8th August 2014

Record Currency Management Limited response to the Financial Stability Board FX Benchmark Group's consultative document regarding Foreign Exchange Benchmarks

Record Currency Management Limited (Record) is a leading independent currency management firm managing $54.1 billion, at 30th June 2014, for institutional investor clients in the UK, continental Europe and North America. The principal 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 agent for its clients, rather than as principal; hedging services are typically offered through separate accounts, whilst currency for return products are offered as separate accounts or pooled funds.

Background

Record welcomes the steps that the FSB's FX Benchmark Group (the Group) has taken to consider the issue of foreign exchange benchmarks. We recognise and appreciate the care and attention that the Group has taken in preparing the interim report, which we regard as well-informed and insightful.

By way of background, as a specialist currency manager, Record has an obligation to achieve best execution for its clients and has no bias towards using WM/Reuters (WMR) or other benchmark rates, only doing so if it better suits our client's objective. Examples of this include Record being mandated to seek to match as closely as possible the performance of an index or other strategy that uses WMR rates, or Record coordinating a change in a hedging program with a change in underlying assets where the underlying asset transaction takes place at a WMR rate. These only represent a small minority of our trading activity, on average less than 5 per cent. We make negligible use of other FX benchmarks.

We therefore consider ourselves expert in the determination of FX best execution and the use of benchmark rates by specialist currency management "buy side" participants, whilst remaining independent from specific interests as to how the benchmarks should be constructed.

We note that the Group has made it clear that its work has been completely independent of the various conduct investigations into allegations of manipulation of FX being undertaken in different jurisdictions and that it does not have access to the evidence that is being considered by the relevant authorities. Similarly we would like to make it clear that we have no connection with or insight into any of these investigations.

Summary views

We see the benefits of a transparent, widely-used and accepted benchmark for use in a wide variety of indices, passive tracker funds, portfolio and custody valuations etc. – both in currency management and more broadly. We think it desirable that there continues to be confidence in the WMR benchmarks and from a practical perspective, it would be useful to continue with the WMR benchmarks so to avoid the costs and administration involved in migrating to a new benchmark source. For this reason, we favour reform over replacement.

However, in principle we believe there to be a fundamental "**conflict of function**" inherent in the use of WMR benchmarks for both *ex ante* trade execution and *ex post* valuation. 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.

The **"purist" solution therefore to addressing the "conflict of function" would be to prohibit banks from accepting orders to be executed at the fixing price in advance of the fix**, requiring instead that trades are executed at known prices given by the banks as per usual market practice.

We note the report's identification of "replicability" of the fix as desirable for users (e.g. pages 21 and 23) as well as the following section on page 25:

> "*One approach would be to seek to prevent dealers from agreeing trades at a yet-to-be-agreed price altogether unless dealers are properly and transparently compensated for the risk. To be effective, an outright ban on fix trading would require legislation or direct regulatory action, which is beyond the scope of this report. And given the current demand for transactions at the fix, it could have unforeseen consequences as asset managers sought alternative ways to reduce their risks. The recommendations in this section of the report are therefore designed to permit such trading activities but to minimise their scope and the potential and incentives for manipulation. This issue may need to be revisited in the light of any future discussions around market regulation.*"

With respect to the concern of the scope of the Group's report, we believe that such a prohibition, were it to gain the backing of the Financial Stability Board and the institutions represented on the FX Benchmark Group, would quickly gain the status of best practice and hence have almost the whole effect of legislation or direct regulatory action.

With respect to the current demand for transactions at the fix, by removing the ability to submit orders to banks in advance, many equity and fixed income asset managers would seek to trade around the 4pm fix anyway. Their inability to ensure transacting precisely at the fix rate will introduce some further "tracking error" in their replication of their underlying index, but this may be seen as a small price to pay to enhance the integrity of the underlying benchmark. Indeed, to our knowledge, although equity and fixed income indices have similarly prescriptive security price sources, no such "transactable benchmark" universally exists in these markets, and managers and clients accept the resultant tracking error from trading close to but not at the price used to construct the index. Furthermore, the move to continuously-priced tracking vehicles such as exchange-traded funds may reduce the market's reliance on transacting once a day, or once a month, and only at the 4pm fix. Overall, **investors may be better-served by experiencing modest tracking error around a benchmark in which they can have confidence, rather than precisely matching a benchmark whose construction may be suspect**.

With respect to the report's focus on permitting such trading activities but minimising their scope and the potential and incentives for manipulation, we would observe that any solution that seeks to make manipulation harder, rather than simply removing the incentive to manipulate, fails to address the "conflict of function". Or put another way, it addresses the symptoms, not the cause.

