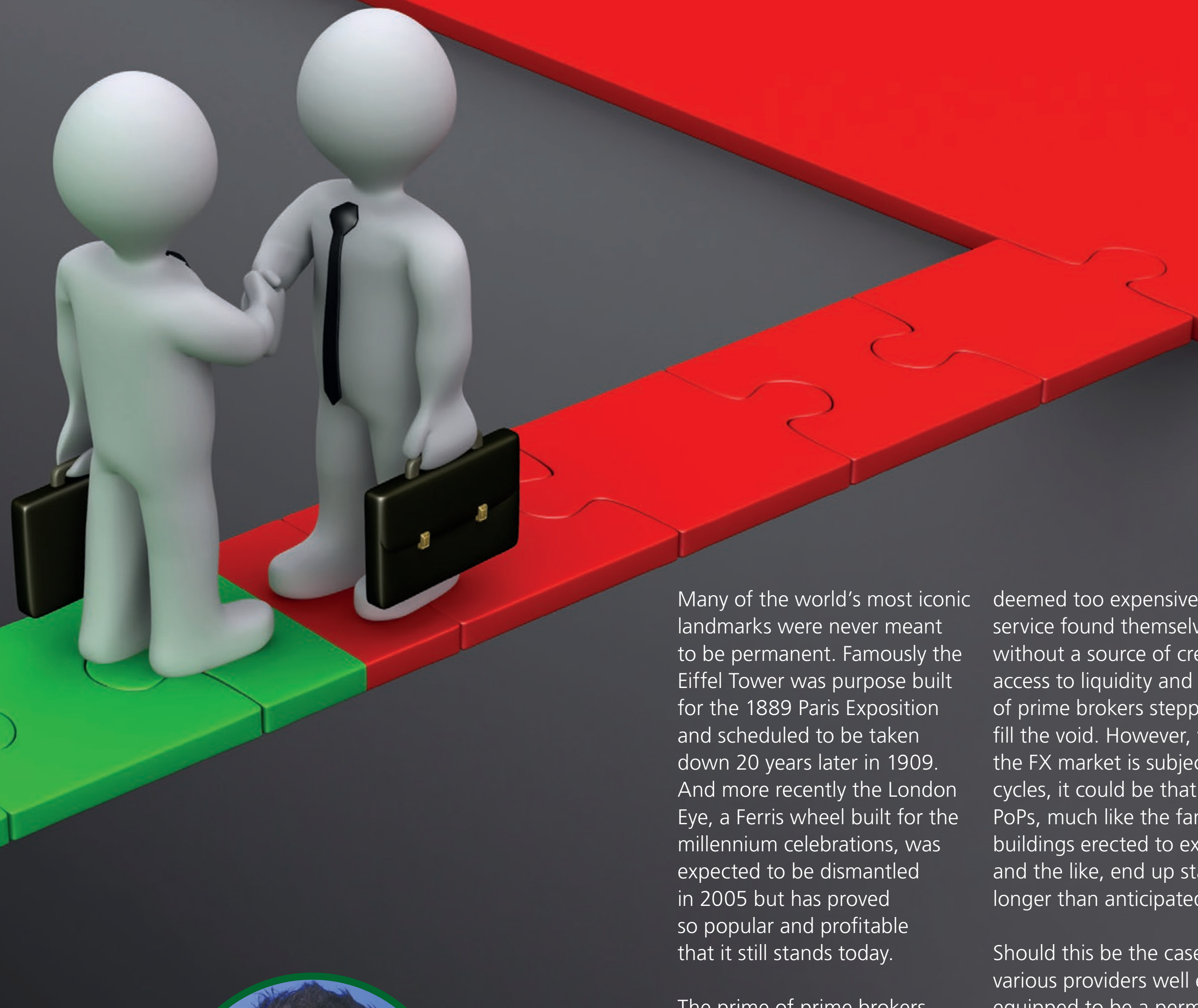
Prime of Primes –

Bridging the gap between the retail and institutional FX markets



As Prime of Primes continue to fill the gap left by prime brokers withdrawal from parts of the FX market, Nicholas Pratt examines whether the PoP model can endure in the long-term and truly act as the bridge between the retail and institutional FX markets.

Many of the world's most iconic landmarks were never meant to be permanent. Famously the Eiffel Tower was purpose built for the 1889 Paris Exposition and scheduled to be taken down 20 years later in 1909. And more recently the London Eye, a Ferris wheel built for the millennium celebrations, was expected to be dismantled in 2005 but has proved so popular and profitable that it still stands today.

