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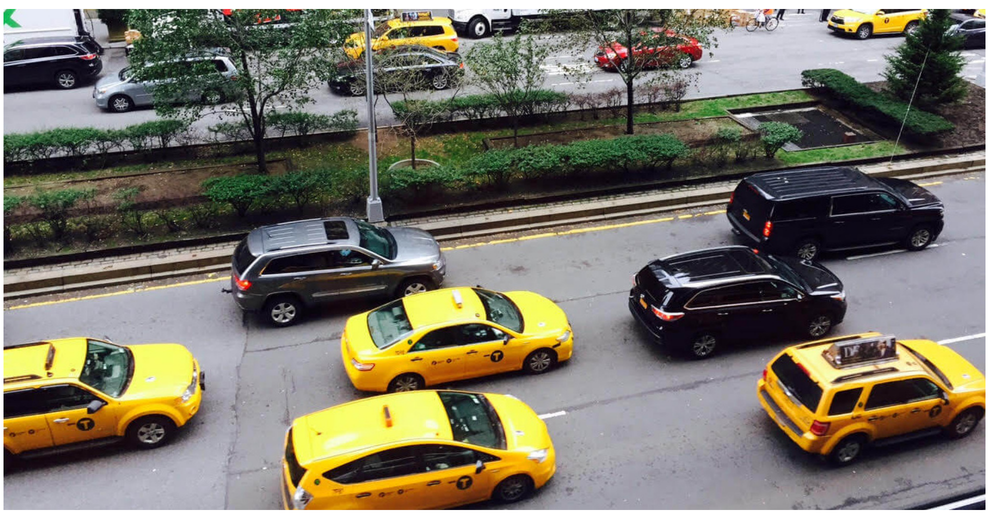
FXCM Coverage, Opinion

FastMatch: Leucadia's sensible, profitable and institutional savior. The rest of FXCM is fire-sale material Op Ed

If it is to save itself from shareholder litigation and massive corporate embarrassment, Leucadia could pick up FXCM's 32% share in FastMatch for pretty much nothing. Bearing in mind ICE tried to buy FastMatch just over a year ago for $200-$250 million, this would put Leucadia in a good position and remove any whiff of association with FXCM from the ECN's copybook. A detailed analysis by FinanceFeeds



The retail FX industry is no stranger to extreme and 'you couldn't make it up' shock events, however the most recent debacle that surrounds FXCM and its CEO Drew Niv along with senior Managing Director William Ahdout is a milestone in that it plays right into the open hands of the exchange-listed derivatives lobby.

In Chicago on a gargantuan scale, in London on a slightly lesser scale and even in of all places, the financial markets void and technological deserts of Frankfurt, there is nothing more that would suit the agenda of the belt and braces, old fashioned and long established derivatives exchanges and venues that list blue chip stock than a revelation that one of the largest retail OTC derivatives companies in the world, operating from the most highly organized region with the world's most upright business environment, is in fact, crooked, and has been for several years.

For the past twenty years, what began as an upstart sub-industry, founded by young, motivated uninstitutionalized go-getters such as Matchbook FX's Josh Levy, the OTC derivatives business has grown and matured to such a level that it consists of vast, global, publicly listed entities that have loyal client bases, and has metamorphosed from its humble beginnings to being the bete noire of the established exchanges whose traditional roots can be traced back to before the industrial revolution.

In short, they want the business that they lost to the highly attractive, much cheaper, much more exciting and much quicker OTC sector back, and the only defense that any regulatory authority in regions with highly populous and technologically advanced financial markets participation could muster was that the established, large OTC firms were bona fide businesses with global client bases and public reporting duties, therefore must be upheld and fostered, whilst the lesser known b-book firms with no regulation and malintent toward customers must be rooted out.

This defense no longer stands and any argument aimed at the OTC world by regulators, driven by lobbying from the exchanges or otherwise, can be immediately debunked with a simple statement that FXCM was duping its clients and the largest and most well organized regulator in the world for many years.

In short, the fall out has not yet really started, but it will begin with some quite considerable finger-pointing and scapegoatery, which will commence with Leucadia's shareholders, as well as FXCM's direct shareholders, who will likely instigate litigation for different reasons.

