The New Change FX Response to the Fair and Effective Markets Review's Consultation Paper

We have chosen to respond only to points 8, 9, 21 and 22.

NCFX is an independently owned Foreign Exchange Consultancy and IT business. NCFX produces live, independent, non-tradeable reference prices for 76 currency pairs in the spot FX markets. We supply data and services to pension funds in the UK and elsewhere and are keen to help asset owners to understand their FX costs on a trade-by-trade basis. Banks in FX often benefit from information asymmetry at the expense of their clients. NCFX aims to correct that asymmetry.

In foreign exchange:

8. **Are there risks associated with internalisation and last look practices? Are there barriers preventing increased pre and post-trade transparency in foreign exchange markets?**

Internalisation

Internalisation allows a market maker to fill client orders without the need to cross the spread. Client orders are matched against opposing client orders, or against the market makers' own trading book. Instead of fulfilling a risk transfer function of a market maker, systematic internalisers fulfil a function that is closer to that of an exchange or dark pool. This raises concerns about transparency, particularly with respect to the basis upon which client orders are filled.

It is entirely possible that internalisation could be performed in a way that simply narrows the spread for the clients, offering a clear benefit. We do not believe, however, that this is the case in many such liquidity pools. More often, client orders are being utilised for their information value by the pool operators at the expense of the clients. It is in the nature of FX market-making that as risk is transferred from one party to another, so the interest of the parties changes. The pool operator is immediately interested in the market moving against the client's interest, and as a price-maker is able to profit from this. Having prior knowledge of the client's interest means that the pool operator can adjust prices and line up opposing interest on a client-by-client basis with impunity.

Ensuring that all pool operators are obliged to reference **an independent price stream** that is not related to its own pool, or any other liquidity pool (they all tend to be linked) would enable clients to understand the cost of their risk transfer via the dark pool.

Last Look

The abuse of 'Last Look' practises by certain market participants is clearly a detriment to certain clients. The aggregation of all forms of FX interest into platforms in pursuit of the Holy Grail of 'flow business' means that completely benign interests are forced to compete with highly toxic interests. Last Look was introduced to protect market makers from toxic clients, but it has subsequently been abused by certain participants.

Abuse of last look takes the form of making a price, waiting to identify the client's interest (buy or sell) and then holding the price for a period over which the client's interest will only be honoured should the market move in the price maker's interest, or if the price maker can effect a covering transaction. This would never happen historically simply because it would be obvious to the client what was going on, and they would move their business elsewhere. The issue now is that speed of price making and client response is now measured in microseconds. Clients might indicate their interest, and then get a response 500 milliseconds later. If one

takes on board the fact that one microsecond is to one second as one second is to more than 11 days, and that systems can now match interests in a matter of microseconds, then this is akin to a 'phone situation where the client says 'sell' and the bank only confirms the trade 9 hours later.

The proof of how a bank is using Last Look lies in the fill ratios and market share. Banks use last look to make aggressive prices (tighter prices), knowing that with last look, they only have to honour the 'good' ones from their point of view. This tight pricing leads to them being hit more often, and a greater market share, but at the same time they will have a low (perhaps only 50%) fill ratio.

Last Look cannot be banned, as it must exist to provide banks with the ability to differentiate between clients. It should not, however, be used against the client's interest. The publication of fill ratios would allow clients to see which banks honour their prices, and are real market makers, and which banks simply use last look to dupe the market and achieve riskless manipulation of pricing.

Pre and Post Trade Transparency

The FX industry strives very hard to ensure that benchmarking of its activities remains obscure. Reference prices are currently (aside from the truly independent NCFX Mid-Rates) manipulable by price makers, stemming as they do from trading platforms (Bloomberg, Reuters, etc.) or from banks themselves. It is a very simple thing to adjust the price in such a reference rate, and by doing so, reduce the pre and post trade transparency being achieved by the client.

At NCFX we believe that a live rate, calculated at arms length from the traded market, but accurately reflecting the mid-rate of the market offers clients a truly objective way of removing information asymmetry. An independent rate means that each transaction can be measured and the cost of credit, liquidity and market conditions can be easily calculated. Doing this enables customers to select their counterparties based on a complete assessment of pricing, and the overall relationship with a supplier. At present the absence of any truly independent pricing is a major hurdle to objective understanding of trading costs, and ensures that clients are continually at an information disadvantage.

NCFX propose that every spot transaction should have an independent reference price recorded on the ticket at the time of execution in order to ensure that the price maker can be properly held to account by the price taker.

9. Are there barriers impeding the development of more comprehensive netting and execution facilities for transacting foreign exchange fix orders?

Mainly the reluctance of banks to support such facilities.

It is not clear that prime brokerage services would be available to platforms where there is no ability for the bank to make prices. The clearing service should of course be a separate question from any other service offered by the bank, but of course the value of making rates to clients by far outweighs the income from clearing client transactions. We have spoken to many clients who would love to remove their interest from the market as far as possible and match off with one another before taking any residual interest to market. It is clear that many such platforms where mid-rate matching is facilitated could exist, but that the banks are reluctant to participate.

Benchmarks

21. Do current domestic and international initiatives by industry and regulators to improve the robustness of benchmarks go far enough, or are further measures required?

With regard to FX, certainly not.

The market continues to adhere to very poor benchmarks, invented long before the high-speed technology of today. They fail to represent the FX markets, they provide a strong incentive for banks to manipulate them and they continue to hide implicit costs while disguising from clients the extent to which their money is being wasted by asset managers. The construction methodology reflects credit issues and quality rather than FX, and as the benchmarks include traded prices, the benchmarks are delivered 'cold' or after the time they are attempting to reflect. In FX this is completely unnecessary, as a live credit neutral rate already exists.

We strongly recommend that reference prices in FX:

- Be independent of any single platform or trading venue. The reference tape should not be manipulable simply by expressing an interest into a single trading venue.
- Must not be contributed to directly by banks. No bank should be able to move the rate either intentionally or unintentionally.
- Should not reflect completed deals as these are entirely bespoke deal rates arrived at for each individual client.
- Should not reflect credit – the pricing of the market through bank systems and algorithmic trading engines depends on the price in 1 million of the base currency (GBP, AUD, EUR, USD, etc.) and so the fact that a price in 5 million is different should not be reflected in the reference rate.
- Must be 'Live' – calculation at a rate of 20 reference points a second should be the bare minimum standard.

Industry-level measures

22. What steps could be taken to reduce the reliance of asset managers and other investors on benchmarks?

In foreign exchange it would be helpful if the regulator could acknowledge that live and independent solutions to price referencing exist. The asset manager's reliance on a live FX benchmark is not an issue whereas their reliance on a very low-quality benchmark (WM/Reuters) is a very big problem. We do not believe that they should stop using benchmarks, but rather they should use one that does what they need it to do.

We do see a role for professional investors in helping formulate products and benchmarks that have good outcomes for end clients. Index providers have a responsibility to construct products that do not impose unnecessary costs on investors. An index that uses a point in time fix for foreign exchange valuation will force passive managers to concentrate their FX flow around the fix, resulting in increased market impact. Increased market impact has a cost, one that is always borne by end clients.

Please contact Andrew Woolmer on **andrew.woolmer@newchangefx.com** or on 020 3745 5221.