The prime of prime brokers (PoPs) that are rapidly becoming a growing feature of the FX market have similarly arisen due to 'events' – in this context, the withdrawal of several FX prime brokers (FX PBs) from servicing the middle class of FX trading firms. Several market participants deemed too expensive to service found themselves without a source of credit or access to liquidity and prime of prime brokers stepped into fill the void. However, while the FX market is subject to cycles, it could be that the PoPs, much like the fancy buildings erected to exhibitions and the like, end up staying longer than anticipated.

Should this be the case, are the various providers well enough equipped to be a permanent fixture in the FX market? And are their potential and current clients fully aware of what they should be looking for from a PoP, especially if they are going to be a long-term partner rather than an emergency stopgap until the FX PBS rediscover their appetite?

FILLING THE VOID

Many of the hedge funds, prop trading firms and retail aggregators that have been jettisoned by their FX PBs have perfectly valid business models but the internal hurdles to on-board multiple smaller clients at the banks has created demand for true PoPs to act as trusted intermediaries between these clients and the large critical mass FX PBs, says Ramy Soliman, chief executive of newly launched PoP Stater Global Markets.

"PoPs that can match, exceed and complement their FX PB's own risk, compliance and operational requirements can act as an important intermediation tool for the clients as well as the FX PBs. These PoPs offer access to the clearing business that the FX PBs traditionally wish to facilitate and at the same time act as an additional risk mitigation layer, removing the FX PB's need to take on the heavy lifting required to on-board and service smaller clients", says Soliman.

That said, Soliman says that most PoPs are not looking to engage in a straight up contest for clients with PBs. "We can probably be more flexible and more familiar with the retail market and the use of MetaTrader whereas maybe other PBs can't serve that market quite as well. But we know that if clients had PB access, they would take it. We are there to replicate a PB service as much as we can for our clients."

Stater Global Markets is entering an increasingly


Ramy Soliman

"A successful PoP is about building trust in a transparent way with all the providers that we work with."

populous marketplace, making it more important for the PoPs to differentiate their offerings and for potential clients to ensure that they are selecting a genuine PoP. The verification depends on the client's requirements, says Soliman. "If it is liquidity, then a PoP may have better/differentiated liquidity to other brokers but brokers operating different business models may well offer a tighter price. So you may want to check who the PoP's PB is. If it is credit intermediation, then a PoP needs to be able to facilitate access to the venues that the client is looking to trade on. Again, generally this is a derivative of the client's primary access that is a consequence of the PB they have. If it is a technology solution, then again, access to some venues will only come as a result of a PB-derived relationship," he says. "Each PoP will work to their strengths – some will focus on liquidity, some will focus on access and venues and some will focus on speed of on-boarding. Others focus predominantly on their clearing services."

For FX trading firms making their first foray in to the world of PoPs, Soliman suggests that they employ a checklist similar to what any market participant would use when working with any financial services provider. "Are they appropriately regulated? Do they have the core elements to be able to provide the service that you are looking for, such as PB-derived direct market access, experienced staff, and a range of technology solutions? And how does the business model perform under stress? We are entering a period of high volatility so this will become more of an issue," says Soliman.

DIRECT RELATIONSHIPS

The rising cost of PB services and the retraction of some of the bank-based PBs has left smaller, under-capitalised firms without access to the interbank markets and has led PoPs to step in and fill the void, says Paul Jackson, global head of sales at UK-based PoP, CFH Clearing. "The PoPs will continue to grow in importance in providing access to liquidity and institutional spreads. Conversely, FX PBs are increasingly looking to use PoP's distribution networks to service a wider audience outside of the interbank space."

According to Jackson, clients should consider multiple factors when looking to appoint a PoP. "Selecting a PoP with direct relationships with a PB and top tier bank is key. In addition, it's important to select a Prime of Prime which operates an STP only model as this means that all trades are sent directly to the market and will therefore achieve tighter spreads with minimal rejection at lower trading costs," says Jackson.

"When selecting a credible PoP, it's also important to check their license, whether they are regulated and where they are located. Being regulated by the FCA is particularly credible – it's considered to be the world leading regulator for the financial services industry. Brokers should also ask them about the transparency of execution and their reporting details. As part of their KYC, they should also check out their security, reputation, how long they have been operational, the support they offer to clients and their financial durability."

Flexibility and choice of customisable front-ends is where CFH Clearing has decided to differentiate its offering, says Jackson. This includes both proprietary and third party platforms including MT4, Seamless FX and NetStation as well as a range of tailored liquidity in multiple asset classes. "This flexibility enables a broker to shape their offering to cater for different types of traders and with customized solutions, they can create their own brand," he states.