Whilst FXCM's CEO Drew Niv is a highly astute business leader, with some of the best negotiation skills in the business, his elegant yet forceful prose being a mark of his successful two decades at FXCM, the house of cards is beginning to collapse very quickly. Share prices are absolutely on the floor, and uncertainty now surrounds the divisions of the company which are located in other regions of the world insofar as whether the FCA in Britain or ASIC in Australia may follow the CFTC's lead, while the company's main operations in the US have been decimated, the ban from the market of FXCM and its two key directors Drew Niv and William Ahdout having been followed by a lay off of 150 staff.

Even if regulatory authorities overseeing other divisions of FXCM do not immediately follow the CFTC's lead, such is the loss of fundamental trust that reputational damage may be the grim reaper.

Today, FinanceFeeds reported the terms of GAIN Capital's acquisition of FXCM's US client base, which, instead of a fixed fee being paid to buy the book, amounts to a fire sale.

Shareholders of FXCM are beginning to add their names to class action lawsuits against the firm via investor rights lawyers in New York, however the perhaps focal point of how any litigation may take shape will perhaps take its toll should any of Leucadia's shareholders sue Leucadia for investing in a company to the tune of $300 million on a handshake and with no due diligence.

In essence, the deal that Leucadia did with FXCM in January 2015 to provide emergency financing following FXCM's exposure to negative client balances as a result of the EURCHF pair having had its 1.20 peg removed by the Swiss National Bank very suddenly, was not a bad deal at all.

FXCM brokered that deal in a heartbeat with a large, public conglomerate, with just a handshake which kept the wolf from the door. In the US, the regulators will not allow firms to reprice their CHF trades as some regulators did in other regions, they also will not allow time to rectify any negative balance exposure. It is a case of officials arriving at the office and winding up operations. Drew Niv kept the company on a completely even keel by brokering the deal with Leucadia and then began selling non-core assets to pay it down, with a lot of progress having been made until this day.

The difficulty will therefore not arise from this, but from the circumstance that Leucadia now finds itself to be owner of a 49% direct position in a company which may well end up defunct very soon. Therefore, litigators could have a case that Leucadia's deal with FXCM was legitimate, but because no due diligence was done (which would have taken months of auditing by professional services consultants) when the $300 million was provided, another circumstance unrelated to the reason for the loan was not picked up, therefore Leucadia has exposed itself to a potential loss.

To save itself from such shareholder blameworthiness, Leucadia could buy out the 32% share that FXCM owns in FastMatch.

FastMatch is the darling of the exchange lobby. It is a fantastic quality, profitable and highly well regarded electronic communication network (ECN) that has first class relationships with Tier 1 banks and non bank institutions worldwide, and has been the subject of interest from the exchanges for some time. In 2015, ICE, one of the Windy City's most prominent electronic derivatives marketplaces tried to buy FastMatch for between $200 million and $250 million in its entirety from its three shareholders, BNY Mellon, Credit Suisse and FXCM.

Far from being a retail offshoot, FastMatch is right up there with FXall, Hotspot FX and Currenex, its technology being aligned with Credit Suisse, one of the world's largest interbank dealers with its own proprietary systems.

In March last year, FastMatch introduced significant fee reductions outlined on to further extend its market share.

The company at the time provided to FinanceFeeds some of the important aspects of its new fee schedule, including $1.50 per million notional for clients trading more than ADV $2 billion notional with FREE trading on all volume above ADV $3 billion notional on FastMatch anonymous ECN, as well as free trading for makers that trade with everyone and will fill all orders on a 100% basis, as well as having eliminated most port fees associated with such transactions.

Competitive? Yes! A burden on the listed institutions? Yes!

In December 2015, FinanceFeeds looked closely at FastMatch's continually evolving edge in terms of innovation and transparency, the company explaining at the time that it values fairness as one of its key tenets. The company has pioneered many concepts that improved transparency among FX ECNs:

– Real time reporting of the venue's volumes
– Public fee schedule

– Real time reporting of all trades with prices and sizes

– Real time dissemination of the FastMatch midpoint

– Indicating of every quote if it is last look vs no last look

– Indicating on the quotes the maximum last look time

In further desire to make FX institutional markets more transparent and operate a fair marketplace, FastMatch has for over one year required all liquidity providers to use only a "Symmetrical Last Look" practice on the ECN Service. "Symmetrical Last Look" is the practice by which the same trade rejection logic is applied to all trades within the last look holding period, regardless of their P&L impact to the maker and / or taker.

