30th January 2015

Record Currency Management Limited response to the Fair and Effective Markets Review consultation document

Record Currency Management Limited (Record) is a leading independent currency management firm, managing client exposures of $52.7 billion as of 31st December 2014, for institutional investor clients in the UK, continental Europe, North America and Asia. The principle activities undertaken by Record are passive and dynamic currency hedging services for pension funds and other institutional investors (i.e. services which seek to reduce the currency risk associated with international equity and fixed income investing) and currency for return products. Record always acts as an agent for its clients, rather than as a principal; hedging services are typically offered through separate accounts, whilst currency for return products are offered as separate accounts or pooled funds.

Overview

As a specialist currency manager whose interests are completely aligned with those of its clients, Record shares the concerns and goals of the Fair and Effective Markets Review (FEMR) in helping uncover any issues related to the fairness and effectiveness of the Fixed Income, Currency and Commodities (FICC) markets. We will limit our response to areas on which we believe we have sufficient expertise to comment meaningfully, bearing in mind the fact that our business is focused primarily on the currency markets.

At the outset, we think it important to recognise that the currency markets as they function presently can serve their users extremely well. The FX spot, forward and non-deliverable forward (NDF) markets, constructed from a series of bilateral relationships with market-making counterparties competing on standard terms, and consequently offering 24/5 pricing, continue to remain highly liquid, with tiny bid-offer spreads relative to all other FICC markets; a fact noted in the FEMR consultation document as well. Attempts at reform must therefore avoid any unintended consequences that may disrupt the already efficient currency markets.

Indeed, it may be the case that the FX market has already begun to see undesirable and unintended consequences of reforms attempted so far. The Swiss National Bank's discontinuance of its defence of the minimum exchange rate of CHF1.20 per Euro announced on 15th January 2015 was followed not only by an immediate and unprecedented exchange rate movement, but also an unprecedented degree of disruption to market functioning. There was effectively no institutional market in Swiss Franc pairs for at least an hour after the announcement, and the market continued to be fragile, with wide transaction spreads and very low liquidity (measured by the size of transactions that could be undertaken without meaningful market impact) for several days afterwards.

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This was of course an almost wholly-unforeseen event of fundamental market significance, so a marked reaction was inevitable. However, it has also been speculated that some of the consequences of recent market reforms may have contributed to making the market less resilient. Specifically higher capital requirements imposed on banks, with therefore less ability to warehouse risk and effectively make markets, may have contributed to a reduction in the market's "shock-absorbers". Similarly the proliferation of trading venues away from traditional bank dealing desks, whilst seeming to increase choice, may prove to offer only phantom or transitory liquidity, less reliable particularly in market crises than longer-established bank liquidity. It has even been speculated that the marked reduction in experienced and senior FX market individuals, as some of those individuals' historic practices have come under scrutiny, could have exacerbated the market disruption.

To be clear, we believe there is no place in the FX market for collusion between market-makers, for market-makers trading against their clients, nor for other market abuses. We are similarly wholly supportive of appropriate and considered regulatory change, but we do ask that any such change starts from a detailed understanding of how the market functions today.

We also think it is important to note who the users of FICC markets are. As these are wholesale markets, the users are typically well-informed market participants with an understanding of the assets and their related derivatives. Secondly, we believe FICC market users should be recognised as counterparties in transactions with market-makers, as opposed to clients. Any attempts at market reform must therefore bear in mind the distinction between retail investors (usually clients) and more informed market participants (usually counterparties). Attempts at safeguarding the interests of users need to be mindful of precisely who those users are.

Potential sources of vulnerability

With regards to the framework set out in Table A in the consultation document, we have commented on the potential sources of vulnerability by addressing them generally as opposed to sorted by possible responses from concerned parties. Our responses focus on potential sources of vulnerability in FX markets in particular.

Market microstructure: Generally, our view is that the market as it is can serve its customers very well, provided that those customers are aware of the nature of their relationship with other market participants, in particular market-makers, and take this relationship into account in dealing with other market participants. While there may be some issues related to specific practices within certain markets (for example "last look" in the electronic streaming spot market; discussed later), these issues need not impact the market functioning as a whole. Further, any responses to these specific concerns ought to bear in mind the nature of the market's users.

Competition and market discipline: Our experience in this regard is that while there does tend to be some concentration of winning trades with a relatively small number of market-makers, there generally tends to be a good set of competitive quotes available for a majority of transactions.

