December 19, 2017

GFXC Request for Feedback on Last Look practices in the FX Market: Results and Recommendations[1]

I. Executive Summary

The Global Foreign Exchange Committee (GFXC) is publishing this paper following its Request for Feedback on Last Look practices in the Foreign Exchange Market ("Request for Feedback").[2] The Request for Feedback was launched on 25 May 2017 and concluded on 21 September 2017. This paper provides brief background on the Request for Feedback, describes the responses and key issues discussed as part of the Request for Feedback, and sets out the GFXC's course of action and next steps.

In light of the feedback received, the GFXC is revising Principle 17 of the FX Global Code ("Code"), as set out in Section V below. Principle 17, as revised, provides that Market Participants should not undertake trading activity that utilises information from the Client's trade request during the last look window. Further, the revised Principle also describes the conditions under which certain trading arrangements (sometimes referred to as 'cover and deal') may be distinguished from this guidance.

II. Background

The GFXC requested feedback on last look practices in the FX market in furtherance of its objective to maintain and update the FX Global Code.

Last look is defined in Principle 17 of the Code as "*… a practice utilised in Electronic Trading Activities whereby a Market Participant receiving a trade request has a final opportunity to accept or reject the request against its quoted price.*" During the drafting of this principle, Market Participants expressed a wide range of views on the features of last look and trading during the last look window. Some Market Participants objected to the use of a last look window, arguing that last look is not necessary as a risk-control mechanism and moreover that it can negatively affect the outcome for the Client. Others viewed last look as beneficial for market liquidity and pricing.

One area of considerable debate was around "*trading activity that utilises the information from the Client's trade request, including any related hedging activity*" during the last look window. The Code, as released in May 2017, states that such activity is "*likely inconsistent with good market practice*". This language reflects input that expressed concern that hedging activity during the last look window could be to the Client's detriment. Upon publication of the Code in May 2017, the GFXC reached out to the

[1] Capitalised terms which are used in this paper but which are not defined have the meanings given to them in the FX Global Code.

[2] The GFXC is a forum that brings together central banks and private sector participants to promote a robust, liquid, open and appropriately transparent foreign exchange market. The GFXC has developed the *FX Global Code* as a set of global principles of good practice in the foreign exchange market.

broader market with its Request for Feedback on this narrow topic of trading during the last look window and posed two questions for further input (see Box below).

Box: Core Questions for Feedback

Question 1

The Code states that *"During the last look window, trading activity that utilises the information from the Client's trade request, including any related hedging activity, is likely inconsistent with good market practice because it may signal to other Market Participants the Client's trading intent, skewing market prices against the Client, which (1) is not likely to benefit the Client…"* Do you agree or disagree? Are there specific situations where this trading activity benefits the Client? In those situations is such trading activity related to the validity or price checks that the Code states as the purpose for last look? Please provide reasons for each response.

Question 2

Based on your response to Question 1, do you consider that the language set out in the Code on this activity should be modified (for example, should it be strengthened further or provide further detail as to what may or may not constitute good practice)? Please provide reasons.

III. Summary of responses

The GFXC received 33 distinct responses to its Request for Feedback. The respondents were of various types, sizes and geographic coverage. Around half of the respondents were banks. Responses were also received from trading venues, proprietary trading firms, asset managers, non-bank liquidity providers and a technology provider. Additionally, some responses were submitted on behalf of industry associations (including a local FXC). In their feedback, two respondents stated that they provide prices subject to last look, one stated that it places trade requests subject to last look and six stated that they both provide prices and place trade requests subject to last look. The remainder of the respondents did not specify how or whether they used last look. However, the nature of the submissions from several of these respondents suggests they may be providers or users of prices subject to last look. A small number of respondents requested their submissions be published on an anonymous basis.

