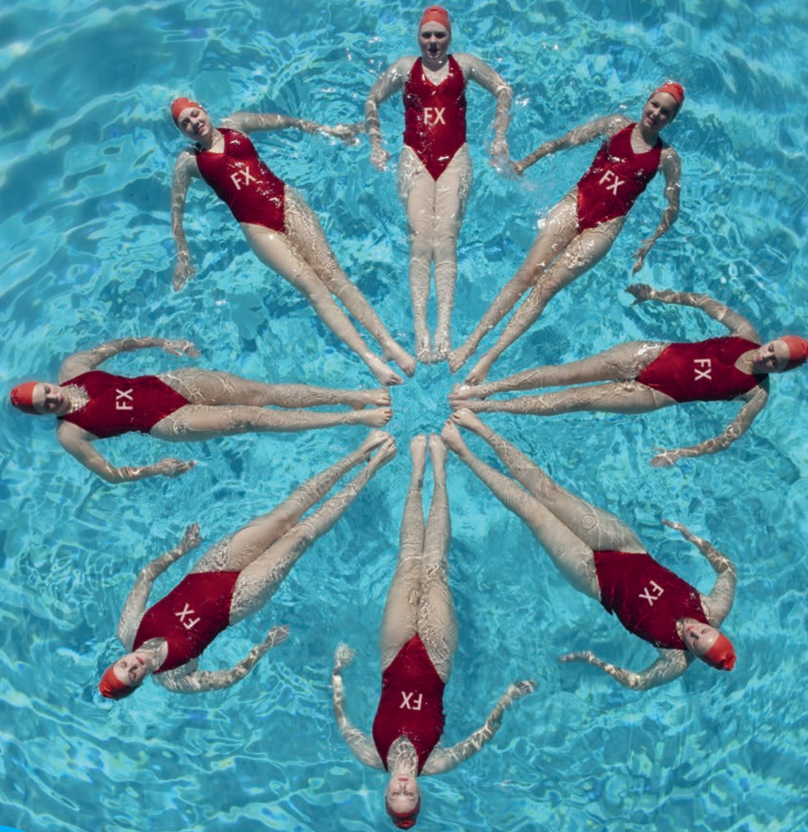
Why FX needs better policy synchronisation and trading transparency

By Richard Willsher



Uncertainty over the future course of regulation and whether more trading malpractice may come to light are continuing to cloud the foreign exchange market. Which is why better policy synchronisation and improved trading transparency are demanding attention.

It all seemed so straightforward then. The 23-page Leaders' Declaration released following the September 2009 G20 Pittsburgh Summit included the following: "Since the onset of the global crisis, we have developed and begun implementing sweeping reforms to tackle the root causes of the crisis and transform the system for global financial regulation. Substantial progress has been made in strengthening prudential oversight, improving risk management, strengthening transparency, promoting market integrity, establishing supervisory colleges, and reinforcing international cooperation. We have enhanced and expanded the scope of regulation and oversight, with tougher regulation of over-the-counter (OTC) derivatives, securitization markets, credit rating agencies, and hedge funds."

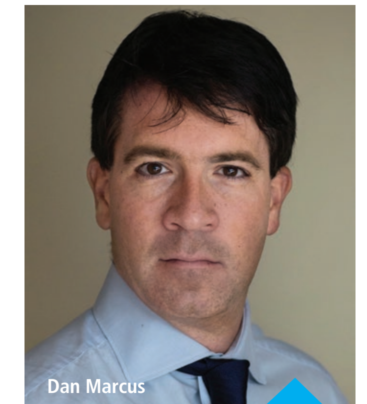
Some of these claims now seem premature. The joint communiqué projects an impression of unity of purpose, implies coordination across the globe and that matters are in hand. Now, more than five years later, different national regulators have moved at different speeds, in some cases producing un-coordinated local market rules to suit their own financial markets. Nations are managing their currencies to protect their own economic interests. Meanwhile in FX, market manipulation and disruptive trading practises have brought the market's integrity into question more than once, giving rise to louder calls for greater transparency.

