GFXC Request for Feedback – May 2021

Draft Guidance Paper 2: Last Look

DRAFT – GFXC Execution Principles Working Group Report on Last Look

1. Introduction

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. This practice has been the subject of much discussion within the industry.

Principle 17 of the FX Global Code (the Code) specifically covers the topic of last look.[1] Following the initial publication of the Code in May 2017, the Global Foreign Exchange Committee (GFXC) amended the text of Principle 17 in December 2017 to provide tighter guidance around trading activity during the last look window.[2] A subsequent report on such 'Cover and Deal' trading activity was published by the GFXC in February 2019.[3]

Notwithstanding the publication of this material, the practice of last look garnered the most feedback when the GFXC surveyed Market Participants in 2019 on suitable areas of focus for the Three-Year Review of the Code. Many Market Participants still had questions and concerns on last look practices, and opinions on this topic remained diverse. Respondents noted that the quality and detail of ex ante disclosures on last look practices could vary widely, including regarding the methodologies used by liquidity providers for their price checks and, relatedly, the length of the last look window. Clearer disclosure on the usages of 'cover and deal' activity during the last look window was also sought. Greater clarity was sought on the appropriate treatment of rejected trade information and, to enhance the capacity of liquidity consumers to evaluate their trade execution, greater accessibility of trade information (including the reasons for trade rejections) was desired.

This paper has been developed by the GFXC to promote wider knowledge and understanding of last look, the role that it plays in the functioning of the FX market, and the appropriate application of last look as a practice. The paper concludes with three recommendations to help address the concerns expressed in the GFXC's earlier survey:

- Liquidity providers should ensure a fair and effective last look process;
- LPs should enhance ex-ante disclosures;

[1] The current (August 2018) version of the Code is available at https://www.globalfxc.org/docs/fx_global.pdf.
[2] See the GFXC's Request for Feedback on Last Look: https://www.globalfxc.org/docs/gfxc_response_paper_dec17.pdf.
[3] See https://www.globalfxc.org/docs/the_role_of_cover_and_deal_arrangements.pdf.

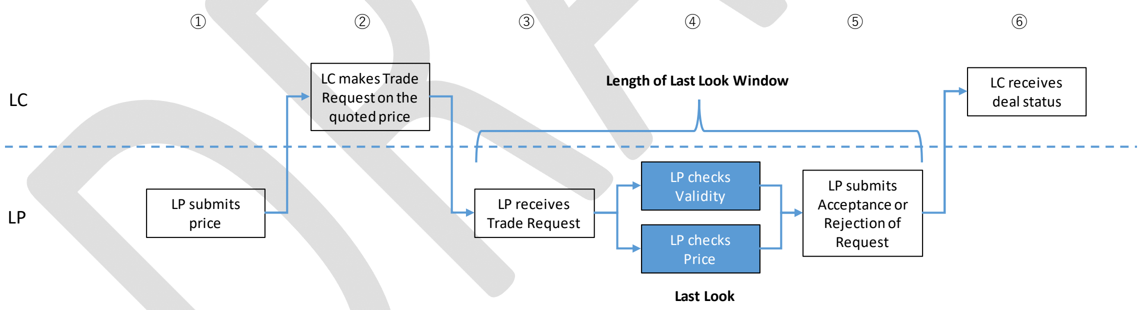
- Information should be available to regularly evaluate the handling of trade requests

This paper should be read alongside the Code, specifically Principle 17, which is included in Appendix A. In its Three-Year Review of the Code, the GFXC agreed that the text of Principle 17 remains appropriate. This guidance paper is not part of the Code. It is acknowledged that the topic is technical in nature and that a wide spectrum of opinion exists on specific aspects of this practice; accordingly this paper is principles-focused and not intended to be prescriptive.

2. What is Last Look

As noted in Principle 17 of the Code, last look is "a practice utilized 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," and "if utilized, last look should be a risk control mechanism used in order to verify validity and/or price." A stylized workflow of last look is shown below, with the Market Participant quoting prices designated as a Liquidity Provider (LP) and the Market Participant making trade requests on those quoted prices designated as a Liquidity Consumer (LC).

Figure 1: Illustrative Workflow of Last Look



Validity Check

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" (Principle 17).

The specific credit-check metrics and the method by which these checks are undertaken can differ widely by Liquidity Provider (LP), as can the length of time required to conduct the check. In cases where an LP is providing quotes on an electronic Request-For-Quote (RFQ) basis, credit may be 'carved out' at the time of the quote request, which may lessen the requirement to check again at the time of a trade request. In the case of indicative streaming prices, LPs will use the last-look process as a final check to ensure sufficient credit limit is available for the trade being undertaken.

