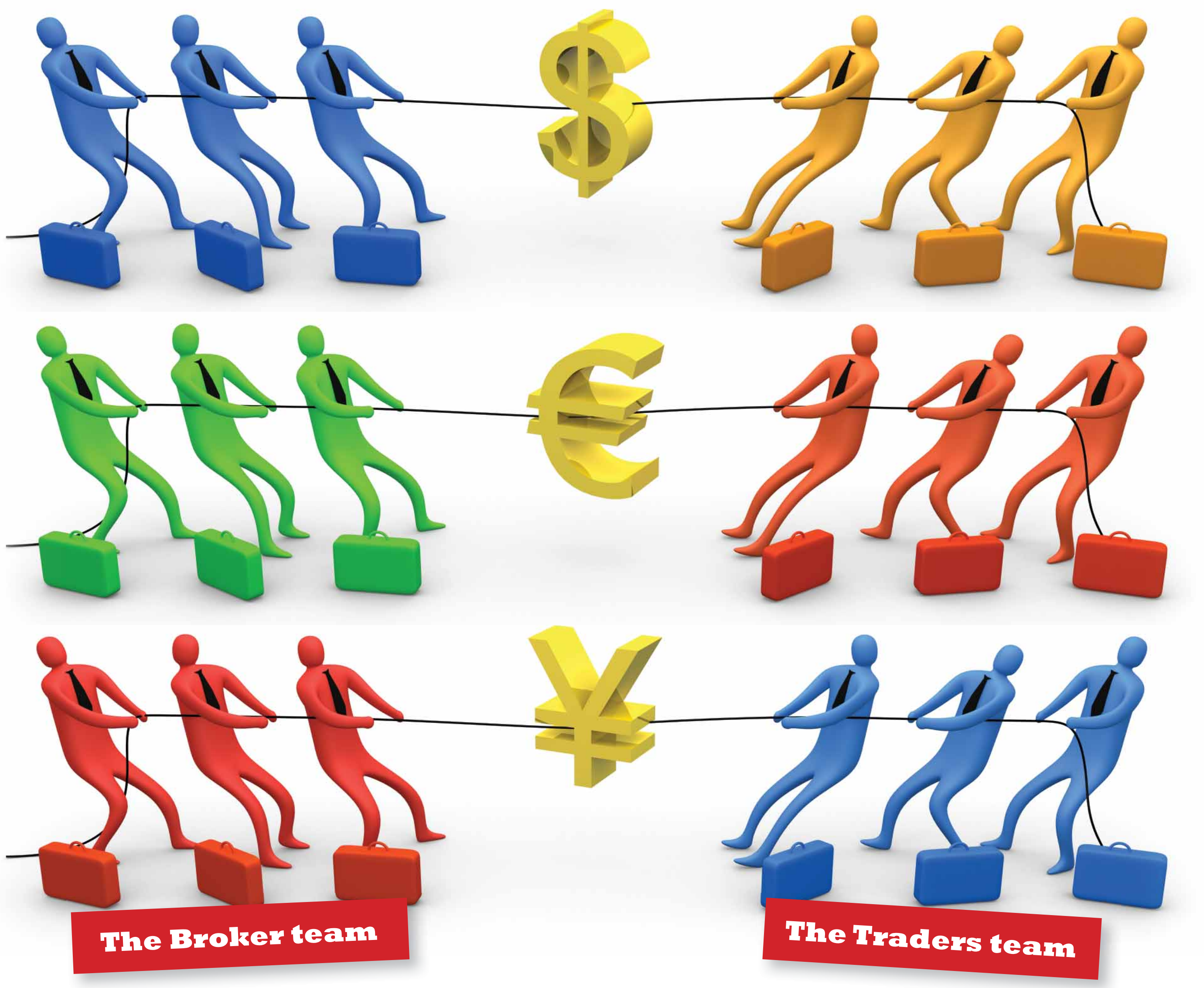

NDD execution:

providing a conflict free environment for Retail FX traders

In forex trading, the electronic execution engine used by Non Dealing Desk (NDD) brokers provides traders with direct access to streaming prices from multiple liquidity providers. Unlike in the past, when trades were managed by the broker's deal desk, trades now go directly to the broker's NDD execution engine, which instantaneously places an identical trade with the price provider. Heather McLean takes a look at why NDD is the electronic forex trader's golden fleece.

