

Global Foreign Exchange Committee Report: The Role of 'Cover and Deal'
Arrangements in the Global FX Market

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1. Introduction

This Report discusses a trading practice used in the wholesale FX market that is often referred to as ‘cover and deal.’ In general terms, it is a type of arrangement whereby a Market Participant looks to facilitate their Client’s trade request without taking on any market risk. This arrangement typically involves use of an electronic trading practice referred to as ‘last look’.

The Global Foreign Exchange Committee (GFXC) is publishing this information paper to highlight to both operators of ‘cover and deal’ arrangements and their Clients the principles of good practice that can be relevant to this activity.

The paper stresses the importance of those operating ‘cover and deal’ models ensuring that there is adequate disclosure of the practice and the way in which it is being used. This paper should be read alongside the GFXC’s report on the role of disclosure and transparency in the Global FX Market.¹

2. The Global Foreign Exchange Committee and the FX Global Code

The *FX Global Code* ([‘Code’](#)) sets out voluntary principles of good practice for the wholesale foreign exchange market.² By providing a common set of guidelines, the Code seeks to promote the integrity and effective function of the wholesale foreign exchange market.

The Code is maintained by the Global Foreign Exchange Committee ([GFXC](#)).³ In 2018, the GFXC formed a Working Group to consider the role that ‘cover and deal’ trading models play in the foreign exchange market and how the Code’s principles could be applied in that context. This followed an earlier GFXC Request for Feedback on ‘last look’ trading practices in which a number of respondents highlighted the relevance of ‘cover and deal’ arrangements to any consideration of what constitutes good practice for those utilising last look.⁴

The Working Group comprised central banks and private sector participants, including those with experience in offering or using ‘cover and deal’ services. The Group also worked with platform providers and industry groups to seek input from a range of other Market Participants that utilise ‘cover and deal’ arrangements.

This report was produced by the GFXC to promote wider knowledge and understanding of ‘cover and deal’ practices and highlight how they related to the Principles of good practice described within the Code. This report is not formally part of the Code and should not be viewed as an extension of the Code.

¹ The GFXC Report on Disclosure and Transparency is available at https://www.globalfx.org/docs/the_role_of_disclosure_and_transparency.pdf.

² The FX Global Code is available at https://www.globalfx.org/docs/fx_global.pdf.

³ The GFXC is a forum bringing together central banks and private sector participants in the wholesale FX market. See <https://www.globalfx.org/overview.htm>.

⁴ For details of this Request of Feedback, see https://www.globalfx.org/docs/gfxc_response_paper_dec17.pdf.

3. 'Cover and Deal' trading arrangements in the foreign exchange market

'Cover and deal' refers to a type of trading activity in which a Market Participant seeks to avoid taking on any market risk when facilitating a Client's trade request. This arrangement may be utilised by certain Market Participants when quoting prices that are subject to 'last look' in electronic trading activities.

When a Market Participant receiving a trade request on its quoted price has a final opportunity to accept or reject the request, it is employing a practice known as 'last look.' For Market Participants quoting prices in a 'cover and deal' arrangement, the decision to accept or reject a Client's trade request will be contingent on the execution of offsetting transactions. The Market Participant will attempt to execute these offsetting trades in the market during the period between receiving the trade request and making its decision on whether to deal with the Client ('the last look window').

A stylised example of a 'cover and deal' workflow is shown below (Chart 1). The Market Participant that is operating the arrangement is labelled an 'Intermediate Provider' and the parties with whom they seek to offset any risk arising from their Client's trade requests are labelled 'Liquidity Providers'.⁵ (The workflow is not meant to characterise all possible 'cover and deal' arrangements, but serves to illustrate the concepts discussed in the remainder of this paper.)

