Moving towards greater transparency: A review of the changes to the FX Global Code

As FX markets evolve, the guidelines governing it have to keep pace to ensure fair and transparent markets. How will the recent changes to the FX Global Code impact workflows for market participants? Vivek Shankar investigates.


Vivek Shankar

FX markets have always differed from their financial cousins. A large network of dealers, central banks, and private institutions come together to execute transactions in what is essentially an OTC market. Naturally, transparency and client focus has always been paramount.

The Global Foreign Exchange Committee (GFXC) brings together all of these actors together to create an open and transparent market that benefits all market participants. The GFXC's FX Global Code is the industry's benchmark concerning best practices and guidelines that promote the effective functioning of the wholesale FX market.

Given the rapid changes that the market has undergone in recent years, the GFXC identified 5 focus areas and began an extensive process of consultation with market participants. Dr. Guy Debelle, Chair GFXC and Deputy Governor of the Reserve Bank of Australia, says "The primary response of market participants was that the Code remained fit for purpose and changes should only be made as necessary. The strong guidance was that changes to the Code should be contained to a few areas."

The result is an updated FX Global Code that preserves the integrity of the market. Here are the areas of concern identified by the GFXC and the changes to the Code that address them.

PLATFORM DATA POLICIES

Anonymous trading activity and multi-dealer FX trading volumes have risen tremendously over the past decade. Anonymous trades in an order book are connected to customers using tags (unique identifiers) with the tag maps known only to the platform. While this prevents information leakage, there are negative ramifications to market transparency as it relates to data usage.

In a bid to address this issue, the GFXC has encouraged anonymous trading platforms to make the Code signatory status of its users publicly available.

In addition, the Code has been revised to promote greater disclosure concerning the management of tags by anonymous platforms.

"The prior version of the Code did not make any reference to tags or tag-related policies," Debelle explains. "Given the relevance of tags and the various ways in which they are managed by semi-anonymous platforms – such as who receives them, how/when they're presented, and to what extent re-tagging occurs – we wanted to make sure that the topic was sufficiently addressed in the updated version of the Code."

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Platforms are now encouraged to disclose what counterparty information is provided, and to whom this information is sent. In addition, users must also be given information about when tags are shared in a transaction.

Disclosure documents outlining tag management policies along with clear audit trails must be present. Specifically, re-tagging should not be used to facilitate trading amongst participants when one party wishes to avoid facing another.

Multi-dealer FX trading platforms should disclose their market data policies, including providing information about the user types data is provided to, the frequency, and latency. Credit limit control mechanisms should also be disclosed to prevent a fallout from an anonymous market participant defaulting.

SETTLEMENT RISK

Mitigating the risks of FX settlement was high on the GFXC's agenda, and the result is a strengthening of the Code concerning guidance on settlement risk. Specifically, the new language places greater emphasis on payment-versus-payment (PVP) settlement mechanisms, when available.

In cases where PVP isn't used, the Code details settlement risk management guidelines. "The revised text in the Code provides guidance on the appropriate measurement of principal risk," says Debelle, "emphasising that risk arises from the time when a payment instruction on the sold currency can no longer be cancelled, and that the receipt of funds should not be recognised until it is confirmed during the reconciliation process." The Code also clarifies that principal risk should be controlled with

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counterparty limits in the same way as other counterparty credit exposures of similar size.

Often, a counterparty's settlement method prevents a participant from reducing their settlement risk. In such situations, the Code recommends decreasing exposure to that counterparty or creating incentives for the counterparty to modify its settlement methods.

To discourage the practice of "strategic fails", the Code has been updated to warn participants of the broader effects of a default on the market ecosystem, which include liquidity dislocations and disruptions in payments.

ALGORITHMIC TRADING

Algorithmic trading is highly prevalent in the FX market and the GFXC has outlined a raft of measures aimed at increasing disclosures in this area. These changes aim to provide clients with an easier understanding of the services being offered. Clients can compare services across providers in a standardized format, which makes selecting a provider easier.

To this end, the GFXC will publish an Algo Due Diligence Template that participants can use to disclose details of their services. Conflicts of interest that impact order handling are of especial interest in these disclosures. Any conflict that arises from interaction with a service provider's liquidity or commercial interests in other trading ventures must be disclosed, along with detailing how such conflicts will be handled.

Neill Penney, Co-Vice Chair at the GFXC, Managing Director and Co-Head of Trading at Refinitiv, believes these changes to the Code are essential. "Clear disclosures are an essential part of good conduct in the FX market. The new guidelines across disclosure will help ensure market participants using algorithmic orders understand how these products work and can make informed decisions about how to apply them in their trading strategies."

