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Investing Wisely in the Power of Next Generation FX Prime of Prime Brokers

One of the most dynamic and innovative areas in FX market structure continues to be the prime of prime sector. But in what ways is this varied sector starting to mature, while also continuing to meet the complex demands of customers, prime brokers and global regulators? Nicola Tavendale writes.

There is currently no standard industry definition of prime of prime (PoP) and so, as a result, clients tend to have their own ideas about the expected levels of service provision, Ramy Soliman, CEO, Stater Global Markets explains. "Access to interbank liquidity, plug and play technology solutions and a conflict-free business model are key requirements that I believe a PoP should be able to offer," he adds. Historically, a common requirement for broker customers has generally been higher leverage than is available from a tier one prime broker (PB). Soliman adds, "A lot of retail brokers were previously offering very high leverage to their end customers. To achieve this, they used PoPs to access good quality pricing but in essence, to pass on the capital call to them. The evolution in the market and the regulatory climate with reduced leverage to retail customers has reduced this need and we see that broker clients are taking a more qualitative approach to their Prime of Prime services."

Additionally, ensuring clients have sufficient collateral prior to trading - as well as monitoring their collateral versus open positions and profit & loss 24 hours a day – should be a key feature of a top tier PoP, argues Gavin White, CEO, Invast Global. "If their collateral falls to an unacceptable standard at any time, we speak to the client and arrange for more collateral to be provided, or for positions to be reduced," he adds. "This is actually more stringent than most tier 1 bank PBs require, as they instead tend to operate on a simple net open position (NOP) allocation system." But because this pre-trade risk management allows Invast to reduce its counterparty risk, it is then able to accept smaller revenue-generating clients who would be rejected by larger tier 1 PBs.

Regulatory reforms have also exacerbated the capital requirements issue, with major institutional banks who are deemed too-big-to-fail now being required to hold additional capital aside when offering certain non-core services. "These capital requirements are particularly high for asset classes that are considered volatile like FX and metals," White adds. "But because PoPs are not classed as being systemically important, we are not required to hold as much capital - therefore, smaller clients are more viable to us in that regard as well."

SLIDING SCALE

In recent months, there has also been a growing regulatory focus on curbing excessive leverage in the retail community, including notable moves by the Financial Conduct Authority (FCA) and the Cyprus Securities and Exchange Commission (CySec). Even so, clients are able to obtain better leverage by

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Ramy Soliman

going through a PoP than by going directly to the PB, argues Sadek Baksh, VP of Institutional eFX Sales, CFH Clearing. "This is still important, even though leverage is being capped in a lot of jurisdictions and clients do want margin or credit line accounts with more favourable, but not excessive, leverage," he adds. In addition, PoPs such as CFH Clearing offer the benefits of collateralised margin. "So instead of posting funds with each bank, you can access multiple banks through one margin or credit account instead," Baksh explains. "We've integrated our technology and liquidity into a one stop package and can offer a bespoke solution to the requirements of each client. A client can come to us for a one-stop-shop. Most of our competitors may not offer this but for us it's standard."

In fact, this lack of an agreed industry standard for the level of service provision offered by a PoP is a key concern, warns Marco Baggioli, Chief Operating Officer (COO), ADS Securities. Without this, or even an agreement as to the definition of what a PoP should be, there are currently a wide range of different products all being sold as PoP solutions. "At one end of the scale, there are brokerages who are simply offering aggregated liquidity and calling it PoP," Baggioli explains. "And at the other end there are those companies, like ADS Securities, who provide genuine FX prime broker intermediation." This has resulted in a huge variation between the costs of the services on offer, he adds. In addition, if providers are offering poorly capitalised clients excessive leverage to get their business, which is often the case according to Baggioli, then this has very significant risk implications for the industry as a whole.