However, we also recognise that **there are good arguments against such an outright prohibition**. In general, markets function better when informed participants are allowed to undertake arms-length transactions and to bear the risk and reward of such transactions – the outright prohibition of a category of transaction should only be a last resort. Furthermore market participants may have different views on the likely impact of such a move on FX market volatility around the 4pm fix, and on the ability of the market to absorb the consequent transaction volumes without disruption. Finally, it could be argued that transacting at the fix mid-rate is a form of market clearing (albeit somewhat opaque), and thus is an efficient mechanism to absorb large market volumes without disruption.

We recognise that the arguments for and against prohibition of "fix" trading are both cogent. However, we do think that the case for prohibition is at least strong enough to deserve a wider hearing in this debate.

Below we respond to each of those draft recommendations where we feel we can add to the debate. Overall it should be emphasised that the FX market serves its users tremendously well, as a continuous round-the-clock market offering deep liquidity in a wide range of currency pairs, including for very large transactions, and at exceptionally low costs. It is crucial not to compromise the effectiveness of this market in meeting its users' needs, in order to address a problem which resides in a small corner of it.

Further observations on the interim report

As noted above, we consider the interim report to be well-informed and insightful. In one respect though we found its conclusions surprising – namely the analysis and conclusion set out on pages 16 to 21 that "*the large spike in average trading volume at the time of the WMR 4pm London fix is not associated with a correspondingly large spike in average volatility at that time*".

This is at odds with the conclusion of our own research, which does show elevated volatility associated with the key WMR fixings. We believe this difference in conclusion may be driven by the Group's use of daily trading data, and for the period April 2013 to September 2013.

Approximately half of this period precedes the first public allegations of WMR manipulation on 12th June 2013[1] and half follows it, such that this period cannot be said to be representative of market practice prior to any such allegations. Our own analysis of volatility around the 4pm fix, based on a longer data period preceding June 2013 (e.g. May 2010 to May 2013) does show elevated volatility (although not uniquely so within the trading day) as well as a higher probability of extreme price movements immediately around the 4pm fix. More importantly though, by including daily data, the impact of the month-end dates, which are more important for index re-balancing and portfolio management, is diluted. We suspect that an analysis based on a longer time period prior to June 2013, and using only month-end data, would show a greater spike in volatility around the 4pm fix.

In addition, we note that the report focuses on WMR benchmarks, and, to a lesser degree, the ECB reference rates. There is another category of FX benchmarks whose construction merits some attention, namely the "NDF spot fixing rates" used in settling non-deliverable forward (NDF) contracts. Such rates are frequently specific to and set in each local market, with a range of practices governing their determination. More transparency on how these rates are determined would be beneficial to the market.

Responses to draft recommendations

Our responses to the Group's individual draft recommendations are set out below, with those in **boldface** as in the interim report:

1. **The group recommends the fixing window be widened from its current width of one minute. It seeks feedback from market participants as to the appropriate width of the calculation window.**

   Were banks to be prohibited from accepting orders in advance of the fix, we would regard widening the window as a sensible measure to deal with the volume of transaction activity that participants are likely to want to transact in the window, in order to reduce (although not eliminate) tracking error. It is important though not to have an excessively wide window, lest liquidity dampening or one-way order flow squeezing occur. Additionally, unnecessary volatility could be introduced, which is undesirable. In all, extending the window to e.g. five minutes may make it easier for market volume to be accommodated whilst retaining the subsequent benefits of a clear "fix" rate.

[1] http://www.bloomberg.com/news/2013-06-11/traders-said-to-rig-currency-rates-to-profit-off-clients.html

However, if banks are still permitted to accept orders in advance of the fix, widening the window may make manipulation harder but would not address the "conflict of function".

2. **The group seeks feedback from market participants as to whether there is a need for alternative benchmark calculations (such as a volume weighted or time weighted benchmark price) calculated over longer time periods up to and including 24 hours.**

   We believe that alternative benchmark calculations can and should be offered by data providers if there is market participant demand for them, but such demand and widespread adoption should emerge from the market, rather than being centrally co-ordinated.

3. **The group also seeks feedback from market participants as to whether the fixing windows should continue to be centred exactly on the hour (half hour) or whether the fixing window should close or start on the hour. Market participants should consider whether this view changes depending on the size of the window.**

   We do not see the exact timing of the benchmark fix window as a major issue, and in particular see very few issues in practice concerning data releases at 4pm London time (as the interim report acknowledges). More importantly, if banks are still permitted to accept orders in advance of the fix, changing the timing of the window would not address the "conflict of function".

