Managing Compliance and Surveillance in the FX Spot Market

By Enrico Melchioni, *Head of Business Analysts*, and Marco Frangi, *Functional Analyst*

Introduction

The FX market is evolving as rapidly as cryptocurrencies have arrived on the scene, so the interest in FX has grown in step with that. New trader types are emerging that contribute significantly to market liquidity, trading is increasingly taking place on electronic channels and the fragmentation of trading venues has probably reached a peak. Combined with these structural changes, cryptocurrencies are now laying claim to a prominent role in the FX scene, further transforming the exchange rate trading landscape.

In the absence imposed or specific regulations, FX market participants created a code of ethics: FX Global Code (Global Code) – more to follow below. Currently several regulators around the world are reviewing this to understand if and how it may fit into new regulations.

In the following we briefly analyze the current FX market trends and explore how an automated surveillance system's implementation using the Global Code requirements, using experience gained by LIST in providing technology for market abuse detection regulations throughout the world. In doing so, we shall address the unique specificities and issues related to the FX markets.

New Trends in the FX Market

Recent publications from the Bank of International Settlement [1, 2] highlight the continued growth of the global foreign exchange market (Figure 1.a below) and, relevant to this article, the significant changes it is undergoing as a result of a variety of factors, including new technologies and the arrival of new types of market participants.
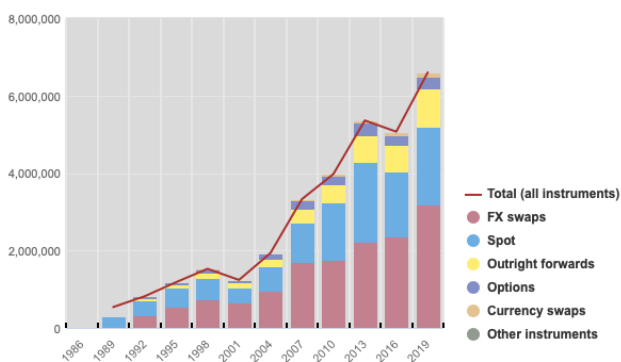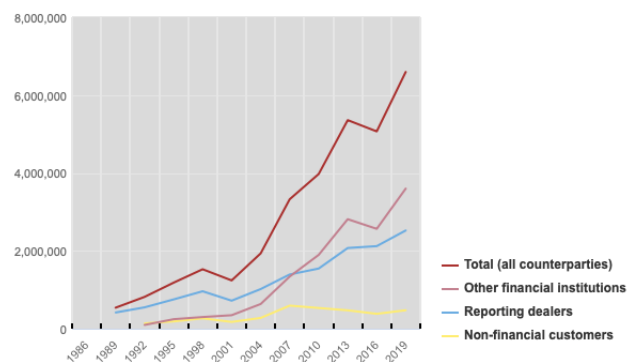

Figure 1.a

Figure 1.b

Source: *Bank of International Settlement*

As shown in Figure 1.b, since 2007 the market has been dominated by new types of operators, such as Principal Trading Firms (PTF) and Hedge Funds, which are introducing new trading styles. The growth in volumes on the

FX markets is also linked to the increased risk appetite of management firms that are reacting to the fall in interest rates by seeking greater returns on emerging markets.

A direct consequence of the change in the profile of operators is the strong growth of electronic trading and algorithmic automation. This trend, already underway on the inter-dealer part of the market, has recently been reinforced by the move to electronic platforms for dealer-to-client trading. The main contribution to this trend, especially in the area of spot foreign exchange, comes from PTFs, which typically trade on electronic platforms (well over 70%, according to [1]), often through a prime broker (Figure 2.a).