Price Check

Principle 17 of the Code states that "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 conducting a price check, an LP compares the quoted price to its estimation of the current price. The estimation of the current price is at the discretion of the LP. The degree to which the quoted price is consistent with the current price is defined in terms of 'price tolerance'. This is typically a value defined in terms of price, usually in currency pips or basis points.

Principle 17 provides guidance that LPs should disclose how "… changes to price in either direction may impact the decision to accept or reject the trade." LPs apply a price check symmetrically or asymmetrically. As the name suggests, a symmetric check applies the same price tolerance level symmetrically around the current price. The LP will reject any trade request on a price that exceeds the defined tolerance level, regardless of whether it is in favor of the LP or the LC.

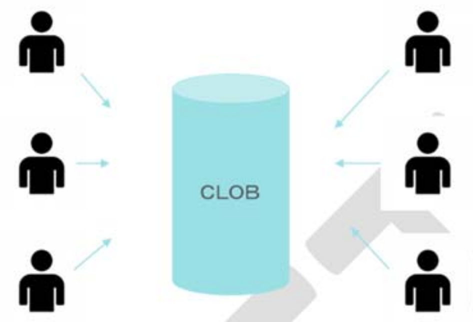
In an asymmetric price check, the application of the tolerance level is asymmetric around the current price. Such an approach tends to lead to trades being accepted when the price has moved in favor of the LP, while trade requests are rejected if the price moves beyond the tolerance level against the LP. Relatedly, some LPs may utilize a price improvement mechanism, such that the LP will accept the LC's trade request at an improved price in cases where the market has moved in favor of the LP, rather than rejecting the trade.

3. The Role of Last Look in the OTC FX Market

To understand the role of last look in the over-the-counter (OTC) FX market, it may be useful to compare the differences between it and a centralized matching model.

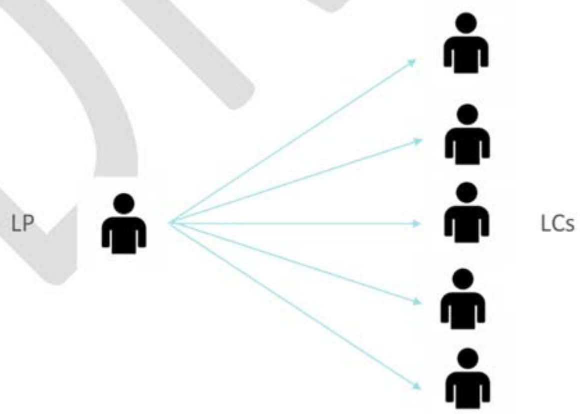
Market participants using a centralized matching trading venue submit their desired transaction amount and price, and transactions are completed when opposite interest is matched on the central limit order book (CLOB). In this sense, the submitted prices represent 'firm liquidity' as once interest is matched, participants are obligated to commit to the transaction. There is no risk of transacting an amount larger than the interest shown to the venue by the market participant. Figure 2 illustrates this model.

Figure 2: Centralized Matching model



The sequence in which a trade is established is fundamentally different in the non-central matching electronic trading model in which most electronic FX transactions are executed. FX transactions are often dealt in this way to allow for market participants of varying sizes to settle a high volume of transactions across many different currencies. LPs simultaneously stream many indicative FX quotes, which allows for access to potential FX liquidity by many LCs in the market. When an LC sends a request to trade on the LP's indicative price, the LP determines whether or not to accept the client's request at that price, as part of the last look process.

Figure 3: Non-Central Matching Model



In a non-central matching model, the LP exposes itself to the risk of receiving requests to trade from many LCs simultaneously, or can be subject to requests that are received significantly later than the time of the quote. LPs manage risks such as this through the validity and price check processes. One consequence, however, is the possibility of trade rejections. When a trade request is rejected, it may have direct bearing on the execution cost of the LC. The LC not only loses the opportunity to trade on the quote that was provided, they may subsequently transact on a worse price.

It should be noted that there are venues in the FX industry that use firm quotes and do not utilize last look. LCs can compare features and choose where and who to trade with.

4. Treatment of Trade Information from Trade Requests

As noted in Principle 17, "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."

Principle 17 explicitly disallows the use of last look for the 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. Using last look inappropriately could potentially be characterized by relatively low trade acceptance rates, differences in the time taken to accept or reject and/or significant market movement against the LC when a request-to-trade is rejected.

The Code also provides guidance that LPs should not conduct trading activity during the last look window that utilizes information from the Client's trade request. Such activity includes price adjustments as well as hedging activity that incorporates information from the LC's trade request, before accepting/rejecting the trade request. These activities would risk signaling to other market participants the LC's trading intent and could move market prices against the LC. If the requests are then rejected, this could disadvantage the LC.

