

XCHANGE

Transaction Network Services

www.tnsfinancial.com

Issue 2

A TASTE OF THINGS TO COME?



Inside:

...A taste of things to come?

...An interview with Hotspot FXi

...Foreword

...Facts about FIX

...Blue System

...News Round-up

...Foreword

Promoting the flow of information

The availability and cost of information is a key topic for this quarter's Xchange.

Victor Anderson, editor of Hedge Fund & Investment Technology, considered the impact of the potential new regulatory climate and level of information required to meet audit expectations.

We also take a closer look at the new electronic dealing room application, Blue, which aims to streamline broker operations, by supporting straight through processing, from conception to completion of trading in multiple asset classes.

I was delighted to get the opportunity to interview Peter Burton and Keith Lite of Hotspot FXI, to discuss the rapid rise of foreign exchange as an asset class and how TNS' Secure Trading Extranet is helping the company connect to customers.

We also feature some facts drawn from the latest annual Global FIX Survey, which turned the spotlight on the level of adoption and growth potential of the FIX protocol. The survey highlighted buy and sell-side firms' plans to focus significant efforts on leveraging FIX across non-equity products. It also named TNS as the first choice provider of primary connectivity services to buy-side institutions around the world.



At TNS, we pride ourselves on the coverage of our network and are driving forward plans to expand this further with new points-of-presence (POPs), the most-recently announced addition being in Bermuda. We now have one of the world's largest communities of interest, offering 96 POPs connecting over 1,000 financial community end-points, representing more than 450 institutions in 25 countries, in America, Europe and the Asia-Pacific region.

For companies in the financial community, real-time information and an efficient flow of communication are essential to allow quick and informed decisions to be made.

If you have any comments on any of the issues raised in this issue of Xchange, we would love to hear from you.

Alex Walker

Vice President, TNS Financial Markets

...Blue System

New dealing room application hits market

When trading moved from the futures exchange floor, Sulim Malook, a London futures and options trader, faced a myriad of software, hardware, data and cabling, and spiralling costs for information, market access and connectivity.

So Sulim decided to create a solution and, drawing on his 20-year career in the financial industry, he set up his own company, Blue System, to make the dream possible.

Five years later, the new, fully integrated electronic dealing room application, Blue™, has just become generally available. It provides unlimited applications, real-time and historic market data, with - uniquely - installation and software licences coming free of charge.

Offering best in class market data, technology, risk management and clearing house services, Blue™ gives institutional brokers and their customers the ability to deal via more than 40 exchanges and ECNs, plus spot currency markets worldwide.

Blue™ also incorporates best-price execution and integrates a full suite of analytics with order routing, using the Financial Information eXchange (FIX) message protocol.

And Sulim's company, Blue System, has just entered into a three-year agreement making TNS, its preferred connectivity provider, enabling Blue™ customers to access trading counterparts for fast, reliable and secure transport of market data and trades, with new connections being established within three days.

Derek Tullett, Blue System chairman, explained: "The application was born because we wanted to streamline and simplify trading, as well as take out most of the technology cost.

"Since the move from open floor to electronic trading in 2000, brokerages have been forced to create and fund their own systems, paying multiple specialist providers for access to information and markets that was previously freely available."

The analytics part of Blue™ has been developed over five years, with the trading element and integration of the two taking about a year. The risk management software and FIX protocol integration lasted six months.

Mr Tullett said: "The analytics application hit the market last summer, when we installed it at selected clients, to gain valuable feedback and help with beta testing.

"Now we're able to offer the full service, interest has been hugely encouraging, with organisations around Europe queuing up to use and distribute the applications from day one."

Sulim said Blue System had assessed a number of financial extranet providers, but opted for TNS because it was one of the world's largest FIX-based communities of interest.

He said: "Connecting with TNS means we can be sure clients will have rapid access to Blue™ and international markets, irrespective of where trades are generated, processed or authorised, and without the need to rely on local telecommunications companies for connections.

"We liked the fact that TNS is hungry for growth and wants to do business everywhere, was willing to think outside the box and be flexible.

"We were also impressed at how quickly TNS can establish connections and its willingness to put points-of-presence in place in new markets and make decisions quickly."

Further information on Blue™ is available at www.bluesysteminc.com



A TASTE OF THINGS TO COME?

Victor Anderson is editor of Hedge Fund & Investment Technology, an Incisive Media publication.

As of February this year, almost all US-domiciled hedge funds were required to register with the Securities and Exchange Commission. How this affects the US hedge fund industry is as yet unclear, although with MiFID around the corner buy-side firms in the UK and Europe will also come under the regulatory spotlight.