4. The group proposes that WM investigate the feasibility of receiving price feeds and transactions data from a broader range of sources to further increase its coverage of the FX market during the fixing window, and should regularly assess its coverage as market structure continues to evolve. In that regard the group also proposes that in the short term, WM develop its methodology to utilise the transactional and quote information from both Thomson Reuters Matching and EBS, wherever both are available.

   Whilst we believe that WMR data sources need to evolve in line with broader industry trends, and that including more data sources is likely to be beneficial including by making manipulation harder, if banks are still permitted to accept orders in advance of the fix, including more data sources would not address the "conflict of function".

5. The group considers that, where central banks publish reference rates, it is the responsibility of each to set internal procedures. Central banks should at least take note of guidance from the IOSCO principles. However, where central bank reference rates are intended for transaction purposes, the group encourages compliance with the relevant IOSCO principles.

   Record has no comment on this draft recommendation.

6. **The group supports the development of industry-led initiatives to create independent netting and execution facilities. However, it also is interested in seeking feedback from market participants on the development of a global/central utility for order-matching to facilitate fixing orders from any market participants.**

   We welcome individual industry-led initiatives to create independent netting and execution facilities, and believe that such individual initiatives will succeed or fail based purely on how effective and attractive an execution venue they offer.

   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.

7. The group recommends that fixing transactions be priced in a manner that is transparent and is consistent with the risk borne in accepting such transactions. This may occur via applying a bid-offer spread, as is typical in FX transactions, or through a clearly communicated and documented fee structure such as a direct fee or contractually agreed price.

   Allowing banks to continue to accept orders in advance of the fix, and requiring them to be additionally remunerated through a spread or fee, will simply increase the banks' remuneration for such transactions at the expense of their customers, and does nothing to address the "conflict of function". On its own therefore it risks being a retrograde step.

8. The group recommends that banks establish and enforce their internal guidelines and procedures for collecting and executing fixing orders including separate processes for handling such orders.

   Allowing banks to continue to accept orders in advance of the fix although imposing guidelines and procedures for such orders may achieve a procedural solution to mitigate the "conflict of function", but does not wholly abolish it.

9. Market-makers should not share information with each other about their trading positions beyond that necessary for a transaction. This covers both individual trades, and their aggregate positions.

   Whilst we are sympathetic to the objectives of this draft recommendation, we would be concerned that an outright prohibition on market-makers communicating with each other beyond information necessary for a specific transaction would impede their ability to provide market feedback and "colour" to buy-side participants, and hence would be to the ultimate detriment of buy-side participants. This detriment is likely only to be exacerbated in stressed market scenarios, and could well contribute to increased volatility at such times.

10. Market-makers should not pass on private information to clients or other counterparties that might enable those counterparties to anticipate the flows of other clients or counterparties, including around the fix.

    Record fully agrees with this draft recommendation, and believes that it should extend to all associates of market-makers, as well as their clients or other counterparties.

11. **More broadly, the group recommends that banks establish and enforce their internal systems and controls to address potential conflicts of interest arising from managing customer flow.**

    Record also fully agrees with this draft recommendation, and would hope that such systems and controls are already in existence.

12. Codes of conduct that describe best practices for trading foreign exchange should detail more precisely and explicitly the extent to which information sharing between market-makers is or is not allowed. They also should, where appropriate, incorporate specific provisions on the execution of foreign exchange transactions including fixing orders.

    We would be supportive of a code of conduct that strikes the right balance between permitting information sharing between market-makers that allows them better to provide market feedback and "colour" to buy-side participants, without permitting collusion on rate-setting or other manipulation. With respect to benchmark fixing orders, as noted throughout, allowing these to continue will not address the "conflict of function".

13. The group recommends stronger demonstration by market participants of compliance with the codes of the various foreign exchange committees, as well as their internal codes of conduct.

    Provided that the relevant codes of conduct ensure the continued efficient operation of the market, Record would be supportive of this draft recommendation.

14. The group recommends that index providers should review whether the foreign exchange fixes used in their calculation of indexes are fit for purpose.

    Record fully agrees with this draft recommendation.

15. The group recommends that asset managers, including those passively tracking an index, should conduct appropriate due diligence around their foreign exchange execution and be able to demonstrate that to their own clients if requested. Asset managers should also reflect the importance of selecting a reference rate that is consistent with the relevant use of that rate as they conduct such due diligence.

    Record fully agrees with this draft recommendation, and indeed as a specialist currency manager invests considerable resources in ensuring best execution for its clients. To achieve that, there is in our view no substitute for a skilled, independent and experienced trading team assessing liquidity, price discovery and execution venue alternatives for every trade.