demand for FX options is coming from the maturation of individual spot FX traders, who are looking at new products as well as by new entrants who have experience trading options in other asset classes.

Best says: "One of the most important things when introducing options to new retail clients is for broker-dealers to give them the comfort level with the different instruments and strategies they need. To this end, FX Bridge has developed a robust education package which includes a Strategy Optimizer tool that allows the end-users to evaluate the different strategies and determine the best one for them."

He says: "Historically, many of our clients have used our analytics to construct their own volatility surfaces and to make their own markets, but there is now a growing number of brokers that want to offer FX options to their end-trader clients but are not comfortable with managing an options risk book themselves."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David Collins

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At the beginning of this year, FX Bridge therefore went live with functionality that allows brokers to pass the risk on, and source liquidity from market-making banks, so they do not have to manage this risk.

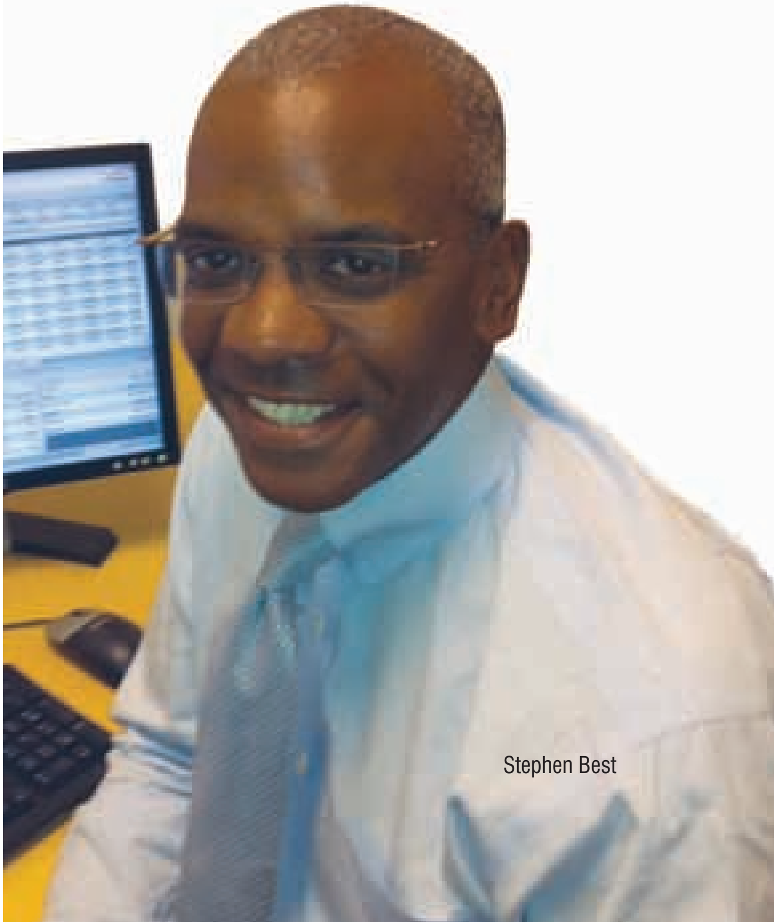
For the broker-dealers, FX Bridge has filled out its risk management offering to enable them to see their client risk, across spot, options and CFDs, on a single screen and run 'what-if' scenarios. The end-to-end solution, from decision support, execution and liquidity provision to risk management, provides all the reporting and compliance tools needed, across all jurisdictions. The platform can also be specifically customised for each broker-dealers' reporting requirements, and, in fact, Best says, no two client systems look the same. FX Bridge can offer a broker-dealer linked multiple platforms for different client groups, or by product, and still risk managed in a single application, regardless of whether they decide to manage the price risk in-house or pass some or all of it on to a liquidity provider.