In recent years, the FX market has witnessed the proliferation of execution venues other than traditional electronic brokers, offering both multilateral trading through order book and bilateral trading (competitive or not) based on Request for Quote models. This sector is primarily responsible for the growth recorded and today the Multi Dealer Platform market offers many alternatives (Figures 2.b. and 2.c).
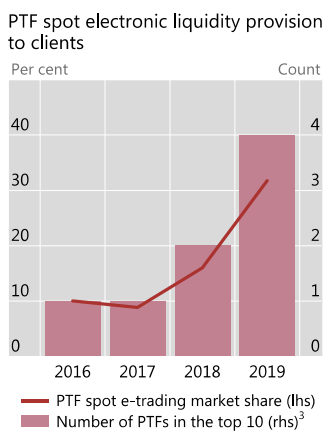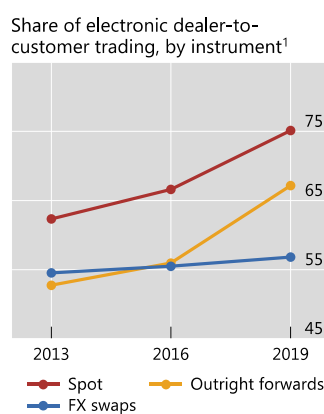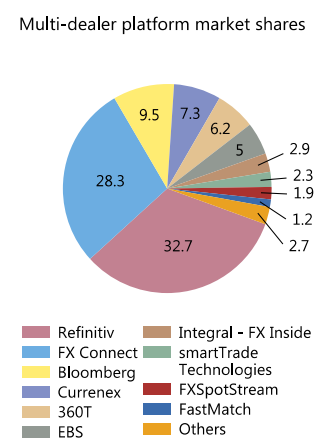

Figure 2.a

Figure 2.b

Figure 2.c

Source: *Bank of International Settlement [1]*

In this context of strong trading venues fragmentation and increase in electronic channels, there is also the issue of Best Execution (understood in a broad sense and not strictly as a regulatory requirement), which favors the use of sophisticated algorithms capable of aggregating liquidity from many pools and fragmenting the order to execute at the best conditions. The mentioned increased activity of Asset Management firms in the FX market is one driver of the increased demand for Best Execution.

While the changes briefly summarized above bring an increase in liquidity and in its resilience (see, for example, the analysis made in [2] on the reaction of FX markets to the pandemic in March 2020), they also introduce new risks to the stability and transparency of the market, related to its substantial opacity (which remains predominantly over-the counter), its strong fragmentation and its tendency towards automation.

In the light of the above and in the absence of structural safeguards such as circuit breakers, which are more common on regulated markets, it is preferable that those operating on the Foreign Exchange market provide themselves with appropriate monitoring and control systems both to contribute to the proper functioning of trading and to avoid market disruptions.

FX and Regulations

Given the FX spot market lacks specific regulations and to mitigate the risks described above, the market has organized itself on a voluntary basis, with the introduction of codes of conduct and best practices. Among these, the FX Global Code [4], drafted by the Global Foreign Exchange Committee, which establishes general principles

of conduct, has been widely adopted. The Code has had global resonance, so much so that access to some liquidity pools is restricted to members who adopt it [2].

The open need for effective, comprehensive and structured regulation for FX spot remains an issue. So much that, at the request of the European Commission, it has been the subject of analysis and evaluation by ESMA. The result of this analysis has been detailed in the MAR Review Report (September 24, 2020) [5] where the most significant fact is the following position taken by the authority: "ESMA concludes that it is appropriate to further analyze the suitability of setting-up an EU regulatory regime on market abuse on FX spot contracts, taking into account the FX Global Code of Conduct currently under revision" (p. 44).

It is apparent that ESMA is focusing attention on the Global Code and its expected revision this year (2021), before proceeding with possible regulation of the FX spot world, and whether this occurs through inclusion within MAR or in some other way.

The FX Global Code, published in 2017, is a set of 55 principles that are universally recognized as best practices in the context of wholesale Forex (spot and derivatives) trading. It, as reported above, is produced and maintained by the Global Foreign Exchange Committee, which represents a collaboration of public and private industry participants. This document was not created with the intent to impose legal or regulatory obligations on market operators but, rather, with the intent to provide a supplement to the various regulatory apparatus, codifying and formalizing recommended and deprecated behaviors related to FX trading. The attempt is to provide guidelines to make the FX market more robust, resilient, fair and transparent.

Most of the principles detailed within the Global Code cover topics such as:

- ethicality and transparency by market participants towards their clients (e.g. proper communication regarding trading capacity, fees, execution policy)
- implementation of systems and procedures for the control and management of risk
- formalization of an adequate disclosure policy for insider information and market colour (e.g. correctly aggregated/anonymized)
- STP, reconciliation, secure settlement

In addition, there are a number of principles that identify and describe specific types of market abuse and unfavorable conduct towards the client. We believe that a focus on these principles can be useful and bring added value as the Global Code is at the center of attention in the process of evaluating FX spot market abuse regulations.

