



## Retail FX Grows Up

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The retail FX market, once seen as a dodgy arena for scammers who would take your money and run, has become a market that even the biggest foreign exchange banks are getting serious about entering.

You can't turn on the television without hearing about the US dollar weakening or strengthening against other currencies. American investors, previously unaware that their greenback might be interesting outside the US, are punting currencies online. The emblematic Japanese housewife trading yen/dollar or yen/euro on top of the Nikkei is also fuelling global retail growth.

David Rutter, deputy CEO for Icap Electronic Broking, says: "It is the coming of age for retail FX. In the early days retail was considered a bit unproven. Things have changed and retail FX is gaining credibility."

A marketplace that is rapidly becoming truly global is the number one driver behind this growth. Charles Henri-Sabet, global head of trading at online FX trading firm Saxo Bank says that diversity, particularly in the present economic environment and to the 'man on the street', is invaluable. "It is one of the fundamental rules of investing and building your wealth portfolio. And now, with stock markets in retreat and daily profit warnings, forex can offer just that," he says.

According to London-based consultancy Client Knowledge, the retail FX market has doubled within the past year. David Poole, COO of Client Knowledge, says: "It is maturing especially in the Far East and Japan. In Japan there is \$15 billion a day traded by the stereotypical 'Japanese housewife'. If you look at the financial stories there, it is all dollar/yen or euro/yen."

Poole says the retail FX market has grown from \$50 billion per day a year ago (generating about \$1 billion in revenue per year) to around \$100 billion per day now. "That figure might be a bit generous, but it is big," says Poole.

And it is getting bigger. With the passing of the US Farm Bill (which came into law despite a veto from President George Bush) the industry expects more banks to get involved in retail, something many have been avoiding due to possible reputational risk.

The Farm Bill offers the retail FX market a new regulator and higher barriers to entry, which are expected to weed out smaller FX trading companies that could go bust with investors' money in tow. The Commodity Futures Trading Commission (CFTC) now regulates the foreign currency dealer members (FCDMs), alongside the National Futures Association (NFA), which registers the dealer members and – soon – the introducing brokers.

Glenn Stevens, CEO of online FX trading platform provider Gain Capital, says because FX is an integral part of the valuation of other asset classes and markets – it cannot be ignored. And its growth is fuelled both by the increase in FX trading by institutions and banks, as well as by retail participants.

"FX will gain as a percentage of the [overall] pie, drawing in new participants and a higher number of accounts and volume. And within the FX pie, retail is growing – it is a double whammy," says Stevens.

Because retail FX has had its share of scams and con artists, it has come to be associated with high risk, speculative trading. Overcoming this obstacle is paramount in the minds of online FX platform providers, who are working to educate the trading public in risk management.

Henri-Sabet says: "Trading forex in an appropriate manner and with stop-losses in place can be a way of playing risk trades. For a retail trader, the main value of utilising forex trading strategies is that they are able to fine tune their risk willingness and risk aversion and trade around that."

The US Farm Bill passage paves the way for better regulation in America, which will help to convince potential retail clients that their money is safe in the hands of the online trading providers. For the first time retail FX gets its own legal definition under the Farm Bill.

Drew Niv, CEO of Forex Capital Markets (FXCM), says before this: "Forex dealer members were created as a sub-category of futures commission merchants but the legal status was unclear. Therefore big institutions weren't interested in getting involved."

A report written by Client Knowledge last year acknowledged that banks have been slow on the uptake of retail FX, even while aware of the opportunities. At the same time, independent retail FX platforms proliferated, and some established a credible and profitable market "outside the reach of the banks' wholesale, retail and wealth management divisions."

Some banks made the commitment early on, although they mostly kept their distance from the possible reputation-wrecking US market. ABN Amro launched marketindex and Deutsche Bank started the dbFX retail platform two years ago, which is increasingly going global. Rather than aim for self-directed retail accounts, dbFX is taking a different route.

Betsy Waters, global director of dbFX, says: "We have been in the retail FX business for two years and are in 80 countries, this is a big accomplishment. What is interesting is managed accounts; these don't exist on the institutional side and very few know what it is. It is a good-sized client segment. We are going after the smaller institutions."

Meanwhile, Citi teamed up with Saxo Bank late last year. Citi took Saxo's white labelled FX platform and tweaked it into CitiFX Pro for institutional and retail traders.

Client Knowledge says banks are prime targets for vendors of white labelled FX platforms because it is quicker for them to take a ready made product than to develop their own technology. "Demand for retail FX is recognised as a potential gap in some banks' coverage models. Leveraging off an existing platform is the accelerated route to growth," says the report.

