

## pricing

# Tail wagging the eFX dog?

**2000 will be remembered for being the year of eFX. One announcement of a Web-based service was followed by another, and another. Every player wanted in on the action. What led to the gold-rush? Mark Galant thinks he knows.**

After lagging behind most other capital markets in the shift to electronic trading, 2000 was undoubtedly the year of eFX. While the interbank FX market has been electronic for years with EBS and Reuters, the vast majority of FX banks were curiously behind the times when it came to providing their client base with electronic trading capabilities. Notwithstanding early efforts from the likes of Bank of New York, Dresdner Kleinwort Wasserstein, State Street and a few others, most eFX initiatives were announced in the latter part of 2000. So what caused the sudden move to eFX? One common view is that the banks' eFX initiatives were a defensive move in response to new competition from independent providers.

To fully appreciate the impetus of eFX and the implication for all FX market participants – both sell side and buy side – it's important to first understand the *status quo*. The banks firmly dominate the FX market and depend on their FX businesses for a healthy percentage of their yearly profits. In theory there is little incentive for banks to change the way they currently handle their FX business.

For this reason, one could argue that independent providers were the catalyst for the banks' embrace of eFX. Consider the example of Currenex, an independent B2B exchange that launched in April 2000. Currenex immediately set about gunning for the top corporate end users, the banks' traditional client base. Within months of the Currenex launch, two bank-led consortia, FXall and Atriax, announced their intention to build their own electronic FX platforms, a similar multi-dealer model to that of Currenex, while State Street opened FX Connect to multiple providers.

Independent firms have also been the first movers in terms of improving price transparency in FX. The market standard request for quote (RFQ) pricing model is notoriously inequitable for all but the very largest or most valuable clients. Regardless of whether a client is dealing over the phone or online, they must request a quote for a transaction and wait for the dealer to respond with a price. This practice restricts price transparency, as it allows the dealer to shade prices against the client's position, or provide tiered pricing based on a client's level of importance.

Multi-dealer platforms take the request for quote model a bit

further via a reverse auction method. Here, clients request a quote and various liquidity providers independently submit bids for that trade. This process results in more competitive pricing, but it still requires the end user to request a quote to initiate a trade.

Independent firms have pushed FX pricing to a new level. Among several new available methods, perhaps the boldest step forward is offering clients the ability to deal directly from real time, streaming quotes. Not only does this practice offer the highest level of price transparency, but it also simplifies the dealing process to support split second deal execution, and provides dealing anonymity, which precludes tiering and shading of prices – both of which are practices far too common at banks.

Gain Capital was the first to implement this pricing method, and now a few banks have taken a step in this direction – with an important difference. Instead of offering truly “dealable” prices, the banks offer instead what could be described as “hard indicative” prices. When a client attempts to deal on a given price, the dealer has the opportunity to review it and choose whether to accept the trade or to re-quote a new price. But just the fact that established players are moving away from the traditional RFQ model towards a more equitable “exchange-like” model underscores the impact of the independent offerings on the market.

In general, independent firms serve two major purposes. One is to challenge the *status quo* and provide an alternative solution to the marketplace. The other is to continually act as a pacesetter. Upstart companies will always push the envelope in terms of providing value to their target market, as they must offer something the established players do not.

Drawing an example from the US equity markets, if it wasn't for firms like Charles Schwab, E\*Trade and Ameritrade, US equity investors would still be paying full service brokerage firms \$300 commission for 100 shares of Cisco. Of course there will always be investors who prefer to pay the higher commission fees in exchange for advice and personal service, but these independents spawned a revolution in the US equity markets. Not only are there now electronic trading platforms to fit each type of investor; there's also an entire new group of market participants.

In the eFX world, independents are now offering their customers lower transaction costs, free access to research, market information and trading tools, as well as state of the art technology that allows customers to view position and P&L information in real time and provide sophisticated order entry and tracking as well as full reporting capabilities. As end users discover the offerings of independent providers, they will demand the same level of service from their bank counterparts.

In eFX the tail is wagging the dog, and the buy side is smiling.

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