Next round of growth

Best believes that the growth of equity options over the past ten years is a good indicator of what is in store for FX options. He says: "One of the drivers behind this growth is that options were being offered in equities. FX options have not really been offered electronically as extensively, but we are seeing increased automation and there is already some algorithmic and high frequency strategies being used for FX options." The FX Bridge platform has a published API to enable electronic trading and Best believes that this will increase rapidly for FX options.

"Every bank and broker offers a platform for spot FX, but just a handful offer FX options trading, and that is where the next round of growth will come. What is important now is having a strategy around taking advantage of the growth there will be in FX options." He believes the provision of training is crucial to support this growth and FX Bridge has a comprehensive educational package that brokers can white-label and brand for both staff and customers.

"Electronic trading ends arguments, by providing an audit trail and a log. Phone trading has a history of miscommunication. As legislation pushes us towards automated ways of settling, the entire end-to-end process will follow."



Stephen Best

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Working with the biggest FX banks, FX Bridge has contributed to the standardisation of fixed APIs and electronic processes and Best believes that the implementation of clearing for FX options will only push users more towards electronic trading and straight through processing. This can only be a good thing, says Best, not only for the automatic audit trail provided by electronic trading. He says: "Electronic trading ends arguments, by providing an audit trail and a log. Phone trading has a history of miscommunication. As legislation pushes us towards automated ways of settling, the entire end-to-end process will follow."

Regulatory pressures

Alfred Schorno, Managing Partner and head of sales at 360 Trading Networks, says, "What is holding back the growth, as well as further investment in technology by market-makers, are the regulatory discussions around the Dodd-Frank act."

However, he says that demand from the buy side for FX options is still very strong and 360T is also getting more demand from the large banks. In fact, the number of FX options executed electronically on 360T has grown by more than 400% over the last year, boosted by the growing number of market makers quoting prices for FX options.

Schorno believes the implications from the regulators are that all derivatives, including FX options, will have to be traded on multi-bank venues, such as Swap Execution Facilities (SEFs) or the European equivalent, Multi-lateral Trading Facility (MTFs). These venues are not to be fully owned by bank market participants.

He says: "This clearly rules out single dealer portals that are 100 per cent owned by one market participant and telephone dealing. When this ruling comes, all FX derivatives will have to be traded electronically and single dealer portals will no longer be allowed to support trading in NDFs and FX options. We expect therefore a a strong boost to this business and we are structuring our business to support this expected shift."

The functionality built by 360T to trade FX options includes structures such as a risk reversals and multi leg option requests. Currently requests are priced manually but going forward Schorno believes that market maker banks will start supporting multi-bank portals with auto pricing instead of investing in their own single bank portals.

Furthermore, he strongly believes that FX options, first generation at least, are sufficiently standardised that they are tradeable electronically, and on a multibank portal.

He says: "When users first start to use a portal, they only use the functionality on the main, standard product. Then the more exotic instruments, such as FX options and NDFs, are gradually accepted over time when they become more comfortable with the electronic functionality. It is an evolution process. But already there is a clear tendency towards trading FX options electronically, just as there was seven to ten years ago for spot and forwards."

360T has offered a request-for-quote functionality for FX options on the portal for the past three years and in the last year further enhanced the functionality to enable trading, not just on the life-basis, but also with a separate delta hedge, to enable trading on a volatility basis. There is also functionality for standard options – call, puts, European and American style – as well as smaller structured products such as risk reversals, bull or bear spreads. STP has been achieved for those customers that have high options volume, using a

XML deal export interface to treasury management systems, which was not very a common three or four year ago, according to Schorno.

He says: "We focus on first generation only, and 360T concentrates only on communication and execution. There are no analytics as we focus on a best-of-breed approach and believe there are already systems out there for pre- and post-trade analytics, instead we are looking at linking into such analytics tools. For post-trade, STP is available when transactions are executed into position-keeping systems."

