

Why A Nasdaq Market Maker Turned to Forex

By Chris Mercer



[Editor's note: As all experienced and successful traders know, markets change. The underlying character of a market can transform from a bull to a bear or from trending conditions to sideways action. Technical indicators or setups that once worked may no longer offer profit in a different market environment. Success in trading requires that one be nimble and adaptable. This is a story of one trader's journey down a road that led him into the forex arena. As successful traders continue to seek out profitable opportunities, the trading vehicles they deal with may change. It pays to keep one's mind and options open.]

I love trading. It's not about the money. Well, it's not just about the money.

Too many people think that trading is a science. They approach the process in a black-and-white manner, looking for a specific, rigid set of rules to follow – like their own black box that works under any circumstance. But there's no such thing. Trading is an art. It's about nuances. It's about experiencing many situations so that you know what decisions have the highest probability of success.

I've been trading in the stock market for a long time, and from time to time I have thought for sure I had learned all that I needed to know. In the 1990s, it was about stocks with good earnings growth that were basing and then breaking out. In the late 1990s, it was about chasing momentum and buying EBay in the morning and selling it

in the afternoon 20 points higher. In 2002, it was about shorting. Just when people finally threw in the towel, the market changed things up again. Most of 2004 was fairly flat and light on volume.

My point is that you have to constantly be willing to reevaluate what you are doing. You need to take what you've learned, improve on it and add to it. That's a big key to successful trading. No one is ever going to find that formula or algorithm that consistently lets you make money off of the same concept over and over.

A Look Back

The process of market making back in the early and mid-1990s was something that firms kept very close to the vest. We used to joke that the trading room itself was something firms hid on the top floor of the building behind the fingerprint and retinal scanners. Many times, one person ran the day-to-day operations of the firm, and his brother or son ran the trading desk. You had to trust the person running all of your business.

In 2005, most people have a similar reaction to the phrase "market maker" – two dirty words when put together. Like any industry, there are bad apples. The process of market making, however, evolved out of the real need for firms to maintain organized markets as the volume and trading activity of markets increased. It was the job of the firms to post quotes and stand by those quotes for buyers and sellers. The firms kept prices somewhat stable and put buyers and sellers together. There was, clearly, risk involved, and their reward for taking that risk was called the spread. In those days, everything was in fractions. The spreads would be maintained by the firms in fractional amounts, and then the firms would deal with each other within those spreads. From a market maker's perspective, a good trader was someone who knew where to call to find buyers and sellers on the stocks that he or she "made."

By the way, barely out of college and after a series of fortuitous career moves, I was second in charge of a trading desk in a major city. I could also trade my own account and learn the tricks of the trade. And while I was learning the market maker end, I was running all of the trades for the brokers around the country, including for

a friend who had a passion for technical trading. I got to see just how successful he was with his clients using a technical system.

Technology Takes Over

Being a big fan of technology and computers, I could see where the trading industry was going. The NASDAQ was a system of networked computers across the country. Firms would put up quotes on a stock and then deal between those prices with each other over a system called SelectNet. If customers wanted to buy and sell, the firm was only obligated to execute the trade if the customer wanted to sell at the bid or buy at the offer. We, however, could execute them in between...and did. Most firms didn't and worked off of the spreads. The spreads weren't fixed, but let's just say that as a team, the market makers didn't necessarily find it in their best interests to keep those spreads too tight either.

Things started changing in the mid-1990s when Instinet came along. To get Instinet, a firm needed a dedicated computer with a dedicated high-speed line connected to other firms on Instinet around the country. That sounds simple in 2005, but in 1995, it wasn't. The monthly costs were expensive, but Instinet allowed firms on the network – mostly bigger firms – to show large institutional orders between the traditional bid and ask prices on the NASDAQ system between firms.

Sometime around 1996 or 1997, ECNs started popping up. The idea was that these systems would allow regular retail customers to open an account and post buy and sell orders for each other to see and hit. The attitude of market makers regarding the ECN concept was fairly universal; they didn't believe ECNs would ever take off. They basically felt that the public wouldn't want to get involved and wasn't powerful enough to play a big role. The costs for someone to set up systems like that were too high for the amount of trading for which the "retail folk" actually accounted. I didn't agree. I felt it was just a matter of time until everything was linked up and people were trading order versus order.

Then ECNs Changed The Landscape

There were a few more steps. As the ECNs evolved, they got the National Association of Securities Dealers (NASD) to incorporate their quotes into the quote on a stock. Now, if a stock was 3 by 3-1/4 and a retail customer wanted to buy at 3-1/8, the stock quote went to 3-1/8 by 3-1/4, and the market makers had to respect that quote. Then, precisely what most of the people running the trading desks thought *couldn't* happen, did happen. The retail customers start using these ECNs. The biggest names left are, of course, Island (ISLD) and Archipelago (ARCA). By 2001, just four years after ECNs hit the mainstream, activity on their networks accounted for more than half of the volume on the NASDAQ. Technology paved the way.

The middleman – the market maker – was taken out of the picture. Though there were benefits to having the stability that came with market makers, the ability to get real prices against the best buyer or seller out there – and at the click of a mouse – was even more appealing.

(So here we are, 1,000 words into this article and no mention of forex. You're probably thinking that I'm writing for the wrong issue. But I'm getting there.)