NDD can help remove the conflict of interest between brokers and traders, states Ross Ditlove, CEO at MB Trading. He comments: "It is your broker's job to get your entry or exit price on a trade. You do not want a broker who will take your order, route it to a bank which pays them the most for that order, and in return gives you less than best price on the fill. FX traders miss this critical point, to their detriment."

NDD assists in reducing the potential for market interference by price providers, says Ditlove.

Considering execution on the MBT system from the perspective of one of MB Trading's liquidity destinations, if they want to buy or sell, they need MBT to route orders to them. "Our system routes to the destination showing the best price available at the time the trade request comes in from our retail customer. The bank will have to display a quote that is the best available on the MBT system to have the chance of getting orders from us. This is a competitive pricing model, and it forces spreads to tighten"

"The tighter the spreads, the less room there is for market interference by anyone in the system. The only way that any price affects the best quote is if it moves between the current best bid and offer. That isn't interference; that's an improvement of the quote. One bank trying to jump their pricing around and play games wouldn't even be seen because of all of the other providers are making better markets. This is fully transparent to our clients on our market depth window," notes Ditlove.

Removing conflicts of interest

NDD can help remove the conflict of interest between brokers and traders because under the NDD model, the broker no longer has to take the other side of the market order, agrees Drew Niv, CEO at FXCM. He says in an NDD execution model, the broker plays the role of trade facilitator, connecting clients directly with liquidity providers and placing identical trades on behalf of clients. The actual specifics of the trade (position, size, stops, limits) are irrelevant because NDD brokers make an identical amount of money in the form of pip mark ups, regardless of whether their clients make or lose money on trades.

"Essentially, NDD has altered the incentive structure that used to govern forex trading," remarks Niv. "With NDD, instead of brokers making money out of whether or not a client's trade is profitable, money is made solely from pip mark ups, which is why FXCM believes in educating clients to trade smart. The logic behind this is that smart traders are successful traders, and successful traders trade more frequently than unsuccessful ones."

The term NDD implies that the conflict of interest has been removed, comments Patrick Meier, vice president and deputy CEO at Dukascopy Bank. He says clients should be able to get an execution in milliseconds, and have access to market depth with multiple streaming prices in order to have full transparency, in regards to what size trades can be absorbed by the market, at any given time, with no re-quotes, he adds.

He comments: "Due to the fact that trading is fully automated with order routing to market liquidity via STP, and the latency is in milliseconds, it simply leaves no room for manipulation by price providers who are also booking trades on their own books."

Transparent and fair

NDD execution provides greater transparency and fairer execution for all traders, because it effectively establishes an environment where prices are not subject to manipulation by a broker or bank's dealing desk, comments Niv. Moreover, he adds that this environment welcomes all trading styles and approaches, including automated systems, expert advisors, scalpers, and news traders.

Niv continues: "In a dealing desk execution model, clients are trading with, or in some cases, against,

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a dealing desk, meaning that dealing desk staff members, in order to secure maximum profits and sustain minimal losses, may strategically intervene in trades whenever they think it's necessary. NDD execution essentially removes the human component of trade execution by electronically automating several of the steps involved in making the market.

"What further distinguishes NDD brokers from dealer desk brokers is that NDD brokers provide completely anonymous trade execution," adds Niv. "When an NDD broker client places a trade, the order is immediately sent to the broker's execution engine, which places an identical trade with the price provider on behalf of the client. When the broker's order is confirmed with the price provider, the broker will confirm the order with client, and the trade execution is complete. This entire process is near instantaneous, which helps to ensure that clients can place trades at the prices they want."

Ditlove states that MB Trading's view of NDD execution is that it makes pricing a competitive model. He explains: "The traditional deal desk model allowed the broker to create and display a quote, but also to determine whether they intended to fill you at that quote. A displayed quote does not mean a fillable quote on a deal desk; it is simply an indication of interest. Not only are these quotes made by brokers, but their incentives to execute are at the detriment of the retail trader.

