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Pressing the case for Peer-to-Peer trading in FX: **Reducing costs, information leakage, and opening new possibilities**

The notion of peer-to-peer trading isn't new in FX. Despite the promise, this trading model had previously struggled to find traction. However, recent changes in regulation and technology have boosted peer-to-peer's appeal. So how are service providers addressing participants' needs and crafting ecosystems? Vivek Shankar investigates.

Vivek Shankar

FX trading has historically relied on buy-side institutions sourcing liquidity from market makers. All participants implicitly understand the risk involved with market making and the reasons why there is a certain level of opacity in price structures.

However, a raft of changes in the broader markets and the FX world is challenging this structure. Recent changes to the GFXC's Global Code have left participants prioritizing execution transparency, a trend that was well underway even before the changes were announced.

Best execution requirements, a desire for greater transparency as well as a better understanding of what drives their execution costs have led the buy-side to look towards peer-to-peer liquidity as a potential solution. This model isn't exactly new to FX. The premise of peer-to-peer is simple: A self-sustaining community of peers

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Jay Moore

that provide and consume liquidity to reduce execution costs (including spreads) while providing greater operational efficiency.

How has peer-to-peer trading evolved over the past year, and which way is the market headed?

SAFEGUARDING TRADE INFORMATION

Jay Moore, Co-founder and CEO of FX HedgePool, points to the elimination of cost uncertainty as a major benefit that peer-to-peer brings to the buy-side. " Markets are volatile, and the unexpected should always be expected when trading with market makers who are paid to price risk and turn a profit," he says. " Peer to peer brings naturally opposing positions together with transparency to deliver consistent cost through all market conditions."

In addition to price transparency, sealing any information leaks and decoupling credit from liquidity are major advantages that peer-to-peer offers. These are attractive benefits when presented to the community of buy-side firms looking to exchange liquidity without impacting the market. However, the same is true for a wider community of participants who share this objective of reducing their execution footprint.

Meanwhile, Claude Goulet, CEO of Siege FX, stresses that it is the peer-driven nature of an ecosystem i.e., how it channels participants with the same objectives, that really drives benefits. He points out that certain order execution workflows naturally lend themselves to peer-driven mechanisms.


Claude Goulet

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" Peer-driven trading is particularly attractive for passive phases of execution where a participant has already decided to execute over time," he says. " When operating in an anonymous environment without signaling risk, it provides the unique ability to manage and monetize the trade-off between market risk (market drift over time) and market impact from execution."

Goulet says that while such conditions are especially relevant for larger orders and less liquid currency pairs, there is a broader appeal. " This ecosystem also benefits from the participation of shorter duration orders to offset more passive liquidity, as long as there is a genuine underlying interest to transact" he explains.

The lit nature of open markets also bolsters the use case for the peer-to-peer and peer-driven models. At first glance, pointing to the dark nature of a closed peer-driven ecosystem might seem at odds with the stated goal of transparency. However, by preventing information leakage, these pools can help participants to significantly reduce market impact.

Moore explains, "At the highest level, peer-to-peer aims to broaden the liquidity available to the market and enhance transparency by empowering buy-side firms to connect directly. Achieving this allows matched trades among peers to bypass the opaque and risky waters of the open markets for transparent and consistent execution for their investors."

SIGNIFICANT COST SAVINGS WHILE ELIMINATING MARKET RISK AND IMPACT

Moore points out that peer-to-peer isn't meant as a substitute for active trading strategies but as a complement to automate and create scale without sacrificing execution quality. This begs the question, does a peer-driven environment almost always guarantee cost savings thanks to favorable spreads?

Goulet contrasts bilateral execution processes with peer-driven ones to illustrate the benefits. " Trading at a mid-rate in a peer-driven environment without signaling risk helps participants save on visible spreads and hidden market impact costs," he says.

"Participants should be aware of every layer of cost impacting their overall execution," he continues. "Identifying the cost of credit, FX platform access, and fund allocation as part of the overall price is a much harder task with direct bilateral execution."

The demand for peer-driven ecosystems parallels the rise of another trend driven by the need for greater transparency of execution: Algo trading. Similarly, algo trading has faced significant roadblocks in the past but is increasingly making its presence felt in FX.

How are these two trends intersecting? Moore highlights the similar goals these trends help the buy-side achieve. "One of the key benefits of algos, like peer-to-peer, is to minimize market impact – the footprint of the trade," he says. "While algos are carefully designed to be as stealth as possible, peer-to-peer eliminates the trade from the market entirely, arguably making it the ideal electronic solution for trade automation."