With regards to FX forward contracts, there is counterparty risk embedded in the position and best execution for our clients entails not just a price element but also a particular client's credit risk diversification needs. As a result, we would caution against using trading volumes alone as an indicator of competition and maintain that the level of competition in the market is relatively healthy.

Benchmarks: The existence of benchmarks *per se* is not a source of market vulnerability. The fact that managers (typically not currency specialists) give orders, and banks are allowed to take orders, ex-ante on a benchmark price that is yet to be determined creates an inherent "conflict of function" in the benchmark that may compromise the fairness and effectiveness of the specific benchmark. By permitting banks to accept orders in advance to transact at the fix, a link is introduced between trading at the fix and the fix itself, which inevitably creates an opportunity for the fix rate to be influenced. The benchmark ceases to be an objective, backward looking determination of the prevailing market rate, and instead inevitably reflects the balance of market participants' desires to trade at that rate. We have illustrated this in more detail in our submission to the Financial Stability Board FX Benchmark Group, which can be found at http://www.financialstabilityboard.org/wp-content/uploads/c_140819ac.pdf.

Standards of market practice: We welcome efforts to communicate better clear standards of market practice to firms in general and market-makers in particular. These ought to be visible to the industry and made clear to individual employees as well.

Responsibilities, governance and incentives: We think it is important that not just firms, but the individuals within them take responsibility for their actions. Furthermore, we believe that incentive structures for employees that are not aligned with the interests of the employer or its shareholders have the potential of significantly adding to market risk. However, we recognise that our understanding of the governance and remuneration structures within the sell side and the impact this may have on market effectiveness is fairly limited.

Surveillance and penalties: Effective enforcement of market conduct standards, informed by surveillance of market functioning and imposition of penalties on the source of breaches of conduct, is necessary to ensure the fairness and effectiveness of markets. However, such imposition of enforcement, surveillance and penalties can be no substitute for all market participants, users as well as market-makers, understanding their role in the market, and acting accordingly and with due regard to those whose interests they are ultimately paid to protect.

FX-specific questions

Q8. Are there risks associated with internalisation and last look practices? Are there barriers preventing increased pre and post-trade transparency in foreign exchange markets?

With regards to internalisation, we recognize the concerns related to market transparency and the concentration of risk. That being said, internalisation also accords various benefits to users, in particular narrower bid-offer spreads. More generally, our view is that as long as quotes can

be competitively sourced by all market users in a transparent fashion from multiple market-makers, it is acceptable for there to be some level of concentration of where trades are eventually directed.

Our own experience has shown that in spite of there being some degree of concentration of where trades are sent, we continue to receive competitive quotes from across the market that leads us to believe that there is still a healthy amount of competition amongst market-makers. Finally, the decision of who to trade with is also impacted by our clients' individual preferences owing to the counterparty risk present in a forward FX transaction. As a result, the final destination of where trades are sent rarely paints an accurate picture of the degree of competition in the marketplace.

We are aware of the concerns raised with respect to last look practices and the possibility that these may allow banks to front run client orders. However, our understanding is that these concerns are likely to be limited to "streaming spot" services which account for only a fraction of our FX trading volumes, thus limiting the scope of the potential problem in our case. Importantly, any attempt artificially to limit such practices could actually widen bid-offer spreads and reduce liquidity, should banks become more reluctant to advertise their best price on electronic platforms. Our view is therefore to encourage transparency and provide market users with complete pre and post-trade information that would then enable them to make more informed decisions; weighing up the possible cost of last look practices with the possible narrowing of bid-offer spreads and increased liquidity.

Q9. Are there barriers impeding the development of more comprehensive netting and execution facilities for transacting foreign exchange fix orders?

We welcome individual industry-led initiatives to create independent netting and execution facilities, and believe that such individual initiatives should succeed or fail based purely on how effective and attractive an execution venue they offer. Any such solution would obviously require the co-operation of the index providers and benchmark agencies.

However, we would be highly cautious of the claimed benefits of a global/central utility for order-matching, and see significant risks of unintended consequences. By way of illustration, since not all order flow will be netted, residual trades would still need to be executed in the market. Either these trades bear a market bid-offer spread, in which case different end users would get different rates depending on whether their trades were netted (in itself a random and unfair process), or the cost of these spreads somehow has to be assigned back in part to those whose trades were netted – introducing further complexity.

In addition, this utility may lead to the market moving towards an exchange-traded model, including the need for significant infrastructure investment, variation margin posting etc., and in our view potentially creating more problems than those solved. This runs the risk of being a prime example of compromising the overall effectiveness of the FX market, in order to address a problem which resides in a small corner of it.