February 2006 is certain to be remembered as a watershed in the US (and global) hedge fund industries. That was when the Securities and Exchange Commission (SEC) mandate came into force requiring all US-domiciled funds with greater than \$25 million under management and/or 15 investors to register with the US regulator under the Investment Advisors Act of 1940. The relatively simple act of registering with the SEC and the costly but not necessarily onerous task of publishing the fund's compliance 'manifesto' are unlikely to cause hedge fund managers sleepless nights, although what is likely to weigh heavy on their minds is the appointment of a chief compliance officer (CCO). Not only will CCOs be directly answerable to the SEC, but those individuals will also need to familiarise themselves with the demands of a position that few in the industry have previously experienced.

So what's driving this increased scrutiny and the tightening of regulations governing the global hedge fund industry? In a nutshell, it's all to do with investor protection - or that's what the SEC has been saying since it took the 'registration' vote back in October 2004, with William Donaldson, the then chairman of the SEC, responsible for casting the deciding vote.

Popular

To my mind the SEC has a point; it's no secret that the global hedge fund industry has grown in popularity among institutional investors since the early part of this decade, and it is this trend that has regulators on both side of the Atlantic in a bit of a spin. Given that almost 90 million Americans have some kind of mutual fund investment, it is not surprising that the US regulator has acted pre-emptively in an attempt to avoid scenarios like that of Canary Capital, which kicked off the US mutual fund scandal in Q3 2003. The fact that the SEC was oblivious to the late trading and market timing practices within the mutual fund industry is frankly neither here nor there - the office of the New York



Attorney General, Eliot Spitzer, led the investigation in to the trading violations, allegedly after a Wall Street tip-off.

What's at stake here is the understanding that the global asset management industry simply can't afford any more scandals, while at the same time the regulators have stepped up to the proverbial plate to offer at least a semblance of regulation in an industry celebrated for its lack of regulation.

At present it's unclear what the post-registration climate is going to look like. Indeed, at the last three hedge fund events I have attended - most notably last year's Algorithmics Hedge Fund Summit in New York in October - all the hedge fund managers I spoke to were more worried about identifying the next source of potential alpha than the rigours of registering with the US watchdog.

Technology

The SEC's stance does not require funds under its jurisdiction to implement a minimum level of technology in order to provide regulators and investors with more granularity into their trading activities, especially when it comes to net-asset value (NAV) disclosures and increasingly, best execution. But funds are required to archive email and trade-associated documents for five years in order to provide the SEC with an audit trail should it require one during a routine investigation. Notwithstanding the archiving requirements, however, the technology status quo is unlikely to change dramatically in the short term due to



the SEC's admitted reluctance to saddle industry participants with prescriptive regulations that serve only to inhibit their effectiveness in generating returns.

The longer-term implications are best described as 'more of the same', especially when it emerges that the current regulations are clearly inadequate when it comes to genuine investor protection. By that I mean registering with the SEC in no way mitigates the market-related risks that hedge funds are routinely exposed to as part and parcel of their day-to-day business. Fund failures are an integral part of the industry, and what will be interesting is how the SEC reacts to blow-ups in the future. My bet is that within the next five years funds hoping to attract and manage institutional capital will have to appoint a chief risk officer and develop an industry-accepted 'best practice' when it comes to managing market and credit risk, and reporting those risks to investors and regulators alike.

What about Europe?

The UK and European hedge fund industries are another matter entirely, especially now that MiFID (Markets in Financial Instruments Directive), scheduled at present to become effective on November 1, 2007, is on the horizon. MiFID comprises two levels of European legislation: Level 1, the directive itself, which was formally adopted in mid-2004; and Level 2, or the 'technical implication measures', unveiled earlier this month.

Areas of the business most likely to be affected from a technology perspective are best execution, client order handling, pre- and post-trade compliance, transaction reporting, and client reporting in general. This means, at the very least, that firms wishing to comply with MiFID regulations will need to have the appropriate front-, middle- and back-office technology in order to provide clients and regulators with a systematised 'guide' to their activities.

Catherine Doherty, principal at London-based investment management consultancy Investit, believes that certain technology requirements are already becoming clear. "You could say that firms would probably need to implement transaction cost analysis tools, although MiFID is more about the processes and being able to provide evidence of the processes, than just the technology. There's a lot of confusion on the buy-side at the moment as to whether this is a compliance or a technology issue," Doherty says. "MiFID is more about the effective use of technology to evidence compliance, and especially from the fund manager's perspective, there's a lot of technology required to gather evidence and to analyse it properly."

That said, the fact remains that when it comes to MiFID compliance, there are still many more questions than there are answers, and it will take a considerable amount of time for the technology implications ushered in by the directive to be fully comprehended.

