

# The road to FX reformation

Restoring trust - a second look at market progress



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**About the report**

This report has been prepared by LMAX Exchange.

The anonymous survey findings documented in this report reflect solely the views reported to LMAX Exchange by the survey participants. LMAX Exchange compiled the data received from the survey respondents and interpreted the data for presentation purposes in order to produce the summary of the results.

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## Foreword

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**David Mercer**  
CEO, LMAX Exchange

Few in the FX industry would now dispute that restoring trust is the biggest challenge we face. The high-profile scandals of recent years have caused reputational damage that requires urgent repair, an imperative which the industry has been working hard to address. In the 12 months since the launch of the Fair and Effective Markets Review (FEMR), a wide range of initiatives have been undertaken to try to rebuild lost trust.

We now have the first tangible results of that work, in the form of the BIS Foreign Exchange Working Group's (FXWG) new Global Code of Conduct, in its first-phase. The 30-page document is full of sound ideas and appropriate sentiments. Indeed, the principles around which it is organised are unarguable.

The problem is, in its present form, the Code is both too narrow in focus and impossible to enforce. Electronic trading, which represents 70% of global FX activity, has not been addressed, while the 'adherence mechanism' to enforce the Code is not promised until next year's second phase.

Given the central importance of restoring trust in FX, it is hard to accept that the industry can afford to wait a further 12 months for the Code to be completed, and quite possibly longer for the terms of its adoption to be agreed. In a continually fluctuating market, that feels like too leisurely a pace and too imprecise a focus. To address the trust and credibility gap that has emerged, market participants need to see action, and they need to see it more quickly.

We believe that action should be focused on measures that can improve transparency in FX. This is one of the clear pain points that has arisen from our surveys of industry sentiment over the last year. That research has shown that an overwhelming majority believe FX needs to become more open and transparent.

### **■ “FX needs to address market practices that are open to abuse”**

Moreover, our new survey has now found that many in the industry believe transparency has not improved despite the ongoing industry initiatives. Nor do many traders feel they can trust market makers to protect their interests and deliver a level playing field.

These are findings that should concern those seeking to reform the FX market. FX can only thrive as the liquid, global and essential market that it should be if it engenders trust among all market

## Foreword

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participants. The evidence of our new research is twofold: the market still has a long way to go before it can claim to have won back trust; and there needs to be a greater focus and urgency on addressing FX market practices that are open to abuse.

### ■ ***“Last look is at the heart of the transparency question in the FX market”***

It is particularly important that the industry moves to combat market practices that are undermining trust in FX. Foremost among these is the use of ‘last look’, which LMAX Exchange has frequently said the market should abolish. Our new survey finds the use of ‘last look’ tops the list of ‘unacceptable’ market practices, while a majority of respondents expressed strong preference to trade without ‘last look’. Yet, ‘last look’, as a market practice, is not due to be addressed until the second phase of the Code of Conduct in a year’s time. Depressingly, those who are shaping the code seem to advocate standardisation of this badly broken and opaque market practice.

The practice of ‘last look’ is at the heart of fairness and transparency in the FX market. At best, it is an anachronism, designed to protect market makers in a way that today’s technology has now made unnecessary. At worst, it feels to some traders like a market practice that fundamentally and unfairly balances trade execution against them. And that perception, reflected in many of the comments we collected as part of our survey, is crucial.

If trust is truly to be restored in the FX market, it is to practices such as ‘last look’ that the collective focus must now turn. The choice is simple: either the market chooses to actively reform itself, or it faces having that reform imposed upon it by regulators, without the luxury of choosing its own terms.

There remains a window of opportunity for FX to move forward as a trusted and transparent market, on the broadly self-regulating basis that is the market’s preference. But it is a narrow window, and another high-profile scandal will likely slam it shut.

### ■ ***“The power to act remains in the hands of the industry, but not forever”***

These are no longer issues which FX can afford to tide over for another day. The power to act remains in the hands of the industry, but it will not do so forever. FX cannot afford to wait another year for a set of guidelines that do nothing to enforce meaningful reform. It must take the opportunity to act, to address market practices that remain open to abuse, and to convince market participants and observers that the promise of fairness and transparency will be delivered upon. In this report, based on the sentiment expressed by FX market participants in our survey, we focus on how that can be most effectively and efficiently achieved.



