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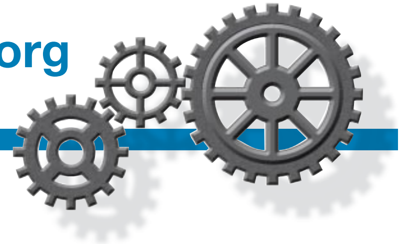

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FXPA "Focus on Last Look"

Policymakers and market participants continue to review "Last Look" and its role in the changing global financial market landscape.

Indeed, the practice has been receiving careful consideration by state and federal regulators in the United States and regulators in the United Kingdom. For example, the UK's Fair and Effective Markets Review (FEMR) calls for, at a minimum, clearer standards regarding the practice.

This FXPA "Focus on Last Look" will explain the origins and evolution of the practice, with a focus on its role in global currency markets. This report will also help address the various perspectives on the benefits and detriments of the practice.

Overview

As described in the Foreign Exchange Professionals Association's (FXPA) "The Modern Foreign Exchange Market,"[1] over-the-counter FX trading activity generally takes place bilaterally, meaning that two counterparties trade at an agreed rate quoted by the market maker. Trades can take place between two market makers[2] (interdealer); between market makers and customers (over multi-contributor or single-dealer platforms); and, on certain trading platforms or venues, between two customers.

The term 'last look' describes the practice in which a market maker provides a price quote to a client or marketplace, but, after a client attempts to execute a trade, the market maker may review and reject the rate provided (i.e., take a "last look").

Last look started as a risk mitigation tool for market makers to protect against a number of potential issues in a predominantly voice-based trading regime. With an increasing reliance on electronic trading, last look has remained valuable to certain market makers conducting global currency activity simultaneously across jurisdictions and trading venues.

Just like today, historically, market makers sought to protect themselves against market fluctuations and the limitations of their technology. In addition, they needed to address and protect against issues such as credit risk (making sure a client had available credit to trade), latency (delays in streaming and receiving information from multiple trading venues and in different locations), and general financial risk management.

With the increased use of electronic trading, some market makers asserted they faced the risk of honoring a quoted price that was traded against by multiple customers on multiple platforms in rapid succession, without having enough time to react to each development and update its quoted prices. Last look allowed them to review each trade prior to execution to determine whether the activity was based on the most recent market and credit data.

Although trading and risk management technology has greatly improved since the advent of electronic market making, there are participants on both the "sell" and "buy" sides that believe the practice of last look continues to serve an important function. With issues such as credit and latency still factors, these participants believe the practice enables market makers to quote more competitive prices than would otherwise be prudently possible from a risk perspective. Conversely, other participants believe last look may be used as a profit maximizing strategy by market makers, which is different than its original purpose.

[1] http://fxpa.org/wp-content/uploads/2015/09/fxpa-overview-7-15.pdf

[2] This paper refers to "market maker" to include both bank and non-bank liquidity providers. While, historically, banks primarily served as FX market liquidity providers, the FX market has seen an increase in non-bank liquidity providers.

The Last Look Debate

– Does Last Look Facilitate a More Competitive FX Market?

The last look debate includes a wide range of thoughts and opinions, generally framed by the market participant's role and experience offering or trading with last look functionality.

As described below, there are compelling commercial arguments for both positions. This paper sets out those positions in greater detail, but can be generally related to the following issues:

Firm Prices vs Indicative Prices

- Last look opponents claim that market participants relying on these non-firm prices may not be able to fully quantify the tradeoffs compared to trading on firm prices.

- Last look supporters recognize that last look provides market makers with optionality, but assert that last look affords them protections needed for liquidity formation to spur price discovery.

Market Liquidity

- Last look supporters argue that the practice fosters more liquidity and encourages market makers to provide competitive prices to FX market participants, stimulating market activity. Without last look, market makers may not offer prices on multiple venues in multiple jurisdictions, particularly during times of market volatility.

- Last look opponents believe that the posting of bids and offers that can be rejected risks creating the incentive for market makers to price as competitively as possible in order to be the best displayed price in the market, leading to rejections and, thus, only provides the appearance of liquidity.

Abuse and Manipulation

- Last look opponents point to opportunities for market makers to see client intentions without honoring prices, which could lead to information advantages, as well as "information leakage" about market participant trading intentions. Furthermore, "asymmetric" application of last look by market makers allows the rejection of only those trades that are unfavorable for a market maker.