"The Farm Bill paves the way for large financial institutions to get investors in the US. This makes the market for us more competitive, but at the same time gives us white labelling opportunities we didn't have before," adds Niv.

Spread betting and contracts for difference shop City Index is so confident about retail that it bought online retail platform provider FX Solutions (FXS) in February. Almost immediately after the deal closed, City Index and Icap inked a deal to provide Icap EBS prices for calculating the spreads on FXS. At the same time EBS will be selling FXS white labelled products to enable its bank and broker client base to add retail customers (see sidebar).

Clive Cook, CEO of City Index, says he is "reasonably confident" that there is \$200 billion a year of revenue from FX providers out there. "Currency has had bad publicity over the years, it wasn't transparent. Now we can use the EBS mid-market price in our pricing engine and create a spread. Customers can sleep easy in their beds at night knowing they won't be ripped off."

Poole says liaisons between banks and white labelling platforms go both ways: "There are only so many speculative retail FX clients, so the platforms need to keep feeding clients in with white labelling. Banks are way behind; they won't catch up to a Saxo, so they latch onto Saxo technology instead."

City Index's Cook agrees that white labelling is the way to go: "What will make us money [with FXS] is the EBS sales force with their relationships with the 1100 banks that contribute prices to EBS."

Icap's Rutter adds that emerging market banks as well as European banks are a major focus for the FXS white labelling solution. "Retail is exciting, it is growing and maturing and as it evolves, we want to have a grown-up response in that we offer this changing marketplace exactly the products it requires."

Mitch Eaglstein, chief operating officer of Traders Development, a wholly owned subsidiary of Avalon Capital Holdings Corp., is also betting that banks will need technology. "I see very major banks integrating FX."

Eaglstein believes that over the next year his firm will be licensing its technology to firms "from upper tier banks and futures commission merchants to lower tier banks such as in Cyprus and Switzerland. We will licence our system to the top companies and service and customise for them."

Traders Development is also working on a system that aggregates best bid and offer among a number of FX trading system feeds including Hotspot, Currenex and Bank of America. "The forex dealer member can offer this to its clients," says Eaglstein, who adds it is also developing a product geared for prime brokers.

#### The Farm Bill

The 2008 Farm Bill, passed by the US Congress in June, is being praised by some forex dealer members who believe it legitimises the retail FX market in the US. The Bill contains a section titled "CFTC Reauthorisation Act of 2008" which strengthens the regulator's authority over retail FX trading.

Prior to this the CFTC was limited to futures contracts in FX. Retail FX oversight was handled by the National Futures Association, a self-regulatory group which registered and monitored the forex dealer members. The NFA is still involved, albeit in the shadow of the increasingly mighty CFTC.

The Commodity Futures Modernization Act of 2000 originally clarified the jurisdiction of the CFTC in off-exchange FX futures and options trading. But FX markets were beginning to blossom and online retail FX trading systems, and scams, began to proliferate.

In trying to prosecute some of these scams, the CFTC found itself hamstrung by older legislation – the Commodities Exchange Act of 1974 – which had limited the CFTC's power over certain off-exchange instruments. The regulator lost a keystone retail fraud case, known as the Zelener case, in 2004 which provided a precedent enabling other scammers to deceive innocent retail customers.

The Farm Bill provides a new category for retail forex dealer members, who now have to maintain sharply higher net capital and are required to be a member of a futures association such as the NFA.

Gain Capital's Stevens says the Farm Bill is one more step in the trend that started with The Commodity Futures Modernization Act of 2000: "The Farm Bill is the next step, and it is a pretty significant step. Generally the FX markets will be re-organised in a fashion to withstand scrutiny. Higher barriers mean higher quality providers within an environment with even greater regulatory standards."

A year after the enactment of the Farm Bill dealer members will be required to maintain a net capital of \$20 million. Data from the CFTC indicates that almost half of all the 150 registered firms have less than \$20 million in capital – and the overall list includes several major financial institutions such as the banks. Also as part of the bill, introducing brokers (IBs) will have to be registered.

This points to some heavy consolidation in the online retail FX provider space, and some of the larger players are already courting smaller ones in hopes of adding to their customer bases. FXCM is already picking up customers from the smaller players, Niv says. He thinks all of the top five participants will double in size now that the legal framework is clear.

Niv says: "\$20 million is for platforms that do not offer excessive leverage which is a standard requirement by retail FX clients.

To offer leverage like customers want, the regulators demand double the minimum so that would be \$40 million," he points out. "In addition, most retail dealers make markets and have a book meaning they carry net open exposure which requires further capital charges of 6% of the notional amount." This means a large FX business may need up to \$60 or \$70 million in capital to do business.