David Mercer

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E X C H A N G E

## Executive summary: Survey results

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This report details and analyses the views of FX industry participants from across all market segments, collected as part of a survey conducted by LMAX Exchange that set out to:

- Assess current levels of trust in how the FX market operates and any shift in perceptions over the last 12 months
- Gather views on changes required to ensure fair and transparent execution
- Explore market participants' expectations on the future of FX liquidity, execution methods and emerging industry benchmarks

### **Key findings include:**

#### **Trust has not been restored and transparency is yet to improve**

- 65% of respondents said their interests are not sufficiently protected
- 54% said they do not believe they get best execution from their trading venue
- 52% of respondents said transparency has not improved in the last twelve months

#### **The Code of Conduct is welcomed but there are questions over its implementation**

- 76% of respondents said there was a need for a global code of conduct
- 66% of respondents said there could be conflict between a global code and local regulation

#### **'Last look' topped the list of most unacceptable market practices**

- 76% of respondents preferred to trade without 'last look'
- 62% of respondents said 'last look' is the most unacceptable market practice
- 79% of non-bank market participants and 80% of professionals said they would favour the abolition of 'last look', compared to only 33% of bank respondents

#### **Key expected changes in the FX industry**

- 75% believe the share of liquidity provision by non-bank market makers will increase
- 71% expected FX will move to execution-only venues
- 77% of respondents believe FX will move to a more rules-based trading environment

In summary, the findings demonstrate that the market still has a long way to go before it can claim to have become more transparent; and there needs to be a much greater focus and urgency on driving change in execution practices to restore trust in global FX markets.

Anonymous FX market survey

**I. A second look at market progress**



# I. A second look at market progress

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## **Transparency and fairness in FX**

Our previous research indicated a pressing need to improve fairness and transparency in the FX market. The evidence of this new survey is that market participants believe the situation has not changed. A majority of respondents across all segments believe that progress has not been made towards creating a more transparent market.

### **Transparency has not improved in the last 12 months**

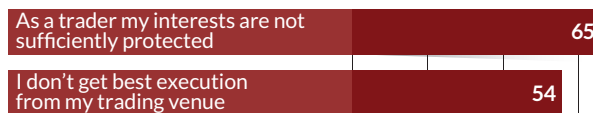
% of respondents agreed



Just as many market participants do not feel transparency has improved, most expressed a lack of trust in execution: a majority of respondents said that their interests are not being sufficiently protected, and that they do not get best execution from their trading venue.

### **Lack of trust in execution**

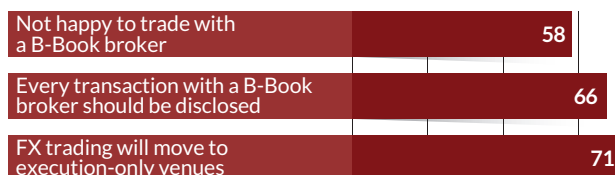
% of respondents agreed



Given the continuing lack of trust in fair FX execution, an overwhelming majority believed that, in the future, FX trading will move away from venues running proprietary capital risk to execution-only venues.

### **Expected growth in execution-only venues**

% of respondents agreed



# I. A second look at market progress

## Impact of regulatory initiatives

Exploring the question of transparency in more detail, our survey asked whether the industry initiatives and working groups that followed from FEMR - including the FMSB and BIS FXWG - have made an impact.

Across all respondent segments, there was a general feeling that they have not, and that the work undertaken in the 12 months following FEMR has not yet succeeded in improving transparency. Moreover, more than half of respondents did not feel sufficiently informed about the scope of work and the results produced to date by the industry groups.

### FEMR has not improved transparency

% of respondents agreed



### Limited visibility of work conducted by FX industry groups

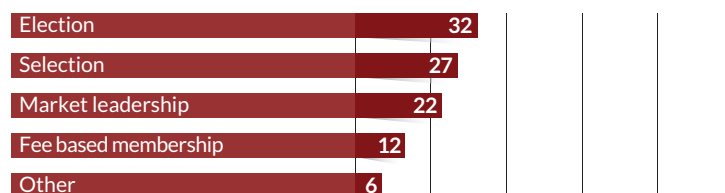
% of respondents agreed



Finally, there was a degree of scepticism expressed regarding the basis on which the industry groups have been formed, given their mandate to represent the industry as a whole. The fee-based participation which the FMSB has embraced was not widely supported, nor the mixed approach by BIS FXWG. Almost a third of respondents believed election should form the basis for forming industry groups, with selection and market leadership as the next most popular options.