Question 1

Around one third of respondents expressed the view that trading during the window could potentially benefit the Client and therefore may be acceptable in specific circumstances. These respondents included banks, associations, a trading venue and proprietary trading firms. Several arguments were put forward:

- Trading on a 'cover-and-deal' (or 'back-to-back') basis was appropriate for banks that do not have their own market-making desk in foreign exchange or are otherwise constrained in the amount of risk they can absorb. These smaller (or 'relationship') banks may still wish to provide foreign exchange services to their Clients by using larger market participants' liquidity and having the ability to hedge in the last look window can allow them to fill their Clients' trade requests. It was argued that the 'cover-and-deal' model is an important feature of the FX market and that this form of trading in the last look window should be named as an exception within Principle 17;
- Trading by a principal during the last look window may allow them to accept a trade request in circumstances where it may otherwise have been rejected. Having the ability to trade in this manner was argued by some to be beneficial to market liquidity and could increase the probability of filling a Client's trade request in full. It was also thought to facilitate tighter pricing for certain Clients. One respondent provided examples of instances where it thought a Client could benefit from the practice;
- Clients should be given the choice of sourcing liquidity from market-makers that trade in the window. With suitable disclosures, it was argued that Clients are best placed to determine the relative cost/benefit of such practices for their own circumstances.

In contrast, around two thirds of respondents viewed trading activity during the last look window as inconsistent with good market practice and not beneficial to the Client. These respondents included banks, associations, trading venues, proprietary trading firms, a technology provider, asset managers, non-bank liquidity providers and a local FXC. The main arguments put forward included:

- There is an inherent conflict of interest between a Market Participant providing last look pricing, and its Client, should trading activity be undertaken by the Market Participant in the last look window. This practice was said to provide Market Participants with an asymmetric advantage relative to their Client, making it open to abuse and unfair treatment to the detriment of the Client and the integrity of the market. In addition, whether intentional or not, trading in the last look window could allow information regarding the Client's trade request to leak to its detriment. Many respondents stated that they are not aware of any evidence that trading during the window is beneficial to the Client. Some respondents noted that even if benefits from such trading could be identified in certain circumstances, the potential for abuse and the conduct risks that arose would outweigh those benefits;
- Providing transparency around Market Participants' last look practices (through disclosures) could not be relied upon as an effective safeguard because of the prevalence of anonymous trading on E-Trading Platforms;
- Some respondents suggested that Market Participants who wished to avoid taking on market risk in association with Client trades, by hedging in the last look window, should only offer such trading services under an Agency model. It was argued that such an arrangement would better allow for any conflict of interest with the Client to be resolved.

Question 2

A majority of respondents were generally in favour of strengthening the language in Principle 17. Those respondents advocating stronger language were predominantly banks, but also included proprietary trading firms, buy and sell-side associations, trading venues and a non-bank liquidity provider. Most of these respondents specifically recommended removing the word "likely" from the section of Principle 17 that states *"… trading activity that utilises the information from the Client's trade request, including any related hedging activity is likely inconsistent with good market practice*" or otherwise clearly labelling trading activity in the last look window as being inconsistent with good market practice.

Some of these respondents thought the Code should also clearly set out that 'trading activity' in the last look window that utilises information from the trade request can comprise both hedging and pricing. Furthermore, it was suggested that the Code should be clearer that making trading or pricing decisions on the basis of a rejected trade request was not good market practice.

Other respondents considered that the general stance in the Code could be retained but advocated additional language that would enhance transparency, such as imposing greater disclosure requirements on those undertaking trading activity in the last look window. Such disclosures (possibly including trading data) would allow the Client to make an informed choice. For example, retaining the word "likely" in the text of Principle 17 would create a presumption that trading activity could disadvantage the Client. The dealer could rebut the presumption by providing information to a Client on request which could enable the Client to make an informed choice about whether the dealer's trading activity is beneficial to that Client.

In this regard, some thought that Market Participants should explicitly ascertain that their Clients both understand the potential risks and benefits of practices related to last look, and agree to be subject to them prior to their implementation. There should also be internal controls and oversight of the hedging practices within the Market Participant.

A few respondents regarded the current language in Principle 17 to be sufficient or did not provide specific recommendations as to any changes while stating that hedging in the last look window may be consistent with good practice.

Other issues raised

Some respondents suggested the Code should provide further clarity on other issues related to last look. One concerned appropriate transparency and disclosure. It was noted that, when Market Participants act on anonymous trading venues, it is difficult to fully understand or detect whether (and how) liquidity providers trade in the last look window. It was suggested that the Code provide guidance on what Market Participants should do in regard to transparency and disclosure in these circumstances. Some made suggestions for how E-Trading Platforms could play a greater role in this area, such as by facilitating the disclosure of each liquidity providers' last look practices, imposing uniform standards on liquidity providers in regard to last look, or operating any last look functionality themselves.