Looking forward

There is little doubt that the \$1 trillion global hedge fund industry plays a crucial role in the financial services market and that regulators on both sides of the Atlantic need to protect investors from hedge fund fraud, while simultaneously allowing sufficient leeway for funds to operate as effectively as possible. But regulators have long memories and few could argue that the industry has covered itself in glory since Long-Term Capital Management's stellar collapse in September 1998. The fact remains that the hedge fund industry has a large appetite for risk and a greater proclivity towards revenue generation, which makes the next blow-up only a matter of time. And whether the new regulatory climate is able to mitigate those risks, or at least soften the blow for investors, is a moot point.



Victor Anderson is editor of Hedge Fund & Investment Technology, an Incisive Media publication.

...Hotspot FXi

Hotspot FX, Inc. operates Hotspot FXi, the world's leading institutional foreign exchange marketplace, and made headlines in January 2006 when Knight Capital Group, a leading equities trading firm, announced an agreement to buy Hotspot as part of its strategy to develop a multi-asset trading platform. Alex Walker talks to Keith Lite, global director of business development, and Peter Burton, head of global marketing, about the rapid rise of foreign exchange as an asset class.

Hotspot FXi was the first and is the leading institutional foreign exchange marketplace? How did Hotspot FXi come about?

Peter Burton (PB): Hotspot was conceived in 2000 by a group of senior traders, sales and technical people on Wall Street who saw an opportunity to develop a new way to trade foreign exchange by setting up an open, transparent system or marketplace. At that time, trading in foreign exchange was fragmented and opaque, with the majority of trades being conducted by phone between trader and their banking institution, requesting quotes on a take it or leave it basis.

But also, a lot was going on with technology and regulation in the US, which made the development of an open, electronic marketplace possible. Such a marketplace would enable portfolio managers at asset management firms, traders at hedge funds, commodity trading advisors and other institutions to deal directly with banks and each other instantly and anonymously.

Clearly the uptake by clients has been strong. By 2004, about 18 months after we launched, our volumes placed us in the top rank of multi-bank platforms.

Foreign exchange is the world's most liquid financial market and has now become something of an asset class. What is driving its growth and interest from institutional investors?

PB: Three elements have converged to create a surge in FX trading with daily volumes growing from \$1.2 trillion in 2001 to \$1.9 trillion dollars in 2004, according to the most recent BIS numbers.

Firstly, leading hedge funds, overlay and currency alpha managers have generated solid multi-year track records, which conferred asset class status to forex or at least recognition it can be robust source of alpha in its own right. Secondly, the ability to trade instantaneously in an ECN environment, innovated by Hotspot FXi, has enabled traders to deploy a new class of arbitrage, algorithmic and short-term technical models in foreign exchange. Also, thirdly, the sustained weak dollar trend through 2004 attracted a lot of assets into FX strategies. At a time of generally low equity and fixed income returns, the environment in foreign exchange has been conducive to profitability.

Do you think multi-bank portals have been the catalyst to growing interest in forex?

PB: Multi-bank portals, in contrast to ECN-structured marketplaces, brought important straight-through-processing (STP) and error reduction benefits to foreign exchange and made it possible to request quotes directly via the desktop. But they didn't alter the traditional dealing protocol, which is where the ECNs have come in, providing live, executable and neutral pre and post trade data and the ability to trade instantly or enter bids/offers to improve dealing rates.

But, half of foreign exchange market participants still have never traded electronically and have no plans to do so. Why?

PB: Earlier we touched on STP benefits of multi-bank portals. It may be those benefits are compelling to a portion of market participants, but not all. Except for these STP considerations, there were no powerful reasons to move from traditional models until Hotspot FXi and the FX ECNs came along. Hotspot provides wholly new reasons to trade electronically centred around transparency, a liquid environment with open dealing, price improvement, pre-trade market intelligence and enhanced best execution and benchmarking practices. Slowly but surely, more and more market participants are understanding the advantages offered by adding an electronic marketplace to their array of execution venues.

Electronic trading in forex has risen from 40 per cent in 2004 to an anticipated 70 per cent of total trades by 2007 and the volume of trades executed by phone is predicted to fall from 90 per cent to 40 per cent. What or who is driving that shift?

Keith Lite (KL): Hedge funds were the early adopters and accounted for the fastest growth in our market share. Others are following suit. The proportion of hedge fund volumes has fallen as we see increasing volumes coming from traditional asset managers, pension fund managers, corporations and client banks.

Anonymity, streaming of prices, bid and offer capability and low latency are some of the features that have given Hotspot an edge. How is Hotspot FXi developing the marketplace?

KL: One of the ways that Hotspot FXi is expanding the marketplace is via a channel strategy through partnerships with other trading platforms. We have taken the view that traders will look for systems similar to those they are trading on in other asset classes. We want clients to be able to leverage the same trading functionality they have today in say futures and equities. Strategic alliances with partners, such as Trading Technologies, Flextrade, Portware, RealTick, Aegis Software and others make it possible for clients to access Hotspot FXi through existing front, middle, and back-office platforms, while maximizing efficiencies and minimizing initial time and IT resource.