CHOOSING WISELY

"This is why I question this segment of the FX market," adds Baggioli. "Since the SNB event, we have seen lots of providers 'window dressing' their normal bilateral trading relationship, margin trading - whatever we want to call it. This is aggregated liquidity provision into what is called prime of prime, but there is very little of prime brokerage in that." The problem with this scenario, Baggioli explains, is that the PoP is adding to the risk of primary PB who then doesn't know who is behind the trade. Then, if something happens in the market, the 0.5 or 1% margin posted by this client to the PoP is not going to be enough to cover the volatility spike, he adds. "The client gets wiped out, but also the PoP has no capital themselves," Baggioli warns. "Who bears the loss at the

Marco Baggioli

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end? Credit will be tightened even further and the whole industry will suffer. We should not allow this to happen."

So how can clients ensure they are dealing with genuine PoPs? According to Baksh, the only way to know your PoP is genuine is to get to know your broker. "It is amazing how many brokers are out there that are not genuine PoPs, who have no direct relationship with a PB," he says. Raj Sitlani, Managing Partner, IS Prime agrees, adding that the main benefit of using a genuine PoP is that a client avoids a third layer of costs - and in certain cases latency - which are associated with PoPs, who are purely reselling another PoP's services themselves. "These so-called PoPs are effectively expensive tertiary PBs that add little value to the chain," Sitlani explains. "The differences will manifest themselves in the overall cost of doing business and increased execution times, both of which are easily determined."

> "We are not internalising their flow, which would cause a conflict of interest with our clients. This is something we feel very strongly about."

Gavin White

Instead, the benefit of a PoP is that it is multi-bank and, as such, it is able to use everyone's volume to be able to obtain better spreads, lower commissions and better fills etc. from each bank, Baksh claims. "If you were to approach each individual bank and apply for credit, you will be taking higher costs and wider spreads because you are new, have no history with them and do not clear sufficient volume," he says. "So better pricing and lower cost are key benefits." This also enables the PoP to secure better credit at a lower cost - because everything is pooled by the broker, that total amount can be leveraged to obtain more credit.

FULLY AGNOSTIC

A further benefit of using a genuine PoP is that, with STP, there is no conflict of interest, Baksh adds. Everything is sent through to the prime broker and the prime broker executes with all the other banks they have on their list. "At CFH Clearing, we are very clear on who our liquidity providers are. We have six," Baksh explains. "Some other firms list around 15-20. With a finite amount of volume, the more banks you distribute to, the less competitive the pricing and execution will be. We have instead selected a core pool of banks to provide optimum liquidity to our institutional customers, without any manipulation."

According to Soliman, PoPs are particularly interesting because they attract customers from the institutional world who are used to dealing on a primary platform, like EBS or Reuters, and who want to reconnect with the same pools of liquidity. "A one-stop-shop like Stater can offer them this," he adds. "Some clients actually need a price rather than a prime broker service. As long as you can ensure that the price you offer a customer is derived from direct sources - and that you have control over it and can offer different price streams for different types of flow - then that is the value add that a PoP can give."

Stater's clients also have very different requirements – some trade retail tickets and some institutional clients trade much larger tickets - of 5/10/20 million, for example. As a result, Soliman warns that the same liquidity stream is not suitable for both client audiences and therefore a PoP needs to be able to customise their liquidity accordingly. "You can only do that if you have control over the liquidity - and the best way to have control is by having a direct relationship with the liquidity providers," he says. "That's where I think the PoPs can really add value."

It's important that clients ensure they are dealing with genuine PoPs

ALL UNDER ONE ROOF

Again, it all comes down to how you define PoP and what it provides to the market, Baggioli warns. "If you think that PoP is just a different way of passing on aggregated liquidity, this is definitely a very overcrowded area and, in fact, the whole PoP craze since the SNB event has just provided a way for brokerages to put a new coat of paint on their age-old bilateral trading offering," he warns. "All we have seen is a few marginally unimportant tweaks." However, Baggioli believes that if PoP is instead viewed as a way of enabling institutional traders

"Technology will make or break a PoP. You could have the best credit lines and spreads - but if you don't have the means to deliver to the end user then it is wasted."

Sadek Baksh

to access direct liquidity when they have not been able to work with a PB, or to access additional trading lines which are not available from their PB, then it does prove to be a very important service. "PoP will always be in demand by serious players, at least while the structure of the FX market remains as it is," he adds.