The only exception to this guidance are 'Cover and Deal' arrangements which feature 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.

5. Recommendations

Last look is a feature of the OTC electronic FX market. As each LP has its own last look policy, without clear explanation the nature of its last look process may be difficult for other market participants to understand. In line with the guidance in the Code, the following recommendations are provided in order to alleviate concerns covering three areas – the designing of fair and effective last look processes, the disclosures to be made, and the provisioning of sufficient information for evaluating trade execution.

Recommendation 1: Ensure a fair and effective last look process

- As LPs are in the position of holding sole discretion over accepting or rejecting an LC's trade request, <u>LPs should strive for fairness and predictability</u> in designing their last look processes.

- During the last look window in which an LP is conducting its checks, the LC is potentially exposed to market risk as the market price may move prior to acceptance, and there is also the possibility that their trade request will be rejected altogether. In the interest of fairness, LPs should aim to minimize this period of uncertainty for the LC and therefore <u>LPs should promptly make their decision to accept or reject a trade</u>. As stated in Principle 17, "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".

- The guiding principle of fairness also applies to the treatment of rejected trade information. Through conducting its validity and price checks, the LP will undoubtedly come to possess Confidential Information regarding the LC's intention to trade. <u>Confidential Information should not be used by the LP for reasons other than the purpose for which it was given</u>, as per Principles 19 and 20 of the Code. An example of misuse would be for an LP to use rejected trade information as an input to make real-time trading decisions that could harm the interest of LCs by exposing them to further market risk.

- LPs should note that the guidance in Principle 17, including references to 'clients', applies to all counterparties, whether named or anonymous.

- As the design of the price and validity checks are often proprietary and not always observable externally, <u>LPs should ensure that there are sufficient internal controls and</u>

management oversight in place around their last look processes. This will serve to provide LCs with confidence that they are being treated in a manner which is consistent with the Code's principles.

Recommendation 2: Enhance ex-ante disclosures

- In line with Principle 17 of the Code, LPs should disclose whether they employ last look and, if so, they should ensure that their ex-ante disclosures provide sufficient information for LCs to be able to understand the implications of the LP's last look policy for their trading. To help LCs access this information and allow for greater comparability across LPs, the GFXC has produced a Disclosures Cover Sheet for LPs that includes the following fields that are relevant to last look practices.

  - LPs should disclose whether their price check is applied symmetrically or asymmetrically. Both methods exist in the market, but the choice of price check logic could materially impact the predictability of the LP's last look processes and therefore the outcomes for the client. Asymmetric price checks introduce greater complexity for LCs in monitoring the effectiveness of their execution and so it is particularly important for LCs to understand the circumstances in which they are used.

  - LPs should disclose information about the expected length of the last look window to their LCs.

  - LPs should disclose if they source liquidity using 'Cover and Deal' arrangements during the last look window , meeting all of the requirements for such trading activity that are set out in Principle 17 of the Code. It will be important for LCs to understand the circumstances in which Cover and Deal arrangements are used, such as whether it only applies to certain currency pairs or during certain operating hours.

Recommendation 3: Information should be available to regularly evaluate the handling of trade requests

- Principle 17 encourages LCs and LPs to engage in a dialogue regarding the handling of trade requests. As much of the relevant information resides with the LP, LPs should be sharing sufficient information for LCs to be able to evaluate their trade execution.

- In cases of trade rejection, LPs should be able to disclose, at least, a high level reason for the rejection that is clear and unambiguous, such as whether it was due to failing a validity or price check. LPs should be accurately recording trade rejection information for orders and transactions and be able to disclose it at a trade-by-trade level at the time of the rejection where requested by LCs.

- With appropriate transparency from LPs, LCs should be able to determine whether their methods of execution continue to meet their needs over time, including whether to trade with LPs that are using last look. A trade rejection due to a price check should be an indication that the market has moved between the time the quote was provided by the LP and the time the LP received the request to trade.

    - High rejection rates with an unusually long or unpredictable last look window may be an indication of inappropriate use of last look by LPs.
    - A consistently strong market reaction that occurs when dealing with a specific LP may be an indication of undesirable information leakage or a suboptimal hedging strategy by the LP.
    - If an LC's trade requests are regularly rejected due to price checks, they may need to consider looking at the market impact of their own trades. While it is difficult to definitively attribute post-trade market movement to any one reason, sharp rate changes should make an LC reevaluate their execution strategy.

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Appendix A – Global FX Code, 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.

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 signaling 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.