Chart 1: Workflow of a 'Cover and Deal' Arrangement

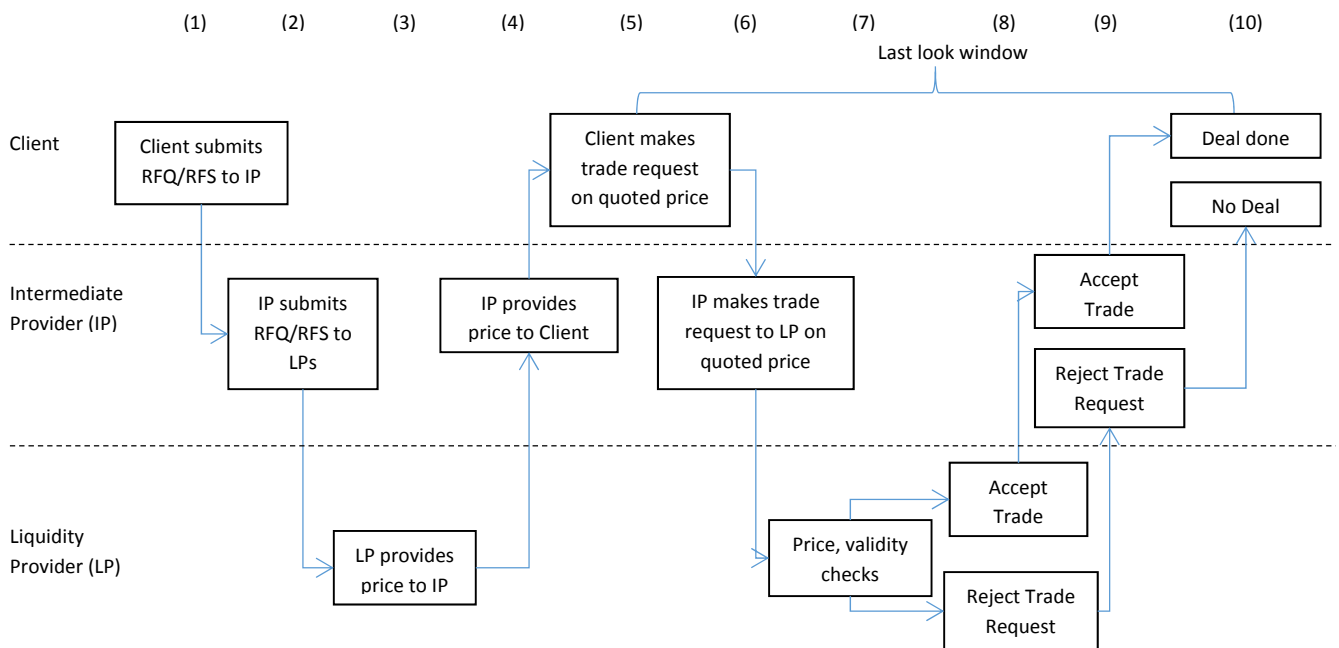


Chart 1 highlights that the Intermediate Provider is able to avoid taking on any market risk as the Client's trade request will only be accepted if the Intermediate Provider has first been able to 'cover' the risk with an offsetting trade.

⁵ In Chart 1, 'RFQ' refers to 'request-for-quote', while 'RFS' denotes a 'request-for-stream.'

The ‘cover and deal’ workflow in Chart 1 can be contrasted with other ‘last look’ trading practices in which a Market Participant accepts their Client’s trade request *before* seeking to cover the risk with an offsetting trade. Under that alternative, any offsetting trades with Liquidity Providers would be contracted after the last look window has closed, not during the window. Unlike ‘cover and deal’, the Market Participant can incur market risk in this scenario when dealing with their Client, even if only for a very short period of time.

Although the ‘cover and deal’ arrangement discussed in this paper has very similar features to an Agency model⁶ of execution, there are two key differences: (1) the Intermediate Provider has some level of discretion in whether or not to execute the trade request; and (2) the Intermediate Provider is quoting prices to its Client in a Principal capacity.⁷ Consequently, by attempting to execute an offsetting trade through external action, the Intermediate Provider will be trading in the last look window as a Principal.

Feedback from industry participants (including those from the buy- and sell-sides, and platform providers) confirms that trading on a ‘cover and deal’ basis is being used by hundreds of banks within the marketplace and across a range of jurisdictions. For example, regional banks that wish to provide foreign exchange services to their clients without taking on market risk may automate the ‘white labelling’ of prices from their liquidity providers. There are different ways in which the service may be provided, such as via a single bank platform interface or hosted by a multi-bank platform. Furthermore, certain ‘money centre’ banks that wish to easily provide foreign exchange services through platforms are also being noticed as users.

