FIDERES
USE KNOWLEDGE. TAKE ACTION.

Secretariat to the Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Submitted via email to fsb@bis.org

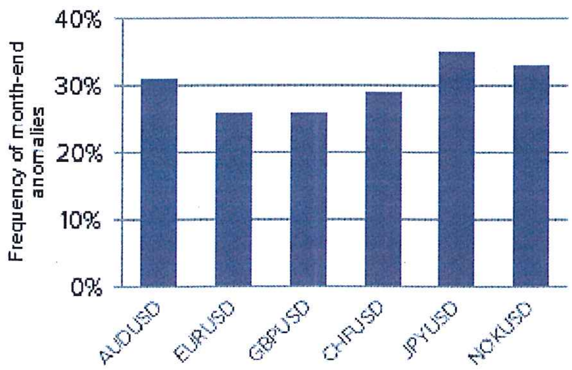
8 August 2014

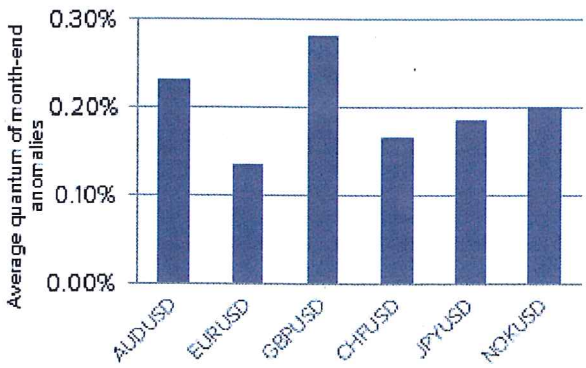
Dear Madam or Sir,

RE: Financial Stability Board consultation paper: "Foreign Exchange Benchmarks"

We are thankful to the Financial Stability Board ("FSB") for their report on Foreign Exchange Benchmarks ("the Consultation"). Fideres appreciates the efforts of the FSB to improve the foreign exchange market's benchmark setting mechanisms and to reduce their vulnerability to potential manipulative and anti-competitive practices. Fideres is a strong advocate of the need for reforms of these benchmark setting processes and believes that the Consultation will significantly contribute to the development of a more transparent and fair market for executing foreign exchange transactions at or close to the level of the benchmark rates.

Analysis performed by Fideres shows that the scope for manipulation may affect FX benchmarks across a number of currencies in a manner which is relatively consistent across the studied currency pairs:





Reducing the vulnerability of foreign exchange benchmarks to manipulative practices may require not only addressing potential flaws in the design of their current methodology, but perhaps more importantly also adopting necessary changes to the execution practices presently followed in delivering execution of foreign exchange transactions at or close to the level of the benchmark rates.

Executive Summary

Fideres recommends that the FSB gives further consideration to the following key points:

- A significant lengthening of the fixing window may create issues that could potentially offset the perceived benefits of such extension. The increased risk imposed on dealers by guaranteeing execution of orders at the official fix, should longer fixing windows be adopted, would likely be passed onto clients in the form of higher transaction costs. As we explain in this document, we believe that an auction mechanism is the optimal means of limiting the risk of manipulation of the FX benchmarks.
- While much of the Consultation's discussion focuses on the alleged manipulative and anti-competitive practices occurring during the fixing window, Fideres believes that it is equally important to consider allegations of similar behaviour occurring during the 15-45 minutes before the fixing window as our studies show that the current fixing process may create front-running opportunities. Fideres' analysis suggests that this behaviour could have a significant impact on the fixing price.
- Any proposals for a move towards a volume weighted average as the means for computing the benchmark price must consider the increased logistical burden of collecting and verifying the relevant information on order volumes.
- The majority of the current issues surrounding key FX benchmarks stem from information asymmetry in favour of the dealers. Fideres believes that a netting and execution facility combined with an auction mechanism for setting the benchmark rate is the optimal means of eradicating this issue.

Responses to Specific Recommendations

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.

With regards to lengthening the duration of the fixing window, it is worth noting that the foreign exchange market is one of the most liquid financial markets and therefore may not require a fixing window of the same duration as some other benchmarks, e.g. market-on-close prices in relation to commodity futures. In other words, regarding the argument of allowing 'greater time to digest the flow of fixing related trades', we believe that the liquidity of the FX market means that the current window length (or a slightly longer window but still in the order of minutes) is already allowing sufficient time for this 'digestion' to take place.