"With an NDD model, the goals of the broker and the trader are aligned," continues Ditlove. "The goal of MB Trading has always been to revolutionise the retail forex industry with fair and transparent order handling. MB Trading displays bank and market maker quotes as well as retail client quotes, aggregated into a single transparent order book.

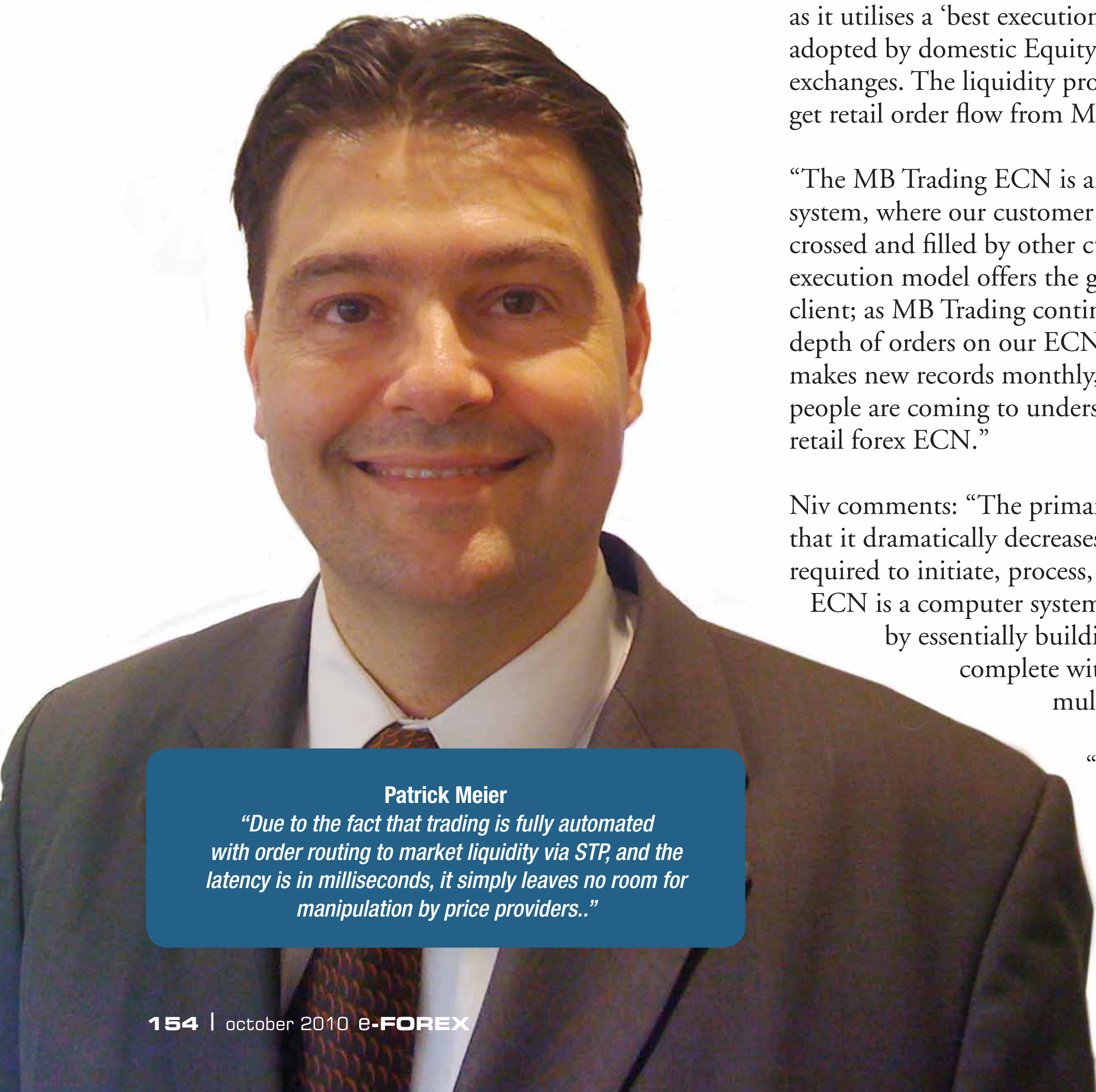
"We have created a simple test that shows anyone using any FX system whether or not the system is transparent and a true FX ECN like MB Trading's. Find any currency pair on any broker's system. For simplicity, use a pair with a three or more pip spread. Let's say the Bid is 250 and the Offer is 253. Now enter an order to Buy at 251. If you and everyone else on your broker's system do not immediately see your new Bid at 251, thus making the market now 251 by 253, then you are not on a true ECN. It's that simple. Without displaying your order immediately for everyone in the system to see and act on, that broker is very much a deal desk," warns Ditlove.