Some advocated that last look should always be symmetrically applied such that both the Client and the Market Participant that has received the Client's trade request are protected from trading on non-current prices to the same degree. Relatedly, another submission argued that any improvements in prices occurring during the last look window should be passed on to the Client in the same manner as any deterioration in price.

Regarding the definition of last look, some respondents thought it would be beneficial for the Code to provide further clarity on the respective roles of price, credit and validity checks, with differing suggestions put forward. One respondent cautioned that attempting to tightly define each activity during the last look window would be challenging as the market environment is always evolving. Another respondent suggested broadening the scope of 'last look' within the Code to also encompass voice trading.

Several respondents thought that the Code should address the duration of the last look window. One respondent advocated that any additional 'hold time' beyond an initial price and validity check should be applied consistently, regardless of whether the Client's request is accepted or rejected. Others argued against the application of any such hold times.

Some respondents also recommended that the GFXC reconsider the role of last look itself (with a view to phasing out the practice). It was argued that the use of last look increases the share of the market based on indicative quotes which do not represent true market liquidity and thus does not support the integrity of the FX market. At the same time, other respondents argued that last look is an important risk management tool for liquidity providers, especially in connection with high-frequency trading.

IV. Evaluation of the responses

Risks around trading in the last look window

As noted in Section III, many of the feedback submissions received highlighted the risks associated with trading activity in the last look window. That said, some of the submissions also highlighted instances where such trading activity could benefit the Client. Taken together, the full body of submissions made clear that there was a balance of risks that the GFXC would need to evaluate in order to make a judgement as to what Principle 17 should identify as good practice in regard to this particular activity. For example, while it appears that there can be some instances where such trading activity might benefit the Client, either through facilitating trades that might not otherwise be filled or promoting more narrow bid-ask spreads, this was countered by serious concerns regarding the risk of misbehaviour around this particular trading structure.

In light of the feedback received, the GFXC considers that stronger language within Principle 17 around trading activity in the last look window is warranted. This stance is driven by a number of factors. First, much of the feedback submitted has helped to articulate the underlying structural dynamics that give rise to a heightened risk comprised of several elements. This risk is related to having the ability to transact based on a Client's trade request, combined with having sole discretion about whether the Client's trade request is accepted or rejected. The rejection of the Client's trade can put the Client at a disadvantage in regards to its execution needs, thus impairing the Client's ability to confidently and effectively transact in a fair manner. Second, the feedback submitted highlighted that this risk was not simply concerned with disadvantaging an individual Client but rather the risk this structure can pose to the overall integrity of the FX Market. Finally, the feedback highlighted the inability for many Market Participants to prove whether or not trading in the last look window is to the benefit of the Client. This impairs the Client's ability to assess the full impact of this trading activity.

Utilising information from a Client's trade request to adjust prices on E-Trading Platforms during the last look window raises similar risks to those associated with hedging activity during the window. Consequently, the GFXC considers that Principle 17 should make clear that "trading activity" refers to pricing activity on E-Trading Platforms as well as hedging activity. This language is not meant to curtail a Market Participant's legitimate market making activities during the last look window; there will be supporting examples to be added to Annex 1 of the Code to illustrate the intended scope of the language. Going forward, the GFXC will undertake work on the broader issue of how liquidity providers adjust their prices, both on E-Trading Platforms and when trading by voice.

Conclusion of the GFXC:

- Strengthen the language within Principle 17 to state that Market Participants should not undertake trading activity during the last look window that utilises the information from a Client's trade request. Such trading activity includes some pricing activity and hedging activity. Illustrative examples of appropriate and inappropriate pricing activity during the last look window will be added to Annex 1 of the Code. See the revised Principle and the examples in Section V below.

- Undertake work on how Market Participants adjust their pricing on E-Trading Platforms and when trading by voice.

'Cover and deal' and similar trading models

Some feedback submissions referred to well-established trading practices in the wholesale FX market designed to limit, or eliminate, the market risk Market Participants are willing, or able, to take in facilitating their Clients' trade requests. Small regional banks and other 'relationship banks' were used as examples of entities that may look to offset with other Market Participants any market risk that arises from providing FX services to their Clients. Technology has allowed the automation of this workflow in today's market. The terminology used to describe these trading models can differ: '*cover and deal*', '*riskless principal trading*', '*back to back trading*', '*technology transfer*', amongst others.