Before launching ADS Securities' PoP service, Baggioli says the firm spent over 12 months looking at every aspect and detail of the service it wanted to offer its clients. "The key credentials we put forward are the financial strength of ADS Securities, the depth and size of the credit relationships with our prime brokers and the quality of the liquidity agreements which we have in place industry-wide," he adds. In addition, Sitlani argues that clients should be benefiting from state of the art execution optimisation first and foremost, unlike with Tier 1 FXPBs whose focus is on clearing. "Also, a true one-stop-shop will not be providing a rudimentary white label offering of someone else's software, but rather a tailor-made solution," he says. "Our combination of sophisticated execution methodology, bespoke technology and unique customised liquidity aggregations provides a compelling and advantageous offering to the client."

Furthermore, Sitlani believes that if a PoP simply chooses to offer clients an "inflexible and generic 'rebranded' solution of third party technology" then they are not allowing their clients to differentiate themselves. "Our philosophy of combining best of breed industry technology, together with in-house built plug-ins and algorithms, keeps us and our clients ahead of the game," he says. "On the operational side, we have built our entire range of live risk and margin engine modules which are the backbone to our proprietary client reporting portal."

FRICTION POINTS

Proprietary IT is also important with regards to back office technology, White says, as it allows the PoP to aggregate statements and reporting across multiple venues/platforms/GUIs and APIs. "Invast Global has its own proprietary back office system called Unicorn, which has been purpose-built to be agnostic to the client's choice of platform/venue/asset class," he adds. However, White argues that when it comes to offering aggregation systems/bridges etc, proprietary IT can actually prove to be detrimental, limiting a client's options and flexibility as a result. "Invast Global instead prefers to offer a wide range of the most respected third party solutions for these functions," he explains.

"Technology is a critical element of a good PoP," adds Baksh. "Even with the best credit lines and spreads, if it is not delivered to the end client over the latest cutting-edge technologies then the outcome is less favourable." As a result, CFH Clearing offers an end-to-end technology solution under which the client is given access to various different platforms, including CFH's and those of third-party providers. They are also given access through to the bridge that they use, all the way through to the latest servers (in LD4, TY3, HK3) and back office and risk management tools (using CFH's proprietary ClearVision suite),

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according to Baksh. "We can take responsibility for a brokers' complete trading operations and this means that we can quickly resolve any technology issues that arise." he claims.

Upcoming regulatory reporting requirements will bring further change, warns Baksh. "CFH Clearing offers full back office reporting, which is transparent and you can receive it anywhere," he says, adding that trade reporting is now becoming an essential part of trading for most clients. PoPs should also be regulated in a high quality jurisdiction and be completely transparent.

White believes. In addition, they should only be dealing with clients who are regulated entities in acceptable jurisdictions. "Pops should also have stringent, institutional quality due diligence, credit, disaster recovery and internal audit procedures," White says. "The best situation is if the PoP is part of publicly-listed entity - like Invast Global."

Firms need to do their own due diligence on their PoP counterparty

GREATER TRANSPARENCY

A further key element is that Invast's clients can see, pre-trade, the name of each liquidity provider pricing them in their stream. "There is no anonymity and, as far as I know, we are the only PoP offering this," White adds. "It shows our clients that we are simply an agent and advisor. We are not internalising their flow, which would cause a conflict of interest with our clients. This is something we feel very strongly about."

In addition to pre- and post-trade transparency, Invast also provides detailed reporting to its clients about the performance of the liquidity providers within their streams. "We report on factors such as response times, rejection rates, market impact etc," explains White. "We then advise clients on whether certain LPs should be remove from their streams so that their stream is more appropriate for the profile of their flow."

In addition, PoPs who rely on an in-house hedge fund, or in-house b-booking dealing desk, in order to price their clients, are at risk of having a conflict of interest with their clients, White warns. He adds: "Invast does not internalise like some other PoPs do. We made a clear and purposeful decision to be fully transparent and STP to the underlying LPs." And for those PoPs looking to provide more customised services, Baggioli does not believe that there is in fact any room for offering more than a

PoPs can help facilitate risk management services

primary PB would. Either way, there is definitely no room for customers to pay for it, he adds.