No human intervention

On why NDD provides greater transparency and fairer execution for all FX traders, Meier states the fact that there is no human intervention needed is the key. "This means the orders go to market in a non-delayed fashion. Orders are executed via a technological framework and whether the trade results in a gain or loss is not considered. The only criteria is execution quality. A dealer desk intervention will know if the trade results in a loss or gain; if the broker booked the trade in-house and the closure will put the broker on the losing end of the trade, the execution may not take place at the best possible price for the client."

While Anthony Brocco, CEO at Advanced Markets, says: "In a deal desk model, the client's profit or loss is the deal desk's profit or loss. When you have a direct market access model, the trades are executed by the banks. With 10 banks pricing, the chances of the same bank getting the open and close is remote. There is no conflict of interest; the clients gain is not one bank's loss, therefore the client has a fair, transparent environment, without conflict, from which to trade.

"Banks send out bids and offers in search of liquidity or flow. They price to be hit, and can price more aggressively on either the bid or the offer in order to get trades on the side that they need flow. They want to be hit on their price. In a deal desk model, one side of the equation is a win for the desk, the other side can be a loss. There is incentive to not fill, or to reject those trades on the side which will create a loss. With the anonymous flow we provide to the banks, and each bank pricing in order to receive flow on the side that they need it, there is no reason to reject the trades," remarks Brocco.



Patrick Meier
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"They are seeking the trades," he adds. "This leads to fewer rejections, regardless of the volatility of the market. Volatile market conditions means more liquidity, which should result in better executions, not worse. In deal desk models, the volatile condition is when the desks profit and loss is most vulnerable, which creates the opposite effect of DMA, more rejections for fear of taking on more risk, which could ultimately lead to more loss."

STP versus ECN execution

On the differences between STP and ECN execution, Ditlove says STP execution simply means that the broker passes the trade request through to another entity, typically a bank. "A broker may just set themselves up as a front-facing platform for a single bank and call themselves STP. That does not mean that their pricing is competitive. The STP part of our system consolidates quotes from multiple banks and entities and routes orders to the one showing the best price at that instant.

MB Trading's STP environment alone is competitive as it utilises a 'best execution' model that has been adopted by domestic Equity, Option and Futures exchanges. The liquidity providers have to compete to get retail order flow from MB Trading.

"The MB Trading ECN is an internal matching system, where our customer limit orders can be crossed and filled by other customers. This type of execution model offers the greatest speed to a retail client; as MB Trading continues to grow, so does the depth of orders on our ECN. Our internal match rate makes new records monthly, which is proof that more people are coming to understand the benefits of a retail forex ECN."

Niv comments: "The primary benefit of STP is that it dramatically decreases the amount of time required to initiate, process, and settle a trade. An ECN is a computer system that facilitates trading by essentially building a virtual trading floor, complete with traders, a broker, and multiple liquidity providers.

"Unlike STP, which is simply a method of augmenting the trade order process through utilising electronic technologies, ECNs are dynamic electronic trading environments in which client trades interact with one another and influence liquidity levels," continues Niv. "With various parties competing for buy and sell opportunities, the results are that ECN participants can get the best possible quotes for all trades at all times. Spreads, of course, are left to the discretion of liquidity providers, but due to competition, they are generally between one and two pips. Moreover, ECN brokers ensure anonymous trading by matching client trades using automated processing engines, display depth of market (DOM) data, and let clients view DOM data to identify the trades that best suit their risk appetite."