MARKET REFORMS

The reform of the market in OTC FX derivatives demonstrates what happens when individual regulators make their own rules. It also shows how much slower governments and their regulatory authorities are at getting things done. As Dan Marcus, CEO of spot FX matching platform ParFX and interest rate swap platform Trad-X, points out: "The Pittsburgh G20 in 2009 wanted regulation of OTC FX derivatives by 2012. This got going in 2014 in the US. In Europe it will be 2017. This highlights the reality that, while financial markets are global in nature, regulators by necessity must maintain a regional or jurisdictional focus. So as a result of these cross-border delays and lack of harmonisation we have seen, there remains scope for regulatory arbitrage. Although this adds numerous challenges and complexities in the regulatory reform process, it leaves a gap in the market for individual firms that are globally operational to take the initiative to shape a new trading mentality underscored by best practice and technological innovation.

"The spot FX market has a history of evolving and introducing innovative trading practices that improve the way participants trade, and this is equally the case with ParFX. In our case we set up our platform in nine months after the industry's largest participants came to us with a vision for reforming the way spot FX is traded, and we delivered with a solution that operates across borders, so there is no scope for regulatory arbitrage. So you can see that if you let the market come up with its own solutions to its problems it can often be optimal as compared with local regulators operating on a national basis who are trying to do the same."

Marcus goes on to add that fragmented regulation damages the very market it is meant to improve. "This is not helpful to anyone, not even the regulators. It just lowers liquidity, widens



Dan Marcus

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the spread and increases systemic risk."

Acknowledging the lack of synchronicity between regulatory authorities, IOSCO, the International Organization of Securities Commissions, launched a consultation on cross border regulation that closed in February. The upshot may be that they come up with principles and tools that assist regulators around the world to align their market regulation more smoothly in the future. Mark Austen, chief executive of ASIFMA - the Asia Securities Industry and Financial Markets Association – hopes so. He has pointed out that some of the major pieces of regulation now on the statute books in western jurisdictions have been onerous for Far Eastern markets to import and implement. He says that they have been very expensive while the markets themselves across the region are fledgling and small by comparison. This has hampered the development of such markets while they are still in relative infancy.

CURRENCY WARS

The extent to which regulation at different speeds benefits one jurisdiction over another by offering regulatory arbitrage opportunities is regularly debated. That it may be deliberate is often implied. Manipulation of the value of a country's currency is a much more blatant method of preserving or enhancing competitiveness. The issue for the FX market is how well any changes such as in interest rate setting or implementation of quantitative easing (QE) are trailed. With enough notice and with streaming economic data over time, the market can price a currency and the systems used to transact trades can handle the impact in terms of market volumes.

The US for example has been cautious to give notice of tapering of its QE programme. The European Central Bank's QE programme was predicted and came as little surprise to the market. There has been recent discussion on Bloomberg TV and in The Economist among other venues of whether the US is now about to engage in currency wars as the USD strengthens to such a degree as to make US exports uncompetitive. What practical measures the US may have left at its disposal to weaken its currency is debatable, but from the market's point of view, it seems unlikely that any action is to be taken in the foreseeable future.

We've seen a market that was completely global become fragmented

Precipitate action such as that by the Swiss National Bank on 15th January this year has been described as a once in a lifetime event. Abandoning the Euro peg without notice turned out to be shocking for the market. Systems and algorithms could not cope either with the flush in volumes nor with the over-reaction to the effective revaluation of the Swiss Franc. It was a behaviour more typical of a banana republic than the conservative Swiss but it has fuelled debate about whether there ought to better controls and coordination on a global scale to enable orderly currency revaluation or devaluation or release of information that would disrupt the market. Such governance would avoid extreme market reaction and preserve the integrity of pricing and trading. As it stands, synchronicity among governments and regulators to assist the markets has been found wanting.