CLIENT PROXIMITY

Some PoPs would argue that rather than being an emergency measure for stranded FX trading firms, they actually offer a

better option than their former FX PBs. "The main reason why PoPs are able to fill the void is proximity to the client," says Jonathan Brewer, managing partner of IS Prime, a UK-based PoP that launched in January 2015. "This means a much better understanding of their modus operandi, whereby traditional FX PBs are one step removed, and there is a structural advantage in that they are better able to manage risk at the point of execution."

The main benefit of using a PoP is scale, says Brewer. "If you are transacting a large amount of volume, you are able to demand more competitive liquidity from your providers. This is turn means that a PoP can offer more competitive pricing to a client than that client would be able to get if they were to access the same liquidity providers (LPs) directly."

In addition to the quantity of flow, a PoP's ability to manage the quality of the flow that is being transacted with LPs is probably actually more important, says Brewer. "In order to manage the quality of the flow, in-depth analytics and execution optimisation expertise are critical. Accordingly, advanced technology and a strong quantitative philosophy are pre-requisites. In terms of onboarding, clearly PoPs are typically likely to be far more nimble with faster turnaround times as they will not have the layers of bureaucracy or technology blockages which prevail at the banks."

Technology is also a large element in PoPs' efforts to differentiate themselves from each other and not just the FX PBs they are replacing. Technology also enables more customised services, especially when it comes to liquidity provision, says Brewer. "We have very detailed flow analytics which enable us to assess the quality of the flow that we are sending to our LPs and we have the ability to intelligently route flow that is less advantageous to liquidity sources that are more appropriate. This is a critical factor in managing liquidity, and our expertise and technology in this field enables us to ensure that we can offer the best liquidity available in the market. There is no 'one-size fits all' philosophy but rather almost an infinite number of aggregation and execution optimisation possibilities."

PoPs are finding particular traction in Asia

Jonathan Brewer

As the PoP market matures, more providers will enter the market and while this should mean greater choice and competition for firms, it will also require more care in firms' selection process, including the ability to discern genuine PoPs from the pretenders. "Many PoPs are simply white labels of expensive, inflexible third party technology solutions with little expertise in liquidity management," says Brewer. "We would advise that clients should do their due diligence and choose a PoP that is able to really provide value added services rather than an 'out of the box' solutions."

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Another key consideration that is often overlooked is whether the PoP provider is really incentivised to operate in the best interests of the client, says Brewer. "There are many PoP providers who operate as, or are owned by large players in the retail market, and are therefore major competitors to their clients. Whilst it is good to look for a PoP that is part of a stronger, broader group, it is counter intuitive to trade with a provider that ultimately can't have your best interests at heart, and also to fund the marketing budget of a major competitor."

LAND-GRAB

According to Gavin White, chief executive of Invast Global, there is currently a land-grab taking place in the PoP market which could lead to a two-tier

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structure in the future. "The PoPs that are able to aggregate the most downstream business are the ones who are able to sustain better conditions at their own PB – and hopefully, sustain multiple PBs. These PoPs will be the ones who evolve into the premium players, and I expect these entities to grow into potentially billion-dollar entities in the next five to ten years. Other PoPs who fail to make this leap will form the lower layers of the PoP landscape, says White. In addition, we are also likely to see the disappearance of some of the smaller PoPs as well as those PoPs who are essentially retail brokers opportunistically hanging out a Prime-of-Prime sign. The key test of a true PoP is the ability of that entity to sustain long-term direct Prime Broker relationships themselves. Those brokers who claim to be PoP but either clear through another PoP, or internalise the flow rather than clear it, will eventually struggle to remain competitive," says White.

For the PoP's it is a case of proving that they can offer more than just an alternative to banks and FX PBs, says White. This includes some of the more obvious benefits, such as a more responsive and flexible service than those offered by banks and also the ability to invest in leading edge technology unrestrained by the anachronistic internal structures that hobble many large corporations.

Another benefit of PoPs that is only just being fully appreciated by clients is the ability for even small clients to diversify their counterparty exposure, says White. "Most PBs have minimum monthly charges. Most PoPs do not. This means, for a hedge fund which has been moved off a PB platform, or who has been subject to increased fees or other altered conditions at the PB, they can now look to establish multiple PoP accounts. This is efficient when there are no longer any monthly minimums in place. It is a real benefit to clients who can now be more agile themselves and can take advantage of the different specialities of each PoP. It's also good for the industry as a whole, as it means risks are more easily distributed across a range of firms, rather than being heavily focused on top tier PBs."