Some algorithms have access to the service provider's liquidity feeds. Penney believes the new disclosure recommendations are particularly relevant in these cases. "Some clients will want to keep a strict separation between provision of the algo service and provision of liquidity to fill the algo, while other clients will be happy to have the algo service operator include its own liquidity when this can result in better quality execution for the client and is done with appropriate controls."

The Code recommends these disclosures be made easily available on the service provider's website or shared with clients bilaterally. Transaction costs are also covered by these disclosure templates. The GFXC believes that standardizing data reporting in the industry will

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enable clients to better analyze their execution costs.

The Transaction Cost Analysis (TCA) Data template that will soon be published will help service providers offer their clients a more organized view of cost data and eliminate the current high barriers of conducting thorough TCA.

DISCLOSURE TEMPLATES

The GFXC has created 3 templates in all to help propagate greater transparency in the markets. The Disclosure Cover Sheet, Algo Due Diligence Template, and TCA Data Template aim to increase accessibility in the markets and provide clients with standardized information they can use to make better decisions.

Market participants receive a large amount of information these days. It can be tough to categorize and analyze the disclosure data given to them. To this end, the Disclosure Cover Sheet templates that LPs and FX E-Trading platforms can use to provide their clients with a variety of information.

Standardizing information disclosures in this way helps market participants better understand the parties with whom they interact. Emphasis has also been added by the GFXC about trade rejection information.

Penney believes the introduction of these templates is "the biggest single benefit from the Code Review for the buy-side." The lack of "standardization in disclosures has meant it is still difficult for buy-side participants to extract key information from them and compare across their multiple liquidity providers," he explains. "Disclosure templates solve both these problems."

Market participants are now encouraged to explain to clients the basis on which their trades might be rejected and maintain a trail of records documenting these reasons. Prime brokers, for instance, must disclose to clients how their credit limits are monitored and their processes for managing limit breaches.

PRE-HEDGING AND LAST LOOK GUIDANCE PAPERS

The GFXC's principles provide guidance to market participants regarding the practice of pre-hedging and the last look period. Following a review, the demand for clarity on the use of these practices resulted in the GFXC deciding to publish 2 guidance papers.

Neill Penney

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These papers are meant to accompany the Code and illustrate its application. They don't replace the Code in any way. The Pre-Hedging guidance paper illustrates circumstances that justify the use of this practice and the disclosures that market participants need to make. It aims to provide guidance on Principle 11 of the Code.

The GFXC's Debelle believes liquidity providers and consumers alike stand to benefit from the paper. "Liquidity providers can use the guidance set out in the paper to evaluate their Pre-Hedging activity, including whether they feel that they have the appropriate controls and disclosures around Pre-Hedging", he says, and "liquidity consumers can use the paper to help guide the way they approach the market for their liquidity needs."

Pre-hedging is defined as any trading activity that takes place when the client requests a firm quote from the LP and before they accept or reject the quote. Any trading activity after acceptance of the quote constitutes hedging and as such, Principle 11 doesn't apply to these activities.

As a rule of thumb, the GFXC specifies that all Pre-Hedging activities must be executed to benefit the client. LPs must first consider whether Pre-Hedging is a valid choice given the size of the RFQ relative to risk limits, prevailing market liquidity, and normal market liquidity levels.

The paper also highlights the importance of market participants understanding the impact of Pre-Hedging on clients and the broader market. For instance, the paper illustrates a scenario where a large RFQ from a liquidity consumer during an illiquid period can cause unintended disruption.

As Penney explains, "The most important use-case for Pre-Hedging is in the execution of orders whose size is significant relative to the amount of liquidity available for that currency pair in the market at the time. These orders can significantly impact market pricing if not executed carefully."

Stop and limit orders are gray areas since their execution is anticipated, but they depend on a trigger being hit. The guidance paper cautions LPs against taking any action that might result in activating these triggers and adversely affecting client positions. In addition, LPs should monitor for any potential conflicts of interest from trading around stop and limit order triggers, and establish clear guidelines and surveillance of their execution.

Helpfully, the GFXC illustrates a variety of order scenarios in the guidance paper to help LPs understand their obligations and pre-hedging actions within the context of the Code. "Pre-hedging can be a useful technique that benefits the client in multiple ways," says Penney. "There are other techniques that may also be appropriate for the execution of large orders, and the guidance paper highlights several of these."

The guidance paper covering the last look period has just been published and we will be talking about it in the October 2021 edition of this magazine

A POSITIVE STEP

The GFXC has encouraged market participants to renew their Statements of Commitment to the Code and signal their intent to create a more transparent market. There's no doubt that certain sections of the market will be more affected than others.

The GFXC envisages a 12-month timeframe within which all market participants will signal their adherence to the new Code and adopt the standardized templates in their processes. "We all have a strong common purpose in ensuring that the FX market continues to operate effectively and with integrity" says Debelle. "The Code will continue to serve its important role of setting the standard for good practice."