'Cover and deal', in particular, was frequently described in the feedback submissions. In essence, it refers to a process where a Market Participant, between receiving a Client's trade request and determining whether to accept or reject the request, attempts to cover the trade request (and thereby offset their market risk) by taking external action. To do this, they may source liquidity from another Market Participant or trading venue. The decision to accept or reject the Client's trade request is ultimately contingent on their ability to cover the deal in advance. This model is different to a Market Participant using the last look window solely for the purpose of running price and validity checks before accepting or rejecting the trade request. In that instance, the acceptance of a trade request by the Market Participant at the close of the last look window will see them absorb market risk, even if for only a short period of time.

'Cover and deal' has very similar features to an Agency model where the Market Participant receiving an instruction to deal from their Client does not take any market risk. Given the prevalence of these types of trading models in the FX market, the GFXC has concluded that the Code's guidance on trading activity in the last look window needs to take them into account. As any such trading activity may signal the Client's trading intent (to the potential detriment of the Client), there should be an explicit understanding between the parties that the Market Participant will fill the Client's trade request without taking on market risk by first entering into offsetting transactions in the market. To ensure that this arrangement does meet its stated purpose, it should provide for the volume traded in the last look window to be passed on to the Client in its entirety.

Conclusions of the GFXC:

- Provide guidance within Principle 17 on how the Code's language on trading activity in the last look window applies to arrangements where a Market Participant does not take on market risk in connection with a Client's trade request. See the revised Principle in Section V below;

- Undertake future work to understand more about the role that 'cover and deal' and similar trading models play in the FX market to inform: (i) the development of relevant illustrative examples for inclusion in Annex I of the Code for consideration at the May/June 2018 GFXC meeting, and (ii) whether the GFXC should provide further guidance around such trading models within the Code, including the pass-through of price improvements to Clients.

Disclosures

As noted above, many submissions focused on the role that disclosures can play in establishing clarity around the trading practices of Market Participants. For some, such transparency was seen as lessening the need for tighter industry-level guidance in the area of last look, thereby allowing Market Participants greater choice as to their modes of execution.

However, it is not clear that disclosures can be expected to fulfil this role at present. Many submissions, particularly from buy-side participants, pointed to practical difficulties in obtaining sufficient transparency about the practices of those with which they may be dealing in the market.

A significant difficulty for Market Participants in obtaining adequate disclosures about last look practices arises with anonymous trading on certain E-Trading Platforms, where Clients cannot identify their liquidity providers due to the intermediation of a prime broker/sponsor. While Clients may be able to differentiate (and thereby monitor) their trading activity with each liquidity provider, the identity of these parties will remain unknown. This inhibits Clients from directly engaging with these parties to obtain a sufficient understanding of their specific last look practices.

Conclusion of the GFXC:

- Undertake further work on disclosures, particularly in regards to anonymous E-Trading Platforms.

Other issues raised in the submissions were assessed to be outside the scope of the current task. Although the GFXC will not pursue those matters at this time, the feedback has been useful to the GFXC.

V. Summary of the GFXC's Conclusions

1. The text of Principle 17 in the FX Global Code is to be amended as per the following:

Principle 17

Market Participants employing last look should be transparent regarding its use and provide appropriate disclosures to Clients.

Last look is a practice utilised in Electronic Trading Activities whereby a Market Participant receiving a trade request has a final opportunity to accept or reject the request against its quoted price. Market Participants receiving trade requests that utilise the last look window should have in place governance and controls around its design and use, consistent with disclosed terms. This may include appropriate management and compliance oversight.

A Market Participant should be transparent regarding its last look practices in order for the Client to understand and to be able to make an informed decision as to the manner in which last look is applied to their trading. The Market Participant should disclose, at a minimum, explanations regarding whether, and if so how, changes to price in either direction may impact the decision to accept or reject the trade, the expected or typical period of time for making that decision, and more broadly the purpose for using last look.

If utilised, last look should be a risk control mechanism used in order to verify validity and/or price. The validity check should be intended to confirm that the transaction details contained in the request to trade are appropriate from an operational perspective and there is sufficient available credit to enter into the transaction contemplated by the trade request. The price check should be intended to confirm whether the price at which the trade request was made remains consistent with the current price that would be available to the Client.