I moved to Phoenix, took charge of a trading desk for many years and eventually left the business to manage money and start Tradesight.com. Again, I've gone through various periods where I think, "OK, finally I've seen just about everything that the stock market can throw at me. My system doesn't need to be adjusted." And then something *new* happens. Probably 90 percent of how I approach the market is fixed, but I make small adjustments over time. But there is no all-encompassing approach to the market that you can just stick with forever. For 13 years, I made a career out of the stock market, as well as options and futures.

Another World

I always knew what forex was. It's a huge market in terms of dollars traded per day, and it's growing rapidly. I knew it had good movement, great liquidity, and I had heard that it acted somewhat technically. But I had also heard horror stories about getting orders executed. Everything is measured in pips; the smallest increment in the forex world, and people would talk about getting slipped 10 or 20 pips on a purchase from the price that they thought they were getting. Spreads were wide and fixed. You opened an account and dealt with one deal desk only, meaning you would be shown a quote and would have to execute within the parameters of that quote (no executions in the middle of the quote at all and no idea how much trading was actually going on above or below your price). Let's just say that forex didn't sound appealing to a guy who was quite comfortable making markets in stocks.

Until Recently

Recently a company called EFX Group, which uses technology of the stock-trading platform known as MB Trading, launched a forex platform that eliminates the "fixed-spread" nature of the forex world. It shows the best bid and ask levels of all banks in the system and is extremely liquid. It provides a wide range of flexibility for the customer in terms of order execution (trailing stops, stop limit orders, etc.) In this manner, the customer is seeing exactly what the deal desks have been seeing but not passing along. In other words, it's a forex ECN, the exact thing that happened in the stock market in the late 1990s.

Access to the "Real Price"

Steve Demarest, president of MB Trading and EFX Group, says their motto is, "Give every customer full transparency and hide nothing." Their goal, then, is to take out the middleman. Sounds familiar. "The whole concept of fixed-spread deal desks makes for an adversarial relationship between the customer and the platform," explains Demarest. "The desk has an incentive to put their quote in the ideal location between their own buyers and sellers. On our system, that isn't so. We're more liquid, and we show the client where the big buyers and sellers lie. That way, everyone can equally participate."

EFX software has been available for a short time, but a coming upgrade allows retail customers to actually hit each other's orders.

EFX isn't the only platform looking for direct-access forex trading. COESfx out of New York is doing the same thing (www.coesfx.com). Michael Weiner, managing partner and co-founder of COESfx also thinks he knows what his customers want. "It's sim-

ple. They want no trading desk or intervention to true bank prices in the forex world. That's where the game is. The public might be interested in the forex markets, but the real forex traders are interested in getting the real prices."

There's Always Action in Forex

The more I started looking at it, the more I realized exactly where forex was in its evolution. It was the stock market of the late 1990s all over again, but not in a negative sense. Forex will never have a bubble because currencies will always rise and fall against each other. Forex isn't a world where things get exciting for a couple of years because it is the hot new thing and then die down as money gets trapped in the system. It's the opposite – forex is the hot new thing because people are recognizing that it is the only market that will always have action and activity. And now, if the execution issues are resolved, forex indeed may become the ultimate trading market.

"The fixed pricing is a great gimmick," says Weiner of COESfx. "They've sold it as a stability factor." The meaning is clear – market makers were the stabilizing force of the market in their day. "When an unemployment number comes out, we have liquidity the whole time, up and down, as the market moves," Weiner adds. "The fixed-spread platforms lock out their own buyers and sellers for a few seconds on the news and then pick up when they have adjusted their prices. Along the way, you can bet they got long or short as necessary. Then they fill their customers when the markets stabilize. Meanwhile, our customers have entered and exited positions. The difference is night and day."

One thing that haunts the forex markets is the lack of a consolidated quote. Even on the platforms that show the best bid and ask prices without fixed spreads to their customers, there are still many other platforms trading. Weiner doesn't think there will ever be a consolidated quote that shows true price and volume. I'm not sure I agree because I'm a technology guy. My belief is that if you build it, they will come. If they need it, you will build it. Someday, I'm guessing that we'll know the exact price on forex and the exact number of contracts traded.

But in that sense, forex is a market coming into its own on multiple fronts. The NASDAQ took a couple of decades to put buyers and sellers together in a methodical manner that organized their quotes by best price. Years later, it allowed anyone to show an order and included that in the price. The forex markets are moving fast to accomplish all of this in a couple of years.

Demarest has a final vision for the forex world. "Just like stocks, the real trading will occur when all interests align on the execution side. As long as execution favors the deal desk, you will have inefficiencies."

I started trading forex in early 2004 and added a forex service to my website in June of 2004. It now accounts for 75 percent of my daily trading in the market. I find it exciting, but then again, trading is my life. I live and breathe it. What I see coming on the execution front reminds me of the NASDAQ evolution of the 1990s, and that's appealing to me. It's the new frontier, but it's evolved more quickly. To focus on the trading, you need to trust the execution system. For stocks, that took many years. Forex is jumping ahead by leaps and bounds.

I'm convinced that I've found my new trading vehicle and method, and now I think I'm done. I can just keep doing the same things over and over forever...until I can't and something new comes along. SFO

Chris Mercer has more than a decade of experience trading stocks, options, futures and forex. He is head analyst at Tradesight.com, a subscription service that provides market analysis, economic analysis, and stock, futures and forex trading ideas daily. Mercer is a commentator on the FX Edge, a radio segment four mornings a week on KFNN 1510-AM in Phoenix. He also can be heard throughout the trading day in his Tradesight Chat Room. A native of Phoenix, Mercer conducts seminars primarily in the Southwest.



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