In the next section, we will present an in-depth analysis of the Global Code, focusing on the abuse cases it illustrates, highlighting the specificities of FX spot, the potential issues in the development of a trade surveillance system for this asset class and some possible approaches to this challenge. This is an independent software vendor's point of view, informed by providing technology for firms operating in global capital markets.

FX Global Code and Market Abuse

The deprecated trading practices, detailed within the Global Code, essentially refer to the following 3 Principles:

- P10: Market Participants should handle orders fairly, with transparency, and in a manner consistent with the specific considerations relevant to different order types

- P12: Market Participants should not request transactions, create orders, or provide prices with the intent of disrupting market functioning or hindering the price discovery process

- P17: Market Participants employing last look should be transparent regarding its use and provide appropriate disclosures to Clients

For each of these principles detailed examples are provided, highlighting some of the possible abuse cases and, on the other hand, the behaviors to be encouraged.

Principle 12 can be identified as the one summarizing all the market manipulation cases that we could define as "classic", also common to asset classes other than Forex. Principles 10 and 17 are, instead, focused on typical FX trading scenarios. Let us proceed, therefore, focusing on the last two Principles to detail the specific characteristics of the FX market with regard to market abuse.

Principle 10 describes how to properly manage specific order types, with particular attention to Stop-Loss and Fixing orders. If the first type is not specific to the FX world, even though it is widely used in this context, the second one exists only in this scenario. Fixing orders are, indeed, orders whose execution price is a particular exchange rate, the fixing, which is nothing but a benchmark rate, comparable to the concept of closing price for regulated markets. There are different fixings but the most important one is the London fixing, calculated every day at 16:00 GMT.

Since this benchmark rate is calculated based on quotations and executions around 16:00 GMT (for details on the calculation methodologies see [6]), it is possible to manipulate it, for example, by placing great concentrations of orders close to the fixing time. This behavior could, obviously, disadvantage the client who has transmitted the fixing order and favor the financial institution that has managed it. This is highlighted as deprecated behavior in Principle 10.

Principle 17 is entirely focused on the 'last look' right that market participants enjoy, allowing acceptance or rejection of execution requests received against their own quotes. Although this practice is not exclusive to FX, it is of primary importance in scenarios where trading takes place almost exclusively in B2C mode and, therefore, makes extensive use of Request for Quotes. The Global Code, therefore, details how to use 'last look', so that clients are not disadvantaged.

Having looked at the abuse scenarios described by the Global Code, with particular attention to those "specific" to the FX world, we now focus on a possible approach to the development of a trade surveillance tool for this asset class and on what we believe are the critical issues for this task.

First, as Principle 12 lists among deprecated behaviors some of the cases already codified by MAR (it explicitly mentions, for example, wash trades and spoofing), it seems natural to consider using the controls which most financial institutions adopted to comply with the MAR, for monitoring FX as well (in particular FX spot).

In our opinion, this approach wins, because using an existing tool enables institutions to save money and leverage on a robust and well-known solution. At the same time, this approach must deal with the specific characteristics of FX.

As described above, there are some scenarios and cases that are not currently codified by MAR, such as manipulation of fixing or incorrect use of the last look. The first step would be to add new ad-hoc controls to cover these new cases.

A concept that must be taken into consideration with regard to monitoring both new cases and more "classic" ones is the very strong interconnection and liquidity of FX market. This consequentially leads to the need for cross-venue monitoring, which considers both the operations carried out on platforms and OTC because, although acting on different systems, it is actually the same market.

However, in our opinion, the most significant and challenging issue for FX spot monitoring is the absence of an aggregate reference market for prices and traded volumes. These data are really important for market abuse

monitoring as they make it possible to assess the impact on the market of the trading activity analyzed. Finding a solution to this problem is certainly one of the most critical and interesting challenges to be faced in the process of developing a trade surveillance system for FX.

Finally, given the growing importance of FX trading and the consequent attention of the Authorities (European and non-European) towards this still little regulated asset class, , we believe it is critical to start focusing on the FX Global Code and on what can be the optimal strategy to effectively implement surveillance on FX.

References and Notes

[1] BIS Quarterly Review, December 2019

[2] FX execution algorithms and market functioning, BIS Market Committee report, October 2020

[3] MAR Regulation

[4] FX Global Code

[5] MAR Review report

[6] WM/Reuters FX Benchmark Statement