Another real benefit of the growth of PoPs is that they provide a channel through which clients can more easily access some of the new non-bank market makers who are really beginning to dominate, says White. "Traditionally, only the largest funds and institutions have been able to get access to the benefits provided by the non-bank market makers. This is because access has relied on the client having a Tier One Prime Broker relationship, as the non-bank market makers rarely have bilateral arrangements with clients. By partnering with some of the heavyweights of the industry, like XTX, Virtu Financial and Citadel, Invast Global is providing access to non-bank liquidity for clients who do not have a Tier 1 FX PB."

In a bid to differentiate itself from the competition, Invast has focused on providing as much transparency as possible to the underlying LPs and giving clients control of the liquidity they are receiving, says White. "So, just like a Tier 1 Prime Broker, we allow

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Technology also enables more customised services

clients to see exactly which LPs are providing pricing in each instrument, pre and post trade. Clients can see the true depth of market and can add and remove Liquidity Providers on the fly. We complement this transparency by providing clients with a dashboard where they can view the live performance metrics of each LP – for example, rejection rates, response times, etc – allowing them to make informed decisions about the structure of their streams," says White. In addition, and like many of the larger PoPs, Invast Global offers multi-asset prime services in OTC products such as FX, Metals, Indices and Commodities, as well as DMA connectivity to over 30 global equities and futures exchanges that can be traded via GUI or API, notes White.

FUTURE EVOLUTION

Given the relative youth of the PoP sector and the opportunistic nature by which it has emerged, potential clients would do well to focus on the likely factors that will influence how the PoP sector evolves. In Invast Global White's opinion, the most influential factor will be regulatory reform. "It could be argued that PoPs exist purely because regulatory reforms have forced the banks to retreat. But the important aspect is that the reforms we are seeing affecting the industry now, and the reforms we believe are coming with Basel IV and MIFID II, are long-term reforms that will have a lasting effect. This is a once-in-a-generation change to the industry."

Another major influence on the PoP industry is likely to be M&A activity, says White. "The PoP space is likely to consolidate naturally as Premium PoPs emerge to dominate and lower tiers of PoP evolve. But there will also be consolidation brought about by M&A."

The PoPs are finding particular traction in Asia, says White. "Financial markets have long suffered from a UK/US preoccupation. The Tier 1 PBs are generally run by their head offices in locations outside of Asia. This can cause issues for the smaller end of the institutional sphere in Asia. They have to work that much harder to be accepted by credit teams based in the UK or US. As a result, there is a real vacuum of prime services in this segment of the industry in Asia. The PoPs are finding success in Asia because there is a genuine need for credit intermediation and prime services. In addition, as Asia continues to undergo rapid economic development, demand for prime services amongst funds and retail brokers continues to grow. For one of the few Asia-born PoPs like Invast, this is a great boost to our own growth."

The business model in Asia is evolving from an investment bank-based model to full institutional provisioning and as a result, the need for a range of products and execution services is growing, says CFH Markets Jackson. "Network and connectivity in the past have proven to be challenges for the industry to access liquidity from banks and brokers outside the region, however PoPs are addressing this through cross connects and hosting in premier data centres in the region."


Gavin White

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CFH has invested significantly in its infrastructure, particularly in China, Hong Kong and Japan so that clients can benefit from reduced latency and more stable connectivity between Europe, USA and Asia, says Jackson. "There are lots of liquidity providers and Market Makers around the world, but in order to obtain a direct Prime Brokerage relationship, a company must first have to undergo rigorous Bank due diligence in order to prove they are operationally and financially sound. This gives PoP clients great assurance that they are dealing with a credible counterparty and a trustworthy counterpart."

Any region where the institutional market participants have been disenfranchised from market access and the complementary services they used to enjoy will be seeking to redress that via a PoP adds Stater Global Markets' Soliman. "But in Asia a lot of FX traders did not have PBs in the first place. They were using the likes of FXCM and are looking to get a more sophisticated technology and service. We are happy to take them on as long as they meet our risk management and on-boarding requirements."

Stater Global Markets uses deliberately conservative parameters, says Soliman. "A successful PoP is about building trust in a transparent way with all the providers that we work with. We are not here to be in a leverage war. We are trying to derisk our platform. We believe in our delivery mechanism and offering direct access to the market. I think there is a risk if you are too flexible with your parameters."

The fact that we likely entering a period of volatility, given the uncertainty over global trade created by Brexit and the election of Donald Trump in the US, makes this circumspection even more important. The volatility is also likely to mean more business for PoPs, says Soliman. "I don't think the FX PBs have the appetite to get back into many of these markets they have exited in a period of high volatility. And for the PoPs, more volatility means more volumes."