- Last look supporters argue that with adequate disclosure and sufficient safeguards, last look can be used effectively without the risk of abuse or manipulation. Market participants can gauge how last look impacts their trading performance by analyzing rejection rate data and comparing how long different last look venues allow for market makers to reject trades.

Latency Risk

- Last look is necessary, supporters say, to protect against latency risk for the transmission of real-time information across time zones and jurisdictions, as well as among multiple trading venues.

- Last look is outdated, critics say, because of the 'electronified' nature of trading and the ongoing evolution of technology. The original justification for last look no longer exists and no other similarly liquid financial market, like equity or futures markets, supports last look functionality.

The Case for Last Look

Supporters of last look argue that it adds to the liquidity in the market, as market makers are more likely to provide tighter bids and offers. At the same time, clients have a choice to use platforms that provide last look functionality or solely transact on platforms that offer only firm liquidity.

To understand why some believe last look adds to the liquidity in the market, it's worth looking at the underlying market structure of the global FX market. Each day, an estimated $5.3 trillion trades in the currency markets around the world. Trading is conducted globally, nearly 24 hours a day, through most of the calendar week. The participants are global in nature with most of the activity taking place in overlapping time zones across four jurisdictions: UK, US, Singapore and Japan.

Having such a wide dispersion in the geography of market participants and trading platforms inherently introduces latency into the market as information is shared around the globe. For example, a market maker based in London could face round trip latency times of nearly three times as long to Tokyo as it does to New York. The distance information must travel takes time, and for electronically traded currencies, this time can impact constantly changing prices. The unique FX market structure varies from other highly liquid markets like futures markets (generally concentrated around centralized exchanges) and equity markets (generally jurisdiction-focused by listed products).

The potential risks associated with price latency in global currency markets can directly impact a market maker attempting to provide real-time quotes to different markets around the world at the same time. The data the market maker is using to construct its price may be stale and may be traded upon multiple trading platforms on a resulting stale price. This issue is particularly acute in times of market stress when prices can change drastically in a short period of time.

Proponents of last look argue that, without the ability to use last look for risk management purposes, they would be required to make markets to fewer platforms, in smaller sizes and with wider spreads. Simply, market makers would have to reduce the price exposure risk they are willing to take on. The result would be less liquidity, and less competitive pricing in the market for participants seeking to hedge currency risk.

Of course, no one is required to use last look. The FX market has a number of different trading platforms available to clients. Some offer last look liquidity and provide some form of disclosure. Some specifically disallow it and offer firm liquidity only. Some allow a client to opt in or out of last look if desired. Those platforms that do offer last look often have policies pertaining to maximum reject rates, response times and other factors[4].

Proponents of last look point to the fact that platforms offering the feature exist with robust client bases. If it were the case that the participants thought last look was bad for market structure, clients would naturally select firm liquidity-only platforms. However, the market supports both models and participants have the ability to rely on or avoid last look.

The Case Against Last Look

Critics of last look argue that it creates negative incentives for the market maker and claim that the practice is no longer needed. Furthermore, given the highly liquid and electronified nature of FX markets, some believe the practice should be abandoned and point to other similarly liquid markets (such as equities and futures), which do not rely on the practice.

By its nature, last look allows a market maker the ability to see client activity (or intentions to act) before deciding whether to accept a trade. This raises the possibility that a market maker could use the practice for profit maximization rather than risk management. At the same time, posted bids and offers, rather than being "firm," really can be described as "indicative," because the market maker might opt out of the trade through last look. By giving the market maker another opportunity to decide whether to trade, last look risks creating the incentive for market makers to focus on pricing in order to be the best displayed price. This could lead to market makers rejecting client requests often, giving the false appearance of liquidity. In addition, without adequate disclosure about the market maker's last look protocol or the particular trading platform's rules, if any, market participants may not fully understand the value of the "tradeoff" (as discussed below) that they are making in using last look liquidity.

There remain instances where last look could possibly be abused, but difficult to detect. For example, a last look market maker could check, post-client acceptance, whether the proposed trade is still profitable and, if not, then reject the price. The concern is that a market maker would not exercise the same last look practice for a trade that has moved in the client's favor (deny the trade and allow the client to trade on a better price now available). This asymmetry in application is another reason some believe the practice can be used unfairly.