As will be discussed in more detail in our response to the 2nd recommendation, any proposals to lengthen the fixing window should also consider the associated drawbacks. As noted in the Consultation, longer fixing windows would reduce the ability to interpret the benchmark as representative of a single price point in time and would also be more difficult for users to replicate. In fact, the increased difficulty in obtaining (guaranteed) execution at or close to the fixing price would represent a greater risk for the relevant dealers who agree to execute client orders at the fixing price. This increased risk would likely then be passed onto clients in the form of higher bid-offer spreads on fixing orders with the end result being that a reform of the fixing process aimed at improving its integrity and transparency ultimately increases the costs clients are forced to pay to transact at the fix.

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 of up to and including 24 hours.

As touched on in our response to the previous recommendation, the problem with a long window, especially for durations approaching 24 hours, is the difficulty users would face in consistently achieving execution at the fixing price. If, for example, the fixing window is lengthened to 24 hours across which observations are taken at predetermined intervals such as every hour, minute etc., those who would aim to execute close to the level of the fixing would tend to trade their orders in smaller pieces across the window at the same times as the observations are taken. The likely result of such trading activity would be that after the first few observations it may become clear to the market in which direction the net order flow is in respect of the fix. This could in turn lead to front-running in respect of the other observation points. For example, consider the case of a day on which the majority of the asset management community appears to want to sell a particular currency in respect of the fix; by executing their orders in smaller pieces around the observation points, it may be possible for fast money accounts to 'anticipate' the order flow at the next observation point and position themselves accordingly ahead of it. If the observation points are very frequent, e.g. every minute or even every second, orders may be more difficult to front-run by 'manual traders' but could still be exploited by high frequency trading algorithms.

For shorter windows, Fideres is of the opinion that a volume weighted average would be a more representative way of calculating the benchmark fixing price rather than the 'median methodology' currently employed as trade volume is an important factor in price determination. One potential drawback of this methodology is the heightened logistical burden resulting from having to collect and verify the additional volume information from market participants. As such, the costs of these additional system requirements need to be assessed when considering the feasibility of the volume weighted average computation method. In particular, consideration must be given to whether this increased burden will be passed on to clients in the form of higher transaction costs, thereby partially or fully offsetting the intended benefits.

A further issue that needs to be addressed in the choice of calculation methodology is how best to deal with the presence of alternative trading venues in the FX market. For example, for a currency benchmark computed using the volume weighted average of EBS activity, it would be possible for a market participant to influence the benchmark price by executing a large order on EBS and simultaneously offsetting the order with trades on other venues, e.g. Currenex. This issue could potentially be mitigated through the use of cross-platform monitoring or, less burdensomely, by requiring explicit agreements from the dealers not to partake in such activity. In any case, a revised calculation methodology will have to go hand in hand with increased regulatory monitoring and enforcement.

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.

There are two points to address on this matter. Firstly, Fideres is in agreement with the FSB's recommendation that dealers should be aware of the times of important news releases and that clients should be advised to avoid transacting at fixing times susceptible to being impacted by significant market announcements, e.g. GDP data, employment figures, etc. Secondly, Fideres is of the opinion that in order to prevent the release of news during the fixing window, as is the case now with the fixing window centred on the hour (half hour), the window should instead start on the hour. This would allow the entire length of the fixing window to reflect current market conditions, i.e., after the release of economic news or indices, and by doing so provide market participants with significantly more clarity as to the current state of the market. A fixing window that ends on the hour would likely reduce the incentives for market participants to trade at the fix given the lack of clarity of any impending market announcements.

A further alternative could be to move the fixing windows to a later period, e.g. 15 minutes past the hour, which, despite potentially appearing somewhat arbitrary, has the added benefit of occurring at a time when the price impact of any on-the-hour news releases will likely have been fully incorporated into the market. Again, this would provide increased clarity to market participants wanting to trade at the fix.

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.

In Fideres' opinion, this would be a useful development in the market for executing FX orders at benchmark fixings. A similar concept is the Trade-at-Settlement ("TAS") market in commodity futures, whereby TAS orders are executed at the relevant day's settlement price or within some spread above or below the settlement price. The advantage of such netting and execution facilities is that anyone who has access to the platform would have the ability to agree to trade in respect of the fix with other market participants without limiting counterparties specifically to FX dealers, as is now the case.