The potential scope of ‘cover and deal’ activity can also go beyond these more conventional bank-to-client settings. ‘Cover and deal’ arrangements can also be utilised in contexts where the relationships between the parties shown in Chart 1 may not be as well defined, and their identities may not necessarily be disclosed. It should be borne in mind that in the context of ‘cover and deal’ (and the FX Global Code, more generally), a ‘Client’ is simply a Market Participant that is making a trade request on a quoted price. (In other instances, they may even act as a market-maker.)

While there are many industry participants that utilise ‘cover and deal’ almost exclusively (where they have little appetite for market risk, but have a need to provide foreign exchange as a service for clients), this is by no means the only model for usage. Feedback from participants indicates there is a wide spectrum of usage, ranging from exclusive use to none at all. It may be helpful to think of a situation where a participant may specialise in a particular currency or jurisdiction, but not in others; hence, they are willing to incur market risk in one area, but utilise ‘cover and deal’ elsewhere.

4. Applying the principles of the FX Global Code to ‘cover and deal’

Principle 17 of the FX Global Code provides guidance on last look practices in electronic trading. It stresses that last look should only be used as a risk control mechanism, such as to verify the validity of the Client’s trade request and whether the price (on which the trade request has been made) remains current.

⁶ “Agency” as used herein is not intended to imply a legal characterization of a market participant’s capacity. Rather, it describes trading conducted by an “Agent”, as defined in the FX Global Code.

⁷ “Principal” as used herein is not intended to imply a legal characterization of a market participant’s capacity. Rather, it refers to the term “Principal”, as defined in the FX Global Code.

Recognising that the Client’s trade request is Confidential Information and that the Client may be left with potential market risk if their request is not accepted, Principle 17 says that last look should not be used by Market Participants for information gathering purposes with no intention to accept the trade request. Furthermore, the Principle provides guidance that “Market Participants should not conduct trading activity that utilises the information from the Client’s trade request during the last look window.”

‘Trading activity’ in this context includes both pricing activity on E-Trading platforms and hedging activity that incorporates information from the trade request. Such trading activity during the last look window may move market prices against the Client, thereby placing them at a disadvantage if their trade request is not accepted.

However, the Code states that this guidance on trading activity “... 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.”

As noted earlier, Market Participants that employ ‘cover and deal’ arrangements in the context of ‘last look’ will be trading in the last look window. Therefore, to be consistent with the principles of the Code, any ‘cover and deal’ arrangements (however configured) must be managed in line with the three characteristics set out above.

The Code also provides more general guidance on disclosures that may be relevant to ‘cover and deal’ arrangements. This guidance is highlighted below. In addition, areas for improvement that the GFXC has identified in ensuring that disclosures support appropriate transparency and facilitate constructive dialogue between Market Participants may also be applicable in this area; namely, issues relating to the disclosures’ accessibility, clarity, frequency of review and content.⁸

- Clarifying the roles and capacities of Market Participants

Principle 8 of the Code says that Market Participants should be clear about their roles and capacities when executing transactions, such as whether they are acting as Agent or Principal. It should also be made clear to the Client if a Market Participant varies the capacity in which they act.

In a ‘cover and deal’ arrangement, the Intermediate Provider is acting in a principal capacity, but seeks to avoid taking on any market risk. However, it may be that this Market Participant takes on market risk at other times.

For example, it could be a feature of a Market Participant’s operational setup that during particular trading hours they process their trade requests using ‘cover and deal’, but at other times they are prepared to take on market risk when quoting prices.

There could also be instances where a trade request is made on a cross currency pair for which the Market Participant is willing to carry risk on only one leg, such that they will look to ‘cover’ the risk on the other leg before agreeing to the trade request.

⁸ See the Report from the Working Group on Disclosure and Transparency:
https://www.globalfx.org/docs/the_role_of_disclosure_and_transparency.pdf

The way in which an Intermediate Provider treats partial fills may also determine how much, if any, market risk they take on. Not all platforms will offer the functionality of partial fills. However, where an Intermediate Provider is able to only partially cover a Client's trade request with an offsetting transaction, the Code's guidance is that these volumes should be passed on to the Client. If, in this situation, the Intermediate Provider warehouses the remaining risk in order to conclude the *full* amount with its Client, they will be assuming a degree of market risk.

Feedback from Market Participants suggests that the capacity and propensity for those operating 'cover and deal' models to take on market risk in certain situations varies. It is not uncommon for some Market Participants that operate 'cover and deal' models to take on the market risk associated with a Client's trade request at times. With electronic execution, there can be technical constraints from conveying that change in approach to Clients *ex ante*.