Schorno says there is demand, on the institutional side, for hedging and leveraging, as well as generating alpha and the demand from the corporates is for physical and non-specific hedging. However, he adds, over the past few years there has been a backward towards plain vanilla, and less exotic, products. Schorno also believes that another area of growth will come from greater integration between execution venues and the providers of analytics, by embedding execution tools into portfolio analysis tools and treasury management system products.

Alfred Schorno

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ECN model

Two new platforms offering electronically traded FX options, which are based around different business models are about to launch. Evgeni Mitkov, CEO of SURFACExchange, says that their new platform is still on-boarding clients and has been testing for eight months. The platform, which will be the first open ECN for FX derivatives, will trade spot, forwards and options in the G10 currency pairs.

There have been other attempts to trade FX options electronically, such as GFI, Icor (Reuters) and Volbroker and Mitkov believes not only that the lessons have been learned, but that this time around, the dynamics and timing have changed.

He says: "The buy-side has grown; the timing is better and most importantly we are not beholden to any particular player. We have taken the best from both worlds: the OTC contract specs and the electronic exchanges' central limit order book. This resulted in a neutral marketplace that works for every institutional player. The electronic derivatives exchange market format has grown exchange traded derivatives volumes at 30-40% annually, and we are looking to do the same in FX."

If we assume that every aspect of options' trading will ultimately be made electronic, then there will be no manual processes at all. This is something that Mitkov believes will empower smaller players and will enable them to participate on an equal footing with the big players. "Initiatives in the past only offered electronic execution, while still requiring heavy manual intervention post trade."

Automating the entire lifecycle on the SURFACExchange platform makes it very easy for any sized bank or hedge fund, with a limited number of traders, to participate actively and not be afraid of the post-trade operational issues.

Mitkov adds: "Our independence is viewed as a great asset as people are comfortable trading with us and pleased that nobody is seeing their trades or acting upon the information that they leave behind in the platform."

"On the options side there is very big gap between major banks and the rest of the participants in terms of technology, in terms of understanding the markets, and in terms of how they trade."

Furthermore, the platform works differently for the different players. He says: "On the options side there is very big gap between major banks and the rest of the participants in terms of technology, in terms of understanding the markets, and in terms of how they trade. A small player might think in terms of premium whereas all the big banks think in terms of volatility and in delta hedge trades. We enable those two different marketplaces to meet in a single liquidity pool by just using technology. We can match the two counterparties and the SURFACExchange becomes the translator between those two counterparties. Using technology we make the meeting of the most sophisticated traders and market makers with hedgers a lot easier."

High frequency and systematic trading

High frequency and algorithmic trading has long been tipped as a growth factor and Mitkov believes the technology which underpins SURFACExchange is geared to high volume in the expectation of the market to move in this direction. He says: "Clearly most players do not have high frequency technology in FX derivatives, but we have accounted for the market evolving in this direction and we are ready to support this kind of trading. By building with 2010/2011 technology, we also safeguarded against our platform creating latency arbitrage opportunities."

While high frequency trading is not expected to happen immediately, Mitkov does expect a greater roll-out of systematic trading models, another area that has been underdeveloped in the FX options world. "Systematic traders face serious challenges where they have to pick up the phone and call five banks and ask for prices. They also have a number of good models sitting on the shelves. However in an ECN, with all types of prices available, we permit existing models to be tuned to generate signals more often and shelved models to be deployed, becoming another source of liquidity to the marketplace," he adds.

New players

While FX options are poised for growth, Mitkov says that the players that will bring this new growth are not in the marketplace yet. One of the biggest sectors is the second tier and regional banks, which cannot afford to participate in the interbank market but see increased demand from their customers as a result of greater volatility. The ones that are in the market are simply trading back-to-back with one or two banks, globally and, he says, the demand from these institutions is to see a multi-contributor, independent, unbiased price that is available to them in real-time.

There is also a renewed interest in FX as an asset class from pension funds and as a result a lot more money has been allocated to hedge funds. A lot of bank traders have now moved on to set up proprietary trading shops or hedge funds and need a platform where they market-make/take, similar to the tools they had when they were at a bank.