"We are also a technology driven industry and it's that we have an in-depth understanding of the capabilities of the different technology companies in the industry," adds Soliman. "Stater uses a number of different technology providers, enabling us to be dynamic in our offering." However, the days of plug and play white label solutions are long gone, Sitlani argues. IS Prime also does not have an out-of-the box solution, he explains, adding that each and every client onboarding typically requires a "customised integration, a unique liquidity set-up and tailor-made reporting". Sitlani adds that because IS Prime is one of the strongest PoPs in the market, it is also able to offer meaningful buying power within the FXPB and Tier 1 liquidity arenas. "This in turn allows us to negotiate the best terms on liquidity and commission costs," he says. "This all works to the advantage of our broker clients."

TWO STEPS AHEAD

According to Baksh, CFH Clearing's clients are also able to customise their streams to have the most suitable bank feeds that match their trading needs, thus offering the most competitive pricing and execution by instrument into their stream. "The banks compete for the clients' volume, therefore the more they price competitively, the more trades they will capture. CFH Clearing liaises closely with the banks to ensure competitiveness." Baksh explains. "With the increase in the volume received, the banks subsequently are more likely to reduce fees – and we then pass that on to the client."

Sitlani believes that collaboration and communication are the two vital components which firms need in order to stay ahead of the latest developments in this space. "We see it as one of our primary roles to take a consultative approach with our clients," he says. "If we can keep them up to speed with the changes that are taking place - be that regulatory, market specific or technology changes - then they will be able to better position themselves going forward." However, if you look at the changes taking place already in the market, a lot of PoPs have already disappeared, according to Baksh. It is not yet clear if

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regulators will require PoPs to reveal the identities of their end-of liquidity providers, but it is important that their reporting system adheres to regulatory requirements and that the client is given access to that system. Baksh adds that with margin changes on their way, PoPs need to make sure the capital requirements are there.

Firms also need to do their own due diligence on their PoP counterparty, White warns. "Non-transparent counterparties should be avoided," he explains. "PoPs should preferably be publicly listed – and should not internalise, which opens up a conflict of interest." Instead, PoPs should be able to provide multi-asset STP/DMA and they should provide institutional quality ancillary services like transaction cost analysis, according to White. "And the PoP should be agnostic and accommodative to technology the client prefers to use," he adds.


Raj Sitlani

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TIME TO DECIDE

Also, the majority view appears to be that the definition of PoP services is aggregating liquidity based on a margin account, adds Baggioli. "But, in my opinion, if you look at the underlying product this has nothing to do with prime brokerage," he says. For Baggioli, genuine prime brokers - like ADS Securities, who intermediate through their PBs - allow clients to trade using their own liquidity relationships. "The other main problem is that under the banner of PoP we are seeing some brokerages offering absurd credit terms to companies that would not pass any direct PB credit check, he warns. "This is absolutely madness – it is almost in sub-prime territory – especially as the underlying PB has no way to assess, and fully understand, the risk they are indirectly taking on," Baggioli claims. "This may well end in disaster and could lead to further credit contraction for many players in the industry. This is ironic as PoP could increase the problem it was originally meant to solve."

And finally, an interesting consequence of what is happening in the retail world is that PoPs are probably best placed to help facilitate risk management services, observes Soliman. "That is a development in this space," he adds. "We've seen a couple of firms starting to offer risk management services to their customers." He believes there is now an appetite among the institutional liquidity providers and risk managers (both bank and non-bank) to manage the risk of people who want to offload their risk books. And Stater believes it is in a good position to be that facilitator as we are a matched principal brokerage, Soliman says.

"This evolution means that marketers have to make a decision," he warns. Many will decide to give the risk management function of their business to an external company - and that is something Stater Global Markets is looking at to see how it can assist, he adds. "Most brokers are generally marketing companies, not risk takers," Soliman concludes. "Regulation is going to force them to make a decision about whether they have enough capital to be a risk taker and a marketer and whether that is the optimal use of their resources and strengths."