- Information usage

Principle 19 of the Code provides guidance that Confidential Information (including information relating to trading activity or positions) "... is to be used only for the specific purpose for which it was given ... or otherwise agreed with a Client."

In a 'cover and deal' arrangement, information about a Client's *trade request* will be relayed by the Intermediate Provider to its Liquidity Provider(s) without any guarantee to the Client that their request will be filled. As this usage of information has the potential to disadvantage the Client (by moving prices against them), the Code says that 'cover and deal' arrangements should be disclosed.

Depending on how the Intermediate Provider has configured their workflow, it may be that the Client's initial *request-for-quote* is also relayed to external Liquidity Providers (as in step 2 of the stylised workflow above). To be consistent with the Code's principles, it is important that the Client understands at what stage of the process the Intermediate Provider interacts with external parties.

The ability to transact anonymously on E-Trading Platforms can raise additional challenges for Market Participants seeking to understand the trading practices of their counterparties, including the degree of information that is being disclosed about them to other Market Participants.⁹ This is as relevant for 'cover and deal' as for other trading arrangements in the foreign exchange market.

For post-trade analysis, Principle 17 of the Code provides guidance on the way that Market Participants can assist their Clients in "... evaluating the handling of its trade requests", including how their Confidential Information has been used during the last look window. Those facilitating trade requests under 'cover and deal' arrangements should be able to perform this role as adequately as other Market Participants that are utilising last look when dealing with their Clients. Notwithstanding the broader challenges around anonymous trading, discussions with Market Participants have not revealed any particular impediments arising from 'cover and deal' models that would prevent Intermediate Providers from assisting their Clients in this way. It may not always be appropriate (or possible) to provide specific information about Liquidity Providers. However, where it is possible, in the context of a 'cover and deal' arrangement it may be relevant for Clients to understand whether the Liquidity Providers used by the Intermediate Providers have committed to adhering to the Code.

⁹ The Working Group on Disclosures and Transparency is continuing its work on the issues raised by anonymous trading.

Similarly, Liquidity Providers that are providing price streams or quotes may also want to understand when their prices are being used by the recipient to facilitate a 'cover and deal' arrangement.

- Price improvements and slippage

The Code's guidance on 'cover and deal' is that volumes traded in the last look window should be passed through to the Client. The Code does not provide explicit guidance on how any price improvements or slippage that are realised by the Intermediate Provider should be apportioned between the two parties. Pricing is a commercial matter between the parties and engagement with Market Participants has confirmed that practices around passing on price improvements/slippage are not uniform within the industry and, in certain cases, will be constrained by the technology used.

Principle 17 of the Code stresses the importance of Clients having sufficient transparency around the Market Participant's execution practices that would allow them to evaluate the handling of its trade requests. Information regarding the treatment of price changes during the last look window should form part of that discussion.

Relatedly, Principle 14 of the Code provides guidance on the determination of the Mark Up that Market Participants apply to Client transactions. It provides that Mark Ups should be fair and reasonable and encourages appropriate transparency, but does not include recommendations on whether Mark Ups themselves should be disclosed. Market Participants should "... help Clients understand the determination of Mark Up, such as by indicating the factors that may contribute to the Mark Up." Whether price changes during the last look window can alter the final Mark Up may be relevant to a Client.

Feedback suggests that 'cover and deal' operators are as capable of providing transparency to their Clients in this area as are other Market Participants that are utilising last look when processing trade requests. Notwithstanding variations in how price improvements and slippages are treated in 'cover and deal' arrangements, providers should be transparent regarding their last look practices in order for Clients to understand and to be able to make an informed decision as to the manner in which last look is applied to their trading.

5. Conclusion

'Cover and deal' is a trading practice used within the wholesale FX market, although the precise manner in which it is used can vary. The FX Global Code makes clear that Market Participants should be aware of whether, and how, 'cover and deal' activity is being used to execute their trade requests. In this regard, clarifying the role and capacity in which one Market Participant acts upon another's trade requests is paramount. Those operating 'cover and deal' models are encouraged to review the nature of their current disclosures and maintain an ongoing dialogue with their Clients that provides sufficient transparency around their practices.