Goulet points out the numerous ways Siege has integrated with algo trade workflows. "We are working with an increasing number of banks looking to integrate Siege as part of their algo execution," he says. "Today, the Mid-Pool is accessed by a range of algo strategies, including ones where users can select the period for which they want to 'rest' in the pool."

Goulet also explains how Siege's Mid-Pool is a critical component of algo trading strategies. "An approach that is gaining traction, and which aims to leverage Siege's Mid-Pool to its full extent, is to place any inactive portion of the order with Siege and load-balance as the execution unfolds," he says.

"Because there is no signaling on order submission, the algo can safely seek offsetting liquidity in Siege as it tries to optimize between market risk and market impact. This gives participants an opportunity to monetize the time risk they would otherwise bear from not being in the open market".

Emin Tatosian

"Itemizing execution and credit cost individually is a big step forward in giving more transparency to the buy-side,"

PRODUCT FEATURES AND ENSURING DIVERSE LIQUIDITY POOLS

While the business case for peer-driven models is strong, advances in technology are making them even more attractive. Emin Tatosian, Co-Founder and CTO of FX HedgePool, points to key features within FX HedgePool that make traders' lives easier.

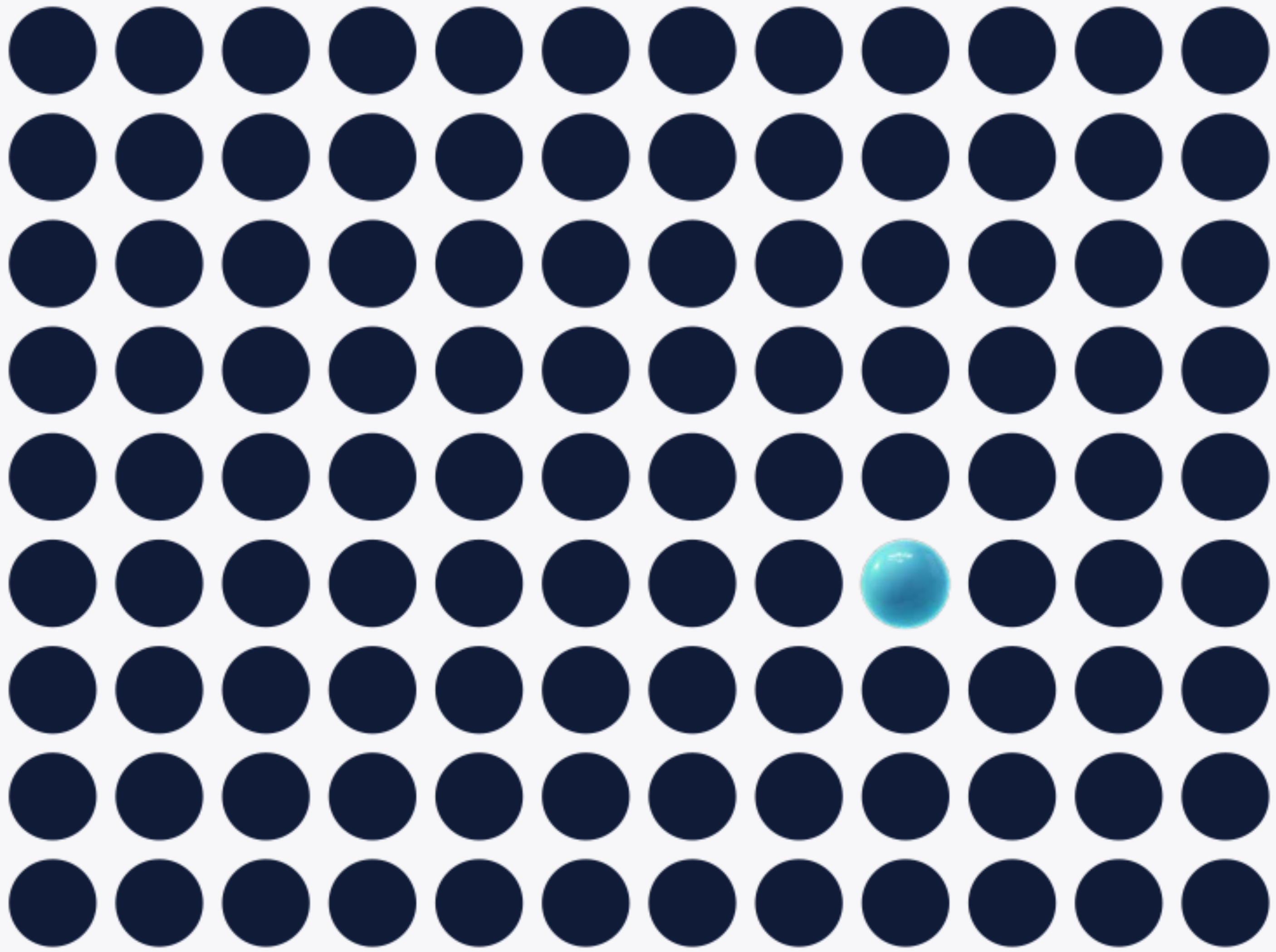
"Through careful curation of liquidity and anonymous matching, FX HedgePool offers safe and dependable execution for buy-side trading desks interested in reducing operational risk," he explains. "This helps in reclaiming time that would otherwise be spent on maintenance trades, and achieving predictable results for underlying investors regardless of market conditions."

