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Forex traders rage against the machine

By Alice Ross and Philip Stafford

Bankers have claimed a scalp in a backlash against ultra-fast traders that has turned the foreign exchange markets into a battleground between high-tech trading systems and old fashioned dealing by "real" people.
ICAP, the world's largest interdealer broker, has come down squarely on the side of the humans, announcing plans to clamp down on "disruptive" practices by high-frequency traders on its popular forex platform EBS.

Investment bankers have been complaining for years that HFTs, often automated models trading at lightning speeds and owned by hedge funds, distort the market, prompting regulatory scrutiny.

Many currency brokers have complained about the activity of certain high-frequency traders, whom they say do not add liquidity to the market, while confusing other traders in the process.

"It's frustrating and it's harder to transact cleanly in the market," says a forex trader at one big bank. "It's something that affects you every day but you deal with it."

The measures announced by ICAP will target practices including "statistical arbitrage", where models attempt to track discrepancies that exist in the forex market, profiting for example from the milliseconds it takes for headlines in New York to affect the London market.

Other HFTs will place and withdraw orders so quickly that manual traders are unaware they are even there. Traders say it takes 300 milliseconds for a human to place then cancel an order. For an HFT model, it takes less than one millisecond.

The move by ICAP highlights how the forces that have reshaped equities and derivatives trading are now pushing at the foreign exchange market.

Equity and on-exchange derivatives trading have been revolutionised in the past five years by new regulations in the US and Europe that allowed competing trading venues to challenge incumbent national exchanges.

New trading firms and electronic market makers have emerged to exploit the tiny differentials in prices on rival platforms by using superfast computers and telecommunications connections.

Foreign exchange has been more resistant to the changes, with an estimated 50 per cent of trading still transacted by "human" dealers. In part, that is because brokers take a far larger role as an intermediary while dealing, and clearing is based on different market infrastructure.

Still, the possibility of breaking into the largest financial market in the world, with $4tn exchanging hands daily, is proving a draw for big HFTs such as Getco and Citadel.

These have moved into forex market-making, searching for better returns in new asset classes as volumes in equities, for example, have fallen.

In the more developed and fully regulated equity market, traders can choose from hundreds of different trading platforms globally. However, there are only about a dozen in the foreign exchange market.

That situation is changing. FXCM and Credit Suisse last month announced a new foreign exchange trading platform that aims to introduce "the speed and transparency of equities trading" to the forex market. Thomson Reuters, which has a rival platform to EBS, announced plans this week to buy FXall, another electronic trading platform, for $625m.

At the same time, some investment banks are taking matters into their own hands, offering new services that specifically discourage predatory practices in high-frequency trading. Five banks recently agreed to back Tradition's traFXpure platform, after becoming disillusioned with EBS.

Some bankers are privately calling for the measures against HFTs to be even tighter, for example clamping down on "flash orders" by imposing even longer minimum holding times. Some HFTs place orders for very short periods with no intention of buying or selling at the price submitted as a way of testing market pricing.

Not all HFTs are seen as disruptive, even by the banks, which count HFTs among their clients and most of which also have their own internal electronic models. HFTs are seen by many as providing useful liquidity in electronic trading.

"There's still a large human component to the forex market," says Simon Jones, head of electronic foreign exchange at Citigroup. "We're just at a different stage of evolution to equities."