Trades rejected only when an order is unprofitable to the liquidly provider by the end of the last look holding period shall be considered to be the subject of "Asymmetrical Last Look" practice.

Off Market Transactions

The ECN Service is designed to prevent transactions that are off current market trading conditions. The current Operating Procedures of the ECN Service will not match two orders if matching them would result in a transaction prices greater than 0.15% from the midpoint of the bid-ask spread (the "Protective Band").

FastMatch has highlighted several times that it will not match two orders if matching them would result in a transaction priced at greater than the pip value listed at for the relevant asset class at the time the transaction is executed. This change will enable the ECN Service to have more precise definition of the protective band per currency pair.

Given this, the last thing FastMatch needs is a 32% association with a company that told its clients and reported publicly that it was processing its trades directly to an impartial liquidity provider when in actual fact it had for several years been operating via an undisclosed interest in market maker EFFEX Capital which employed HFT and algorithmic systems to trade against customers, and then provide up to 70% in rebates to FXCM.

The absolute antitheses of transparency and fairness, a 32% stake in FastMatch by FXCM could cast doubts over execution practices, therefore it is possible that FastMatch may have to remove FXCM from its structure.

As correctly predicted by FinanceFeeds, FastMatch this week removed Drew Niv and William Ahdout from the board of directors and replaced them with senior Leucadia personnel, however it is quite possible that Leucadia may buy the 32% of FastMatch owned by FXCM, and it certainly will not be for 32% of $200 to $250 million that the firm was valued at when ICE attempted to buy it.

This should be thought of as a fire sale, therefore $1 is likely.

The upshot would be fending off disgruntled Leucadia shareholders in acquiring 32% of a top quality ECN for nothing and then abandoning the rest of FXCM, and at the same time saving FastMatch from any association that may cause doubt in the mind of institutions and customers on the buy and sell side that have relationships with FastMatch.

Just a few weeks ago, FastMatch CEO Dmitry Galinov spoke in detail to FinanceFeeds about how the exchange sector views the OTC market.

He explained “Trade settlement is expensive these days. If I want to see how disproportionate this is, I compare the commission on the market to the cost of settling the trade. In the exchange listed futures sector, the settlement cost is around 1/1000th of the average electronic commission, whereas in FX it is often larger than the commission” he said.

“The exchanges will be the ones that solve this” said Mr. Galinov. “It is still much cheaper to clear exchange traded derivatives than clear on an OTC basis for the FX market so I really hope that the exchanges will step up and solve this issue.”

> *“A particular benefit of that would be cross margining capabilities. Exchanges can cross margin all asset clases and come up with an effective system that takes care of the cost as well as the counterparty risk” – Dmitri Galinov, CEO, FastMatch*

It is absolutely a major issue that OTC counterparties face, in that the curtailing of credit from banks even for well capitalized firms has caused a ‘credit crunch. With exchanges as a centralized counterparty, Mr. Galinov concurs that massively capitalized venues are much more favorable to banks and liquidity providers than having to face every party separately.

“As an example” said Mr. Galinov, “CLS does not guarantee settlement. The fact that two people traded via CLS doesnt mean two people will get their money. If you survey institutional participants and ask them whether OTC clearers guarantee the trade, they may well say that it does and this would be a misunderstanding. Exchange clearing would lower the cost and lower the risk, as you would have to settle with one well capitalized central party" he concluded.

The astuteness and understanding of this level of detail by some of the world's regulatory authorities is much less granular and much more limited than the full extent of knowledge displayed by industry professionals whose acumen and career standing is as high as these executives, thus the regulatory methodology is much more generic, meaning that instead of garnering this much knowledge and working with the industry, which is time consuming and expensive in a world in which the development cycle would out accelerate any regulatory progress, they use a pick axe to crack a peanut.

On this basis, the exchange lobby may have an even larger cause after the events of this week played straight into their gigantic hands, however should Leucadia and FastMatch play this right, they will come out of it with the same level of standing as Thomson Reuters FXall as a vast and evergreen institutional ECN that bears no resemblance to the retail world, and at the same time FXCM's once admired ship will become the preserve of the asset-stripping pirates.

#drew niv, #fastmatch, #fxcm, #gain capital, #josh levy, #Leucadia, #OTC derivatives, #William Ahdout