Secondly, a market maker, assuming there is information in the trade, could decide to over-hedge the trade prior to acceptance, effectively front running the client trade. Finally, a market maker, believing there is information in the client's intention to trade, could deny the trade, but still act on the information. In these instances, a client may notice a higher than expected reject ratio and may have cause to question the platform (or market maker). For example, a client may only notice that the market always seems to move away from him as he trades, requiring the participant to find an alternate counterparty, which may result in a less attractive price. Either way, the market maker gains information about the client's trading intentions that could result (intentionally or inadvertently) in trading strategies being revealed.

In addition to these negative incentives, critics argue that the practice is now outdated and therefore unnecessary. They argue that technology has progressed to a point in which market makers, particularly banks, have reached an equal level of proficiency as the rest of the market. Risk management techniques have also progressed such that the original intent of last look is now moot, they say. Simply put, the risks last look were designed to address no longer exist. Critics point to the many industry platforms that don't offer last look and are successful nonetheless, suggesting that the market has shown it's no longer a necessity.

[4] 'Reject rate' refers to how often a market maker rejects a rate that a client wanted to accept. 'Response time' refers to how long a market maker can wait before confirming that the trade is executed.

Moving Forward

As we've seen, there are substantive arguments on both sides of this issue. Whether market participants believe in the efficacy of last look or not, there are emerging industry conversations around how platforms that offer last look should approach its use. For example, participants are discussing how trading platforms should disclose their use of last look, its customization for customers, and how clients can analyze the use of last look for their prospective trading activity. As we noted above, there are also emerging practices among trading platforms that offer last look, including the introduction of required metrics related to acceptable reject rates, acceptance times and other pertinent factors.

Policymakers continue to delve into the intricacies of last look. In June 2015, the UK's Fair and Effective Markets Review (FEMR), established by the Chancellor of the Exchequer and Governor of the Bank of England, published its Final Report, which sets out 21 recommendations to help restore trust in the wholesale Fixed Income, Currency and Commodity markets. Among the points that the FEMR makes, it concludes that "attention should be given to improving the controls and transparency around FX market practices where there may be scope for misconduct, including 'last look' and time stamping."[5] Relying on these recommendations, the Bank for International Settlements (BIS) has established a new Foreign Exchange Working Group to create the first global code of conduct standards and principles in the FX marketplace.[6] The group targets completion of its principles-based, single global code of conduct standards and principles by May 2017.

In the United States, the New York Department of Financial Services recently levied a substantial monetary fine against a market maker for certain of its last look practices.[7] According to media reports, the Department of Justice, Securities and Exchange Commission, and Commodity Futures Trading Commission, are all engaged in similar investigations and proceedings, though nothing has been announced publicly.

Legislators and regulators need to understand the complicated factors surrounding last look, which vary depending on the market participant, its trading strategy, and its goals for accessing global currency markets. To be sure, this issue requires a comprehensive understanding and a thoughtful consideration of the intended and unintended consequences of any regulatory action. Similarly, given the cross-border components involved in last look, initiatives on this topic are best framed as multilateral discussions that coordinate activity among multiple jurisdictions.

[5] FEMR Final Report at 57 (4b).

[6] Bank for International Settlements, Working Group to strengthen code of conduct standards and principles in foreign exchange markets has commenced work, July 24, 2015, *available at* http://www.bis.org/press/p150724.htm.

[7] NYDFS Announces Barclays to Pay Additional $150 Million Penalty, Terminate Employee for Automated, Electronic Foreign Exchange Trading Misconduct, *available at* http://www.dfs.ny.gov/about/press/pr1511181.htm.

About FXPA

The Foreign Exchange Professionals Association (FXPA) is a Washington, DC-based organization that represents the collective interests of professional foreign exchange industry participants to advance a sound, liquid, transparent and competitive global currency market to policymakers and the marketplace through education, research and advocacy.

The FXPA officially launched on September 25, 2014. The group is focusing its activities on educating U.S. and international legislators, regulators and central banks, the news media, and the general public, as well as coordinating with multinational organizations and trade bodies.

**The Foreign Exchange Professionals Association "Focus on Last Look" does not represent the specific individual opinion of one particular member.*