### Expected basis for forming FX industry groups

% of respondents agreed



**“FX industry groups should not be selected by major FX market participants. The process should be government initiated, transparent and accountable with the possibility of legal recourse”**

Professional respondent

Anonymous market survey

## **II. Global code of conduct**

## II. Global code of conduct

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The BIS FX Working Group recently released the first phase of its Global Code of Conduct. This was still in development when our survey was undertaken, and it found a high level of agreement that a code was needed, and optimism that it can be enforceable.

### ***Need for a global code of conduct***

% of respondents agreed



### ***Enforceability of a global code of conduct***

% of respondents agreed



For the Global Code of Conduct to succeed in changing behaviour within FX, its adherence mechanisms and relationship with local regulation must be seamless and effective. The importance of these factors was reflected in the survey, with a majority highlighting the potential for conflict between a global code and local regulators: something that those shaping the code will need to address and resolve.

### ***Potential conflict between a global code of conduct and local regulation***

% of respondents agreed



Anonymous market survey

### III. 'Last look'

### III. 'Last look'

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A key part of our survey assessed awareness and perceptions of 'last look' pricing: we looked at whether it was familiar to market participants, if it was thought to be acceptable, and how it could and should be regulated.

The first striking finding was that only half of respondents were even aware of 'last look', reinforcing that it is a practice open to abuse through lack of transparency.

#### **Market awareness of 'last look'**

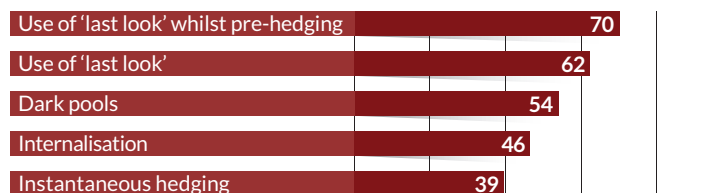
% of respondents agreed



Furthermore those who are aware of the practice, rated it as the most unacceptable FX practice, ahead of dark pools or internalisation.

#### **Unacceptable FX market practices**

% of respondents agreed



In relation to their own trading preferences, an overwhelming majority of respondents expressed a preference to trade without 'last look', including 70% of respondents from banks.

#### **Preference to trade on no 'last look' prices**

% of respondents agreed



**“Last look benefits those who thought it up...”**

Professional respondent

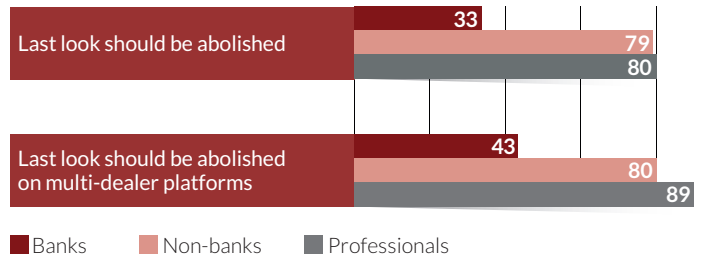
### III. 'Last look'

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When the question was extended to whether the practice should be abolished, there was strong agreement from non-bank respondents and professional traders, but not among the banks, most of whom argued for its retention.

#### **'Last look' should be abolished**

% of respondents agreed

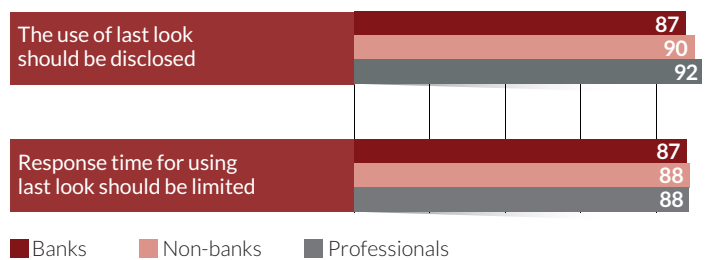


#### **“Last look should stay, but it has to be regulated by a code of conduct”** Bank respondent

Were 'last look' to be maintained, there was a strong belief that it should be more closely regulated, with mandatory disclosure and the response time for its use to be limited.