TRADING TRANSPARENCY

Meanwhile public perception of how the global FX market operates may not necessarily be well informed but it matters. Because public and press outcry brings governments' and regulators' powers and actions in to question they have to be seen to act. If LIBOR rigging was not enough, collusion over exchange

rate fixes added further fuel to the fire. While the result may have been hefty fines for most of the major global FX market liquidity providers, inevitably the press and public will be asking what will be the next piece of skulduggery to emerge. That is why the market has to be more transparent that ever before.

"We are very fast approaching the time when it will be too late for the market to be self regulating," says Yaacov Heidingsfeld, CEO and co-founder of New York-based FX technology firm TraderTools. "With every day that goes by, and with every announcement of potential wrongdoing by some of the largest and most reputable participants on the market-making side of the equation, we are fast losing that opportunity. If you think about what we have done as an industry since February of last year and what new allegations and settlements have occurred since, the self-regulating horse is pretty much out of the barn at this point."

TraderTools itself provides "… fully disclosed, one-to-one relationship pricing at no cost to liquidity bank providers…" and at ParFX, Dan Marcus is equally acute in his awareness of the need for transparency. "The spotlight is now on FX for a number of reasons. It is understandable that the regulators are looking for greater transparency in spot FX – the primary liquidity venues for the spot market had become a comfortable duopoly and certain systems, protocols and practices had gone unaddressed for too long. There is now a focus on transparency and efficiency because that's what the market wanted. For example, we introduced post-trade name give up so counterparties know whom they're trading with, which is very different from any of our competitors. This is important because many disruptive traders would hide behind the identity of the prime brokers to disguise who they were. At the same time controlling cost and maximising return on investment are what everyone is looking for in the current environment. ParFX operates a low cost, efficient, uniform execution model that was designed by the market for the market."

> "I'm an optimist. FX is the largest market in the world; it's not going to go away. All the things that have happened in the last five years in the market can only result in a healthier, more robust market in the future."

Alan Schwarz

Another force in the push for transparency is bank-owned FXSpotStream that operates as a market utility to route trades from clients to liquidity providers. CEO Alan Schwarz is forthright about the question of the need for greater transparency. "We speak with our service. Ours is a completely disclosed bilateral channel between banks and clients. We believe that transparency and openness are good and markets function when both sides are aware of what the other counterparty is looking to do. We've been growing rapidly for three years now so the market is responding to our offering."

So how much further the drive for greater transparency has to go to satisfy regulators is the moot point. One more major scandal in the market would not help however. Is it conceivable that there could be regulation on a global scale, of the 24-hour a day spot market, turning over USD5 trillion each day. Could it be implemented and managed? The market would argue that this is no one's interest and that there will always be bad apples in every market and every field of human endeavour. To eradicate these would be impossible though strong penalties for mis-behaviour should act as a strong deterrent.

DISRUPTIVE TRADING PRACTICES

Within the market itself disruptive trading practices mar transparency and mislead market participants. For example Andrew Haldane, the Bank of England's chief economist and executive director, monetary analysis and statistics has coined the term "liquidity mirage" to describe HFT quotes that appear in vast numbers but disappear when a counterparty attempts to take them up. He was referring then to the US equity market but the same issue affects, or infests, FX.

The ParFX solution to the problem of disruptive behaviour – for which some HFTs, rightly or wrongly, are perceived to be partly responsible – is to include a randomised pause of between 20 and 80 milliseconds in the trading process. "This means that you cannot predict the timing on the platform," Dan Marcus explains. "For example our randomiser prevents abusive practices such as order submission and cancellation prior to execution with the sole purpose of moving the market. It nullifies speed advantages like dark fibre, cross connect and low latency systems and models. These are things that people were using, in essence, to gain a market advantage. The 20-80 millisecond pause is meaningful for those wanted to execute disruptive low latency strategies but meaningless to those who really wanted to trade. We are replacing the concentration on speed with a focus purely on intelligence."

