FX Week

FX platforms encouraged to consider liquidity enhancing pricing models

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A proposal made to the FX Joint Standing Committee in July 2012 for a per-order fee that is rebated in proportion to actual executed volume has garnered support among market participants

Driven by calls for greater transparency and equality in pricing, several major foreign exchange trading platforms are rethinking the way in which they charge clients. While there is little consensus over how pricing should ideally be calibrated, many share the view that it could be tailored in such a way that incentivises the provision of a better quality of liquidity to platforms.
In equity markets, some exchanges rebate fees for large amounts of passively traded volume, but Alex Gerko, head of FX trading at GSA Capital Partners in London, believes that kind of model would need adapting for the FX markets.

"With the traditional model of incentivising market-makers, there are massive rebate programmes where participants are paid for passive trades. But there is nothing that incentivises that market-maker to provide real liquidity rather than ‘phantom' liquidity, untradeable for a human. Furthermore, since there is no fee for orders, these programmes result in extraordinary quote traffic, which puts a huge strain on the platforms and on other participants," says Gerko.

Invited to present to the Bank of England's Foreign Exchange Joint Standing Committee in July 2012, Gerko proposed a pricing mechanism to reward participants that achieve high order-to-fill ratios, whereby participants would pay a fee to place an order, which would be rebated in proportion to actual executed volume.

"You start with imposing fees on all passive orders. It should be quite a small fee; in the context of FX markets, we could say 10 cents per order. Then you collect this pool of fees and instead of just keeping it for the exchange, you rebate it back to the market-makers, in proportion to the volume they have actually traded. My proposal introduces an element of competition on quality, which is right now completely absent from all exchanges that I know," says Gerko.

Such a mechanism, he adds, would create an advantage for manual traders that tend to have a fill ratio of more than 50% on venues, as they would pay very little in terms of order fees but would receive generous rebates. "On the opposite side of the spectrum, you will have a high-frequency trader that places 1,000 orders and gets one fill – they will be paying a lot in fees for orders but will get very little in terms of rebates, and so will be incentivised to place fewer orders but get more fills."

As one of the largest non-bank market-makers in the FX market, GSA has worked closely with EBS on some of the changes it has made to its core platform over the past year, but it is still too early to say whether a mechanism resembling Gerko's proposal could be adopted by EBS or other platforms. But some market participants believe the idea has merit.

"Whether people should pay for transactions or messages, which include the placing and cancelling of orders, is one topic that has come up as a way of improving the market by making it more expensive to carry out disruptive behaviour. Whether the proposal would fly or not, I don't know – but it's an interesting idea that warrants further discussion," says Richard Anthony, global head of FX e-risk at HSBC in London.

Josh Levy, executive director at **Tactical Asset Management**, an algorithmically driven FX trading operation in New York, says the proposal could be an effective means of deterring traders from trying to artificially move the market, but the devil lies in the details.

"It's not a bad idea. You would be very careful, and much more selective, about the orders you send. You wouldn't send an order unless you thought it had a legitimate chance of being filled. Philosophically it sounds good, but to the extent it might scare or prevent real or legitimate bids, or certainly would eliminate a lot of bids and offers from entering the market in the first place, it also has the potential to negatively impact liquidity," says Levy.

One proprietary trader in Chicago agrees the proposal makes sense at a high level, but says careful tailoring would be required to avoid any adverse impact. "The concerns that frequently come up about rules related to order-to-trade ratios is that they don't always take into account the liquidity concerns for illiquid pairs or illiquid times of day. As a market-maker under such a system, we would have to scale back the amount of market-making we do during Asian hours or the US afternoon, for example, because it wouldn't achieve a very good order-to-trade ratio."

Topics: electronic trading, High-frequency trading (HFT), HSBC Bank,Proprietary trading, EBS, Bank of England, The London Foreign Exchange Joint Standing Committee (FXJSC)