There are still more potential new players, says Mitkov, that are still not in the market and avoid OTC FX options because they are not electronic, require a lot of manual processing, and there is no unbiased trading venue available. The only way to trade OTC FX options is to pick up a phone to a bank and these professional traders do not pick up phones – they have servers and they cross connect.

One particular example is the equity options prop shops and market-makers. They have seen serious correlations between equities and FX, while equity volatility is three to four times higher than FX volatility. They want to vega-hedge their equity exposure with FX, but currently CME is the only venue offering electronic trading in FX options.

He says: “With six interbank players disappearing in the crisis the liquidity has suffered massively. There is a serious dislocation between the liquidity provided by the banks and by the assets under management at the buy-side firms, which has increased significantly over the last few years. Banks don’t market-make as much as they used to and buy-side firms have much more assets to deploy in this market so it is a lopsided market at present, while there are plenty of new players willing to fill the void.”

Multi-bank model

Mark Suter, CEO of Digital Vega, says that its new electronic FX options trading platform, Medusa, which is in pilot phase, will shortly be rolled out to a diverse group of more than 30 buy-side firms covering corporations, asset managers, regional banks and broker-dealers. Liquidity will be provided by an initial group of 7 major banks, with this number expected to increase to 12 by year-end.

Mark Suter

“Until recently, I did not believe the technology existed to trade FX options electronically very well, but now there is much greater flexibility and participants are investing in new technology.”

The first release of Medusa will offer single vanilla options, straddles, strangles and risk reversals, with or without hedges, and will start with six currency pairs, which Suter says will be rapidly expanded once the platform is in operation.

Electronic trading platforms for FX options have been attempted before but Suter says that the ease of use of the platform will be a key to its success. He says: “It is a very easy to deploy a browser-based solution – it runs on any browser or platform, This is combined with the fact the platform will bring much needed transparency to FX options. Meeting regulatory requirements means greater transparency is needed, and proof of best execution so we have already built a lot of analytics and reporting into the platform.”

“Until recently, I did not believe the technology existed to trade FX options electronically very well, but now there is much greater flexibility and participants are investing in new technology. It is all being driven increasingly by the regulators, especially in the US, with the Dodd-Frank act. The drive towards electronic trading has been given a boost by the fact that foreign exchange options will now have to trade on a Swap Execution Facility (SEF) in the US, once the Dodd-Frank is in place.”

Conclusion

Suter believes the move online had already begun following demand from the buy-side community, as part of the evolution of what has happened in the FX cash market. In preparation for this, Digital Vega has built the tools to provide straight through processing functionality and is working with partners to deliver more complex STP solutions, building on what market participants have already delivered for FX spot and forwards over the past ten years.

However, despite this, Suter believes that some of the more exotic options will never successfully be electronically traded. He says: “Exotic currencies, yes, but exotic options are not an area we will venture into – they are too customised and specialist, and do not lend themselves easily to platform trading. We are looking at the more commoditised, more liquid products.” He believes there is now sufficient flow that can be traded electronically; as additional products and services are added to the platform and, against a backdrop of increasing regulatory pressure, he feels that the opportunity can only continue to grow.

FEATURE

Developing new Back Office and clearing connectivity services for FX

Connection to CCPs, Swap Execution Facilities (SEFs) and Trade Repositories will add another layer to an already complex and sophisticated automated system, writes Frances Maguire.

All aspects of the FX trade life cycle, pre-trade, trade and post-trade will be greatly impacted by the incoming regulations for OTC instruments and the systems in place to support this workflow, including telephone based trades, will need to be reviewed. Most importantly, credit risk systems will need to reflect changes in credit risk due to CCPs, while trade processing systems will need to be enhanced and configured to include OTC instruments for the newly established Trade Repositories.