Making the case for DMA models

Brocco states: "In our DMA model, we only have the banks execute our clients' trades. In an ECN model, clients' trades can be executed, or 'matched', by other clients' orders. It can be a hedge fund making prices, it can be a client's resting order than is being matched, or it can still be the brokers deal desk making the market for which their clients' are still hitting. This makes the ECN model more susceptible to partial fills and higher rejection rates. You can have a hedge fund or deal desk not wanting to take that trade, and reject the flow to protect themselves.

"ECN models also have aggressive algorithmic traders, which banks will not provide their best pricing to. In our DMA model, the banks give us their best price knowing they are getting 100% of our trading activity. No trades are matched client to client, or priced by hedge funds, nor to we have a deal desk to make a market into this ECN. All trades are filled for the full amount that the banks are streaming," adds Brocco.

Brocco states that as far as what order placement flexibility and variable spreads are available with NDD, with best bid offer models, you can only have a variable spread. "If it is a true DMA model, there should be no minimum spread as well. If there is a minimum spread, then the broker is making the difference when the best bid/offer spread goes real low. Advanced Markets does not have a minimum spread, because the market does not have a minimum spread. That is complete transparency."

Continuing, Brocco says: "I believe that the whole DMA model is innovative. It is different from ECNs, different from deal desk models, and is really the only model that creates true transparency for the client. The function of having every single trade that a client places executed by one of ten banks, competing against other banks to get your trade, creating a tight price with extremely low rejections, I believe is innovative."

Who should use NDD?

NDD is best suited for institutional traders including hedge funds, money managers, large prop traders and any high frequency traders, remarks Meier. "Scalpers are often refused by dealing desks because their frequency is too high; often such traders end up being requoted. Also, big blocks are best traded with NDD's that have sufficient liquidity in their networks."

On how retail FX traders can utilise NDD to benefit from the multiple price provider model with competition between banks to offer their best bid and ask prices, Brocco comments that with a fair DMA model, fair competition is created amongst banks to

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price well in order to get the trades of clients. "The more aggressively they price, they more trades they will get. You cannot have a more fair model than that. The best part is the client is the beneficiary of the banks competition," he notes.

Retail traders are often forced to take on high leverage, remarks Meier. "Losses due to bad executions will cut into limited equity rapidly, leaving the retail trader under-collateralised and unable to trade after just a few trades," he says. "The quality of the execution is key to anyone trading, be it the retail trader or the hedge fund. Indispensable are low latency executions, transparency such as market depth, tight and stable spreads, and low commissions."

Adds Ditlove: "As a retail FX trader you should demand the best priced fill possible. How does a retail trader assure themselves that a broker is fair? Any broker that does not charge a commission must be getting paid from someone; this is a conflict of interest.

If you are not paying the broker a commission then it's the bank that is and thus your broker is controlling the quality of your fill. MB Trading believes that this form of auctioning off your order to a bank only hurts the industry."

Which provider?

Before selecting an NDD broker, traders should consider a couple of very important questions, observes Niv. They include: Is the broker registered with a legitimate regulatory agency?; How much leverage does the broker provide?; How wide are the broker's spreads?; Does the broker offer any educational resources? What kind of customer service and technical support does the broker offer?; How strong is the broker financially?; What kinds of premium services does the broker provide?; How does the broker handle deposits and withdrawals?

On factors that should influence a trader's choice of NDD provider, Ditlove says spreads are important, but they don't tell the whole picture. "We urge traders to use 'the test' when picking a broker. Place a limit order between the spread and see if that order changes the price of the quote and displays out to the rest of the traders on the platform without delay. If that doesn't happen, then you are not on a fully transparent system.

"Clearly, the best way to get an order executed is to get it in front of as many people as possible," concludes Ditlove. "If your broker doesn't do that, then they must have a different incentive, and it probably isn't in your best interest."