#### **Potential ways to regulate 'last look'**

% of respondents agreed



#### **“If 'last look' is to continue, it needs to be disclosed and audited to ensure the disclosure statement is correct”** Bank respondent

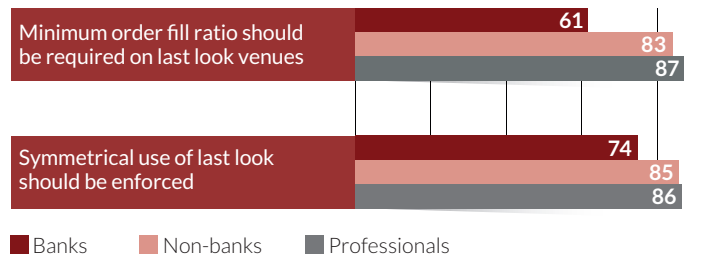
### III. 'Last look'

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Other measures, such as imposing minimum fill order rates and enforcing symmetrical use of 'last look' were welcomed, but thought to be as less effective in ensuring fair execution, than disclosure or imposition of time limits.

#### **Ensuring the fair use of 'last look' practice**

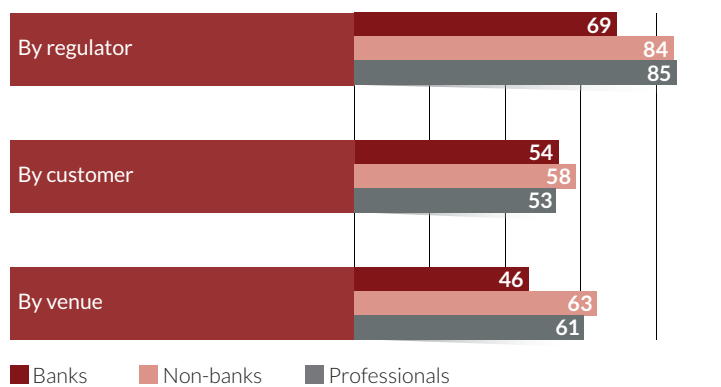
% of respondents agreed



On the possibility of standardising the use of 'last look' which has often been mooted in the industry, the responses showed a lack of clarity on who should be responsible for enforcing the new rules, reflecting the near impossibility of enforceable standardisation and its weakness as a solution to the 'last look' problem.

#### **If the use of 'last look' is standardised, how should the new rules be enforced?**

% of respondents agreed





Anonymous market survey

#### **IV. The future of FX**

## IV. The future of FX

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In the final part of the survey, we asked market participants how they expect the FX market to evolve in the coming years.

### Liquidity and trade execution

In terms of liquidity provision and management, a majority believed the share of liquidity provision by non-bank market makers will increase.

#### **The market share of non-bank liquidity providers will increase**

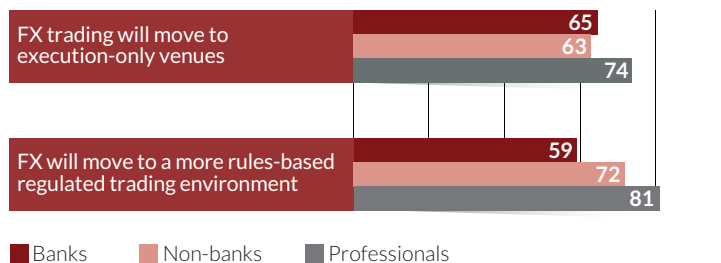
% of respondents agreed



A majority of respondents believed that FX will move to execution-only venues and to a more rules-based trading environment.

#### **Expected changes in execution**

% of respondents agreed



In fact, some respondents commented that exchange-like execution for FX could ensure more permanent and sustainable transparency than the Code of Conduct.

***“In an ideal world, I would like to see that FX should be traded through a single global exchange, where all orders are processed and so the best prices can be hit regardless of the liquidity provider”***

Professional respondent

***“We don't need a global code. We just need a proper exchange mechanism. There's no equity or bond code of conduct”***

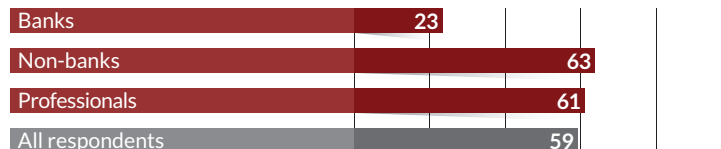
Bank respondent

## IV. The future of FX

The majority of respondents, other than those from the banks, believed the enhanced price discovery and transparency, made possible by streaming market data, will provide market participants more granular price references and ultimately make 'last look' venues obsolete.

### **Pre-dominance of continuous streaming market data will make 'last look' venues obsolete**