In the context of last look, the Market Participant has sole discretion, based upon the validity and price check processes, over whether the Client's trade request is accepted or not, leaving the Client with potential market risk in the event the trade request is not accepted. Accordingly, and consistent with related principles in the Global Code:

- Last look should not be used for purposes of information gathering with no intention to accept the Client's request to trade.
- Confidential Information arises at the point the Market Participant receives a trade request at the start of the last look window, and use of such Confidential Information should be consistent with Principles 19 and 20 on Information Sharing.
- ~~During the last look window, trading activity that utilises the information from the Client's trade request, including any related hedging activity, is likely inconsistent with good market practice because it may signal to other Market Participants the Client's trading intent, skewing market prices against the Client, which (1) is not likely to benefit the Client, and (2) in the event that the Market Participant rejects the Client's request to trade, constitutes use of Confidential Information in a manner not specified by the Client.~~
- Market Participants should not conduct trading activity that utilises the information from the Client's trade request during the last look window. Such trading activity would include (1) any pricing activity on E-Trading Platforms that incorporates information from the trade request and (2) any hedging activity that incorporates information from the trade request. Such activity would risk signalling to other Market Participants the Client's trading intent and could move market prices against the Client. In the event that the Client's trade requests were subsequently rejected, such trading activity could disadvantage the Client.

  - This guidance does not apply to an arrangement that features **all** of the following characteristics:

    1. An explicit understanding that the Market Participant will fill the Client's trade request without taking on market risk in connection with the trade request by first entering into offsetting transactions in the market; and
    2. The volume traded in the last look window will be passed on to the Client in its entirety; and
    3. This understanding is appropriately documented and disclosed to the Client.

It is good practice for Market Participants to be available to engage in a dialogue with Clients regarding how their trade requests have been handled, including the appropriate treatment of information associated with those trade requests. Such dialogue could include metrics that facilitate transparency around the pricing and execution of the Client's trade requests and assist a Client in evaluating the handling of its trade requests in order to evaluate whether the execution methodology continues to meet its needs over time.

2. The following examples will be added to Annex 1 of the Code (referencing Principle 17):

A Client requests to buy 25 million EUR/ USD on an E-Trading Platform. During the last look window the Market Participant, taking into account the Client's request to trade, skews its pricing on E- Trading Platforms higher.

Market Participants should not use the information contained in a Client's trade request during the last look window. In this example the Market Participant utilises the information contained in the Client's trade request to change its prices on E-Trading Platforms during the last look window. By doing this, the Market Participant potentially signals to the market the interest of the Client, who then may be at a disadvantage were the Market Participant to subsequently reject the trade.
A Client requests to buy 20 million USD/ MXN with a Market Participant on an E-Trading Platform. During the last look window associated with that trade request the Market Participant continues to update its prices in USD/MXN and other pairs on a number of platforms. The prices the Market Participant shows on these platforms reflect normal inputs into the Market Participant's pricing algorithms, including movements in market prices and other transactions completed by the Market Participant, but does not use the information from the Client's request to trade as an input into those price changes during the last look window. Market Participants may update pricing while a last look window remains open if the update is entirely independent of the relevant trade request, as doing so allows Market Participants to continuously make prices. Given the speed of electronic trading Market Participants will commonly need to update pricing while one or more last look windows remain open. In this example, the Market Participant takes no account of the trade request when updating pricing during the last look window.

3. Undertake future work to understand more about the role that 'cover and deal' and similar trading models play in the FX market to inform: (i) the development of relevant illustrative examples for inclusion in Annex I of the Code for consideration at the May/June 2018 GFXC meeting, and (ii) whether the GFXC should provide further guidance around such trading models within the Code, including the pass-through of price improvements to Clients.

4. Undertake work on how Market Participants adjust their pricing on E-Trading Platforms and when trading by voice.

5. Undertake work on disclosures regarding last look practices, particularly in regards to trading on anonymous E-Trading Platforms.

It is recognised that these recommendations may have implications for the current business practices of certain Market Participants and that a period of transition may be required before they are aligned with the Code and Market Participants are in a position to issue their statements of commitment.