Aggregation

Further to this, Gil Mandelzis, CEO of Traiana, says that the introduction of aggregation, such as that offered through the CLS Aggregation Service (CLSAS), a joint initiative between Traiana and CLS, and through Harmony NetLink, a retail aggregation solution offered by Traiana, provides an intermediate step that will also significantly change the way front to back office processing operates in FX. Last year, Traiana and CLS joined forces to enable aggregation of trades from post-trade through to settlement. Harmony NetLink provides a similar offering for firms aggregating trades from retail customers.

Mandelzis says: "Both CLSAS and Harmony NetLink aggregate trades before they get to the back office and are settled. By providing these solutions, we have changed the way the trade flows work to increase capacity and reduce risk in the industry."
Mandelzis says that getting an affirmation of the trade before it is aggregated makes a huge difference to the efficiency of the back office, and in achieving real-time risk management of trades. Using these solutions, not only is operational risk reduced but trading capacity is also better managed. Using CLSAS, banks can dramatically reduce their volumes quite often arising from their prime broker businesses. Reducing these volumes equates to a significant improvement in operating efficiency and capacity.

Likewise, using Harmony NetLink retail FX market participants can reduce costs and decrease risk by

compressing tickets in a controlled and automated environment. Liquidity providers and retail platforms benefit from lower cost processing while still having visibility into the original tickets (called component trades) so they can manage their exposure.

With clearing for FX on the horizon, Mandelzis adds that significant complexity is added compared to the current situation. In a cleared environment, there will be changes in execution, because some of the FX products will have to be executed on SEFs. "We're currently working with major prime brokers to enable post-trade connectivity associated with SEFs and CCPs."says Mandelzis.

In a significant step towards developing a clearing solution for the OTC FX market, Traiana in March announced that it will provide straight-through-processing (STP) connectivity through the Harmony network to parties wishing to link to central counterparties (CCPs). The solution, called Harmony CCP Connect, will allow for connectivity and matching between executing banks, prime brokers, execution platforms and CCPs for OTC foreign exchange (FX) trades. In March 2011, Chicago Mercantile Exchange (CME) became the first CCP to connect to the Harmony network.

However, Mandelzis says that as the new regulation continues to be defined, it is still too early to say whether this will be a catalyst for the improvement of FX technology, post-trade.

Improving processing operations

But for Richard Kiel, global head of post trade services, sales and trading, at Thomson Reuters, the recent emphasis has been on the implementation of electronic solutions to increase processing timeliness and efficiency whilst reducing risk and enabling a more effective management of headcount versus technology.

"In some markets it is true to say that post-trade efficiencies have significantly improved the front office ability to increase trade volume. Electronic affirmation and confirmation processes have virtually eliminated the rising outstanding confirmation levels in the OTC markets, which regulators were demanding be addressed, and have provided a level of trade certainty not seen before. With the financial world focusing on regulation, risk mitigation is critical," says Kiel.

He adds that these processes are now given far more importance, moving closer to the point of trade execution so that details can be quickly, efficiently and