If the facility is set up as a continuous trading platform, as is the case in the TAS market on commodity exchanges, then the transparency of information to all users is fundamental to the success of the facility. Under this setup, clients would then most likely have to execute orders in a similar way to other exchanges. For example, to avoid the market-moving impact of large orders users may have to place such orders in smaller pieces so as not to reveal their overall order size. Alternatively, if the exchange is set up as a "one-shot" netting auction, users would presumably be expected to submit their orders in one piece, regardless of their size. Of course, given the sensitivity of market prices to these orders, the larger orders in particular, this information would have to be treated carefully and kept confidential before the computation and release of the net order figures for each relevant currency.

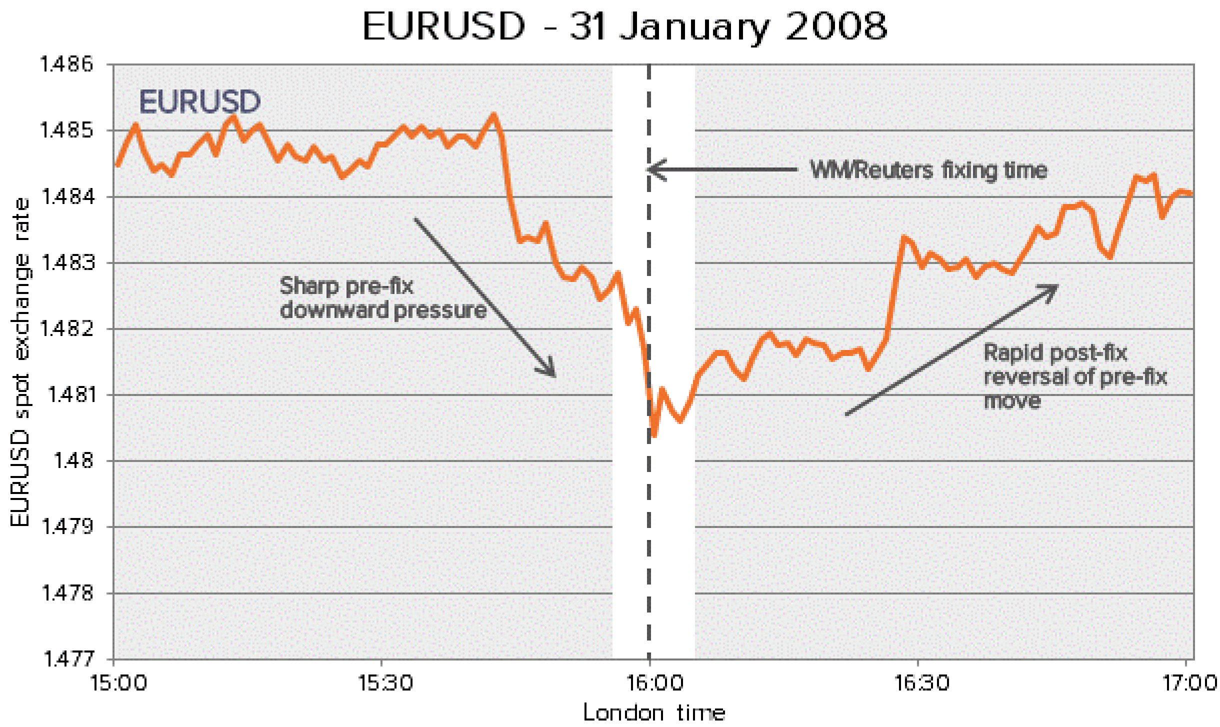
Fideres believes that using an auction system to compute the price that minimises the net order imbalance of orders placed on such a netting facility is potentially the optimal method of computing the fixing price. Despite the increased logistical burden of establishing and maintaining such a facility, this system has the added benefit of not having to place orders with dealers in advance of the fix. This would serve to remove the information advantage currently possessed by the dealers over the rest of the market and in doing so would reduce both the means and motives to engage in any of the alleged manipulative and anti-competitive practices surrounding the fix. As noted in the Consultation, obtaining an independent auctioneer to conduct the auction process would be of paramount importance to the integrity of the process.

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.