Decoupling liquidity from credit, a key FX HedgePool innovation, has also improved transparency significantly. "Itemizing execution and credit cost individually is a big step forward in giving more transparency to the buy-side," Tatosian explains.

For Goulet, Siege's appeal is bolstered by its ability to quickly integrate within existing workflows and enhance processes. As an example, he mentions how Siege improves transparency. "Timestamps are recorded and reported at each stage of the order lifecycle, from submission to execution," he says. "Fees, which can be collected through the all-in settlement rate or be invoiced, are also fully disclosed to participants ahead of trading."

Liquidity diversity is a common concern when speaking of limited pools. Moore points to a transformative credit model that allows liquidity to be provided to and taken by all with a bank to settle the trade against. "This opens the pools to asset managers, pension plans, overlay providers, corporates, and numerous other firms that would otherwise remain captive to the select panel of banks with whom they trade today," he says.

Goulet points to the importance of participant behavior when increasing diversity in a pool. "We seek out diversity by client type and geography, as it increases the matching rate and broadens liquidity across currency pairs," he says. For instance, Siege can be accessed by approved algo



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WHILE THE BUSINESS CASE FOR PEER-DRIVEN MODELS IS STRONG, ADVANCES IN TECHNOLOGY ARE MAKING THEM EVEN MORE ATTRACTIVE.

strategies but is closed to high-frequency trading strategies that seek to gain information. "Operating a common, peer-driven rulebook, including controls and monitoring processes, is crucial to foster and preserve diversity," Goulet explains.

ENSURING HIGH PARTICIPATION

Increased participation remains a critical driver of peer-to-peer demand. The challenges posed by limited participation, systems integration, and workflow automation are typical roadblocks that a peer-driven ecosystem faces initially. How did FX HedgePool and Siege overcome these challenges, and are there any clues about pool quality and diversity on offer?

" In the early days, FX HedgePool jump-started its growth by offering a lightweight integration-free usage option that removed lengthy integration projects from the critical path of client onboarding," explains Tatosian. "As such, early adopters quickly reaped the benefits of peer-to-peer matching, then gradually moved towards systems-level integration and workflow automation."

Tatosian points out that there is no one-size-fits-all approach for onboarding participants. " Having a variety of access options along a spectrum of simple and quick-to-implement protocols (e.g. SFTP), to sophisticated yet slower to implement ones (e.g. REST, FIX), is necessary to boost platform participation at all levels," he says.

Goulet highlights the importance of sell-side and FX platform partnerships in deploying Siege's agile technology and ensuring the continued growth of its peer-driven offering. " We want to be available to participants inside their existing execution management frameworks to drive greater participation and efficiency".

He also points to the growing popularity of FX algo trading as a driver of greater participation for peer-driven ecosystems, and cites additional product offerings (e.g., NDF) as potential evolutions that will continue to boost demand for peer-driven mechanisms.

WHERE DOES PEER-TO-PEER AND PEER-DRIVEN GO NEXT?

Both Goulet and Moore are optimistic about prevailing trends increasing demand for peer-driven and peer-to-peer environments.

Goulet remarks that peer-driven mid-pools are unlikely to dominate the market structure anytime soon, if at all. " There are benefits that can be achieved by trading in a dark environment (when properly controlled), but this doesn't suit all order types or market conditions. Also, price formation needs to happen somewhere."

However, lessons from Equity markets point to possible evolution. " What the Equities market has shown us is that peer-driven mid-pools are a valuable part of the execution process and integral to achieving best execution policies," he says. " There is a wide spectrum of opportunities, and this seems to be a turning point for wholesale FX markets."

Moore points to the technological standards available to solutions providers as proof of almost unlimited potential. " The technologies available today allow firms like FX HedgePool to create and deliver web-based solutions to the market where incumbents have historically dominated," he says. " The time is now, and the market is ready for change. Peer-to-peer is here to stay."