Gil Mandelzis

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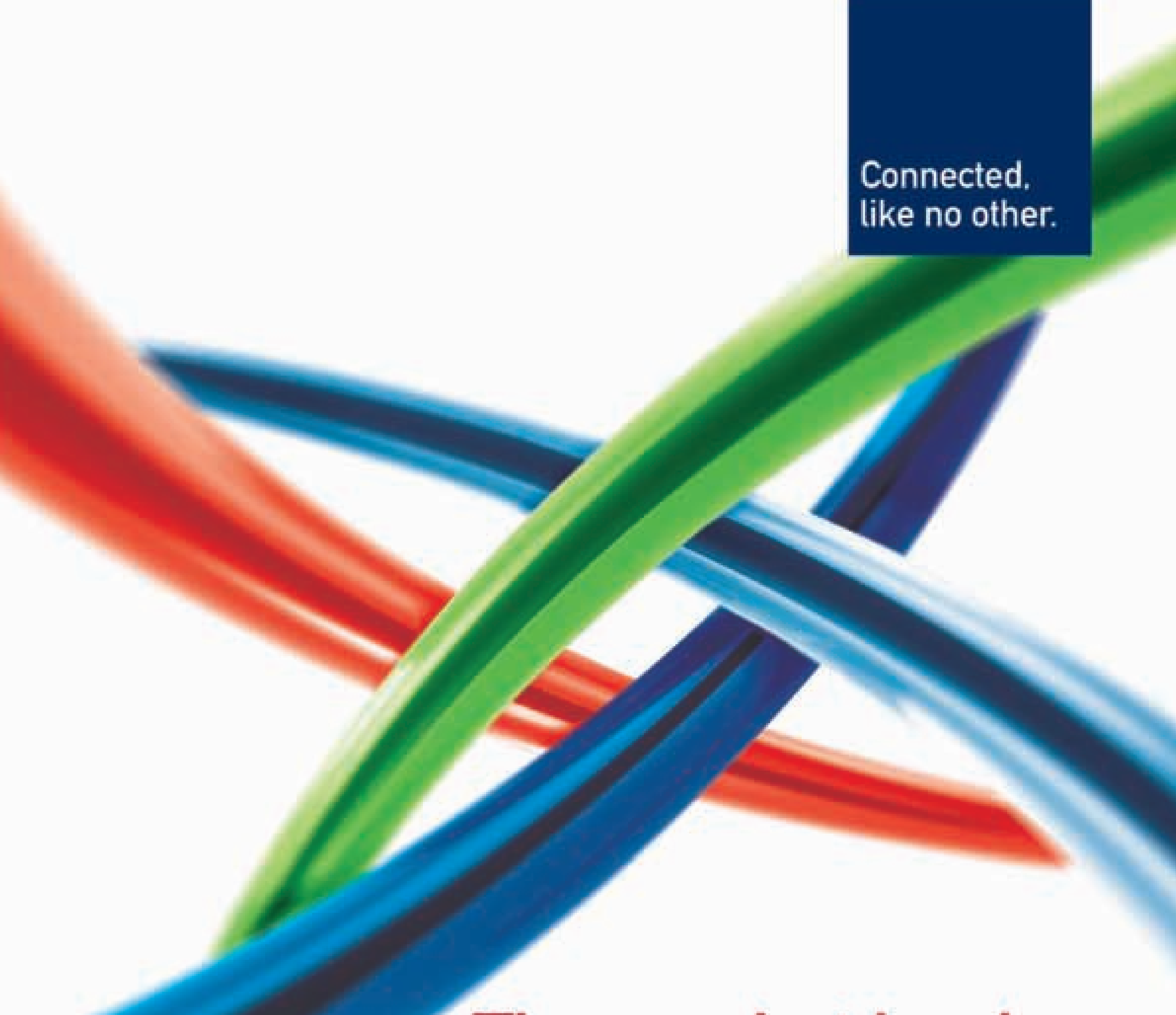
accurately executed to provide trade certainty within seconds. He says: "Post-Trade automation is now seen as a requirement and a key differentiating factor rather than a 'nice to have' by all market participants, from the regulators through to buy-side customers."

Whilst we await the results of the consultation period for the FX exemption proposed by the US Treasury as part of the Dodd-Frank Act, and the pending EMIR legislation, Kiel says the financial markets are looking at how the new rules will be implemented.

Kiel says the fact that FX derivatives will need to be cleared will have a huge impact on cost and resources. He says that firms will need to re-prioritise their development roadmaps and redesign process and procedures to deal with such challenges as the bifurcated workflow between cleared and non-cleared trades; a margining process that is significantly more dynamic than that under bilateral CSAs; the reconciliation of portfolios and payments; new settlement processes and collateral implications; not to mention the individual CCP's Default Management Process which will need to be regularly tested with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