Tom Plaut, co-CEO of City Index FX Solutions, says it is beneficial to the market that IBs have to register, although FXS did not do business with unregistered IBs or trading advisors anyway. "Those that haven't registered using the Zelener exclusion will now have to, that has been changed in the bill. This is good for our market, the goal of the regulator is to make it fair and to give the customer a level of protection."

Plaut says some of the introducing brokers will disappear, but the registration requirement might create a backlog at the NFA, "so there might be slippage".

A spokesperson for the NFA says that as the CFTC has not developed the rules and guidelines for registration yet, there is no deadline set. "We don't even know how many will have to register yet," he adds.

Eaglstein foresees a more dramatic decrease in IBs: "The number of introducing brokers will significantly decrease which should increase the profit margins for the largest retail FX providers since their rebate expenses should decrease."

Meanwhile the larger retail FX platform providers are on a mission to not only sell their platforms to banks and brokers, but to educate the general public in forex and to make them aware that the market is now safer to enter.

Stevens notes: "Because it is commonly called the Farm Bill and not the online FX bill, FX traders might say 'I don't own any pigs so why should I care?' We will help the message get delivered, and regulators will let the customers know. It adds credibility. And might help US-based companies compete overseas."

Globalisation of FX should help too. Saxo's Henri-Sabet says: "Over the last 10 years we have witnessed the acceptance that all markets are interrelated. Therefore, anyone who has an interest in trading US and Japanese stocks should consider currencies and the impact geo-political risks can have on them, and in turn on the values of those assets. In effect, trading forex can act as a partial hedge against currency movements."

The Farm Bill may have opened a can of worms for investment banks and asset managers which currently enjoy the freedom of charging customers what they please for FX transactions. "Because the fund customers are squeezing them on equities fees, they don't look at FX. They have no idea what they are paying for currency," says Niv.

With new transparency thanks to the Farm Bill, these spreads and fees will become exposed, and clients more savvy, and that savvy should turn into dollars for surviving FX retail providers – if they play their cards right.

### **FX Solutions Offers EBS Prices**

An indication of the pace of evolution in the retail FX space came last month when platform provider FX Solutions (FXS) said it is now able to offer prices from Icap's EBS foreign exchange platform; at the same time EBS will be selling FXS products and adding a new client base.

FXS was acquired by spread-betting shop City Index, owned by IPGL which is also a 20% owner of inter-dealer broker Icap, in March. The exclusive data deal from Icap EBS means that FXS is the only retail platform on the market that can offer prices directly from the dealing banks on EBS.

Tom Plaut, co-CEO at FX Solutions, says having EBS prices helps to legitimise retail FX: "There is a feeling out there that there is a lack of price integrity in retail FX. This deal is good for the whole market; it legitimises the space."

David Rutter, deputy CEO for Icap Electronic Broking, adds: "EBS is the leading source of price data in the spot FX markets and as such we believe that our market data partnership with City Index will greatly support the development of the retail FX market."

The exclusive deal between EBS and FXS enables the retail provider to integrate data from EBS to support its pricing engines. It does not offer FX Solutions or its clients access to transact on the EBS platform.

"The price for FX is where it originates in the market. There is no exchange as such, but there is EBS. Getting prices directly from where they originate is an advantage for our clients," says Plaut. "We are now standing shoulder-to-shoulder with institutional offerings."

Competitors may have to try harder to get accurate prices to keep up with FXS. Currently most retail platforms cobble their prices together from single bank feeds, or multi-dealer portals. Some still update FX prices by hand, says Plaut.

But Tim O'Sullivan, chief dealer for Gain Capital and its competitive Forex.com retail platform, says establishing a reliable and highly accurate price feed has been an important part of Gain's offering from day one. "We have long-standing liquidity relationships with multiple top tier FX banks and other major FX liquidity providers. Currently, our pricing engine aggregates real-time data from nine distinct liquidity sources. All in all, we are very confident about the accuracy of our price feed. That said, what really differentiates retail FX firms today is the quality of execution from those bids and offers."

The other part of the EBS and FXS deal is leveraging the global Icap Electronic Broking sales team and relationship managers to introduce FXS's retail white-labelling platform into their client space. It gives EBS sales a product that targets a new client segment - retail aggregators, says Plaut. "Banks, broker dealers and financial institutions can use FXS for their retail client base. It adds a whole new class of introducing brokers to the market."

And using the EBS global salesforce gives FXS the opportunity to offer its white labelling solution. With the passing of the new US Farm Bill, the retail FX market now has legal standing and more banks and brokers are looking to get involved. The deal between Icap EBS, City Index and FXS adds weight to this: "In my opinion, it is big news and demonstrates the retail FX market has arrived," concludes Plaut.

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