Yet there is a debate around whether HFT provides liquidity to the market. FXSpotStream's Alan Schwarz is unequivocal in his views. "When it comes to disruptive trading practices, all market participants should engage appropriately in the market, full stop. Anyone who is engaging in activity in the market that is not designed to trade with a counterparty, that needs to be addressed. This can be someone who is a high frequency trader, someone who is trading systematically, somebody who's trading manually. But I don't support the view that any of these players are all bad or all good. It isn't a productive conclusion."

So one should not condemn any particular form of trading per se. The acid test is whether they are disrupting the market for other participants and are not really in the market to trade. Yaacov Heidingsfeld notes however that electronic trading in itself will not cure disruptive or misleading trading practices. "Does the requirement for electronic trading eliminate the possibility of market abuse?," he asks. "I think that in a vacuum it does not. There has been recent investigation here in New York that two large banks programmed their electronic platforms to take advantage of certain situations that were of disadvantage to their customers. An honest system will only be as honest as the people who programmed it." He goes on to add there is still some way to go, "There are still vendors who are hiding behind the idea of dark pools. And if they are not hiding then the customers are hiding. There is still a big dark pool in foreign exchange. It's still a big part of our industry. To the extent we can shine a light on this and make it more visible, that will eliminate some of this abuse. Requiring people to trade electronically will eliminate some of the abuse."

Yaacov Heidingsfeld

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In general the dependency on speed of trading has become a much-abused competitive game. Is the market only to be for the benefit of those with the fastest connections and systems? Or is it to be more inclusive so that large or small, fast or slow players can all do their business without fear of abuse?

A BRIGHTER FUTURE?

No one at present has the answers to these and other questions about what the future of the market will look like. But given the pace at which regulation, technology and market volumes are advancing, we can say with a degree of certainly that the market is likely to be in for continued change and evolution into something different and hopefully better than it was, say five years ago.

Alan Schwarz is characteristically sanguine. "I'm an optimist. FX is the largest market in the world; it's not going to go away. All the things that have happened in the last five years in the market can only result in a healthier, more robust market in the future. As an example, FXSpotStream grew out of a desire by the banks to lower costs and trade on a fully disclosed basis and that points to a better result for the market and for clients in the long term."

Inevitably there is likely be a land grab in order to seize or develop the dominant technology and platform that becomes the market standard. But ParFX' Dan Marcus' view is that there will still be room for innovation and diversity. "Five years from now, who will become the market standard in spot FX? Of late we've seen some of our competitors come closer to us and mimic some of the innovations we pioneered on our platform, while others have gone down a different route by introducing low latency rooms. We are in many ways a primary market of natural interest and price discovery, designed according to the vision of our founders. But all of these platforms do different things. The market does have a place for different models and they all interact with each other in different ways trying to do different things. Of course liquidity and user experience is key so they may not all survive. Some will win and some will lose."

Yaacov Heidingsfeld agrees with Marcus is many ways. "Looking ahead five years from now, what is not electronic will be forced to become electronic. I think there will be some kind of standard that we will have to submit our algorithms to, to provide an additional level of transparency. Confidential rules differentiating trading platforms may not be able to be kept secret in future. If left to their own devices regulators may force published rules of engagement and execution. This goes for technology vendors like us as well as market participants – banks, brokers, retailers etc. This however is a very anti-innovative kind of world to live in. Because if I am forced to share my strategic advantage with the rest of the world, why would I want to innovate? I think innovation would stagnate. This is something that I fear. So I see a market that is more regulated. I see a market that is more electronic. I think that's clear. And I think that this is a market that allows for significantly greater transparency and I would hope that innovators will find a way to be fairly compensated to innovate regardless."

CONCLUSION

Those involved in electronic trading of FX have a good deal to be optimistic about. The drive from human interaction to electronic trading is being powered by regulators, liquidity providers and technology vendors alike. It remains to be seen whether greater regulatory synchronicity or greater transparency will be achieved first however. Most people's money would be on transparency as it is within the power of the market and its participants to achieve, whereas getting governments and regulatory authorities to act in unison can seem like herding cats. May be it's better that way though, so that over-regulation can be avoided and the FX market will become more efficient and effective for those who trade in it.