How far does FIX have a role to play in the development of foreign exchange?

KL: In the past, development of the FIX protocol to support foreign exchange lagged behind that for other asset classes. The FIX Protocol Organisation is doing a lot of work on developing full capability to support foreign exchange. FIX 4.2 supports spot forex and has allowed Hotspot to integrate with clients and other platforms, which are FIX based.

Multibank marketplaces have also brought visibility of trading to foreign exchange and made it possible to measure performance and cost. How is Hotspot working with traders on best execution?

PB: In the past, many of the critical concepts relating to best execution practices for traditional asset managers, including benchmarking, centralised transparent price data, and transaction cost analysis (TCA), had little or no practical application to foreign exchange trading. Today, we see leading plan sponsors working with their asset managers to develop robust best execution practices for foreign exchange including TCA and benchmarking. This is an area where banks are doing a tremendous amount of work and new market data tools and transparent market structures are playing a key role.

How does use of extranets, such as the Secure Trading Extranet, support Hotspot FXi in connecting to customers and how will it benefit TNS customers thinking about trading on Hotspot?

KL: As the marketplace has matured, we have seen a tremendous change in the speed with which clients expect trades to be executed and confirmed. Hotspot FXi has been at the forefront of this evolution, but we recognised the need to continuously improve our products and offerings. We are working to constantly refine our system logic, software, hardware and telecoms to deliver reliable instant trade executions to clients. Incidentally, we ranked first in Speed of Execution in 2005's Euromoney Foreign Exchange Survey so it seems these efforts are paying off.

Having secure, reliable, fast connectivity to clients is paramount in that effort. Operators such as TNS are experts in managing networks and in making sure they are always up and running. Of course, we are driven by the needs of the client and will do whatever we can to get and stay connected.



Peter Burton



Keith Lite



...Facts about FIX

The 2005 Global FIX Survey, released at the end of the year by London-based analyst Tower Group, revealed some interesting findings:

- Over the next two years, buy and sell-side institutions plan to focus significant efforts on leveraging FIX across non-equity products.
- The majority of exchanges believe trading volumes have increased, and the average order size decreased in the last year, with the majority of the volume going through an open interface into the electronic marketplace.
- The biggest priority for buy-side firms over the next two years will be on direct market access (DMA), whereas sell-side institutions have already made significant investments in DMA and plan to focus more efforts towards algorithmic and program trading.
- Regionally, North American firms lead European and Asia-Pacific firms in leveraging FIX for various methods of trading electronically.
- Cross and multi-leg orders have lagged in FIX support because of their complexity, but each shows substantially increased focus over the next two years.
- Early FIX engine providers still maintain dominance, while many sell-side firms still utilise proprietary technology to differentiate themselves.
- European buy-side institutions lead the way in the utilisation of new approaches to electronic trading.
- Global buy-side firms view compliance as a high priority, due to the increased risk and complexity of managing international regulations, while best execution and access to liquidity are the most important client account features in all regions.
- The costs of adapting order management systems and changing standard operating procedures are the biggest obstacles to achieving greater benefits for electronic execution.

Firms interested in obtaining their own copy of the survey results can download the report at www.fixprotocol.org/survey

...News Round-up

- TNS has announced a partnership arrangement with Peresys, South Africa's leading provider of technology solutions to financial markets, enabling TNS' global financial community to trade with Peresys' South African clients. TNS and Peresys will partner to ensure seamless trading counterpart connectivity for FIX-based transactions between South African buy-side and broker companies and their trading partners in Europe, Asia and North America.
- Raiffeisen Centrobank AG has connected with TNS' proprietary IP network, the Secure Trading Extranet™, to transport market data from the Warsaw Stock Exchange.
- TNS has expanded its international network with a new point-of-presence in Bermuda.

....Trading Places

25 - 28 April

***TradeTech**

Paris

Contact: +44 (0) 20 7368 9465

www.wbresearch.com

2 May

***Screen Event**

Athens

Contact: +31 73 6122 940

www.screenconsultants.com

10 May

***FIX Asia, Electronic Trading Summit**

Hong Kong

Contact: +852 2810 6269

www.fix-events.com

17 May

Dealing with Technology

London

Contact: +44 (0) 20 7484 9916

www.dwt-event.com

18 May

***Screen Event**

Stockholm

Contact: +31 73 6122 940

www.screenconsultants.com

22 May

***ISIPS**

London

Contact: +44 (0) 20 7613 6422

www.stpevents.net

*Transaction Network Services exhibiting.

Contact us

- would you like further information on any services or applications available over our Extranet?
- do you have a comment or question about one of the articles?

Please get in touch

Telephone +44 (0)20 7264 0820

Fax +44 (0)20 7264 0821

Email financial@tnsi.com

Web www.tnsfinancial.com