From Fideres' viewpoint, enforcing internal systems and controls is naturally always good practice. Key to such enforcement, however, is that one has to be careful that it has a permanent effect and not just a temporary one. While internal systems and controls are often enforced through the mandatory sitting and passing of applicable online examinations, a more explicit way to ensure that all employees are fully aware of the relevant issues is to ask them to also provide explicit affirmations, e.g. affirming that to the best of their knowledge such illicit activity is not occurring and that they have no reasonable suspicion that it may be. Ideally, these affirmations should be enforced retrospectively for current employees and from the outset of employment for new employees. This would make employees consider the issue in greater detail and make such internal controls a more robust deterrent against manipulative or anti-competitive practices.

General Comments

While much of the Consultation has focused on the vulnerability of the benchmark calculation process to manipulative and anti-competitive practices during the fixing window itself, Fideres strongly believes that it is equally important to consider trading activity in the build-up to the window, potentially as much as 30 minutes before the start of the window or in some instances even longer. Based on Fideres' quantitative analysis, it is a frequently observable pattern for exchange rates to move sharply in one direction during the minutes prior to the fixing before reversing to pre-fix levels soon thereafter. An example of this type of behaviour is shown in the following chart.



Source: Thomson Reuters, Fideres' calculations

Given that many participants will place their orders to trade at the fix with dealers well in advance of the fix, these dealers may have an information advantage over the rest of the market in terms of the net order flow to be executed at the fix. Such information advantage may prove to be a strong incentive for some dealers to pre-position or pre-hedge their own position ahead of the fix in order to profit from the impending market moves.

With regards to the Consultation's finding concerning the absence of any significant increase in trading volume prior to the start of the fix, this does not necessarily invalidate the theory outlined in the previous paragraph. Allegedly, upon receiving large orders to execute at the fix, relevant dealers would often place a small amount of the order, e.g. 20%, into the market ahead of time, e.g. 30 minutes ahead of the fix. In the remaining period before the fix they could then attempt to move the market in the direction of the order flow in order to profit from their pre-positioned 20% by reversing the trade at the fix. This pre-fix movement could be achieved by leaking the size of their order books to other dealers and/or by colluding with other dealers to place a high number of small orders to temporarily move the exchange rate in the desired direction. This has allegedly been a commonplace activity in the FX market and would explain the lack of sharp increases in volume in the build-up to the fix. A market move prior to the fix would happen not necessarily in response to the transactions executed before the fix but in anticipation of the large residual volumes waiting to be executed at the fix. If there was indeed a degree of coordination in the market then it would likely be that such activity occurred on days when a consensus was formed that there would be a large imbalance of orders in respect of the fix on that particular day. Of course, such activity is anti-competitive and results in those who place the orders in respect of the fix receiving a significantly less favourable execution than under ‘normal’ market conditions.

For example, if a certain group of dealers had large orders to execute at an upcoming fix the mere prospect of the orders being hedged could already cause the market to move well ahead of the fixing – in particular if some information was leaked ahead of time. If any market participant had this information ahead of the rest of the market they could execute a smaller trade than the full size of their order book and once the information about the impending large orders becomes known throughout the market (either directly or indirectly e.g. by hints or inter-dealer chat rooms) the market may move in the favour of the initial small position. If such behaviour was found it would have to be comprehensively addressed as part of the proposals for reforms of the benchmark setting process.

Concluding Remarks

In summary, Fideres believes that the recommendations offered by the Consultation are a useful step to improving the current state of the foreign exchange market’s benchmark setting process by making it a more transparent, fair and robust methodology and thus improving market participants’ incentives to trade at the benchmark rates.

Please do not hesitate to contact us if you would like to discuss in more detail any of the issues raised in this response.

Yours faithfully,

Petr Luksan, Partner

About Fideres

Fideres is an advisory firm specialised in supporting investors and their legal advisors in protecting their investments and recovering what is rightfully theirs in complex financial disputes. Fideres has extensive experience in analysing the alleged manipulation and anti-competitive practices surrounding a number of financial benchmarks. Specifically, Fideres is retained as expert advisor in various financial benchmark cases involving LIBOR, the London gold fixing, credit default swaps and foreign exchange trading. Fideres is also assisting a number of regulators in their investigations into potential financial benchmark manipulation and has recently given evidence before the U.K. Treasury Select Committee as part of their ongoing investigations into these areas and in particular with respect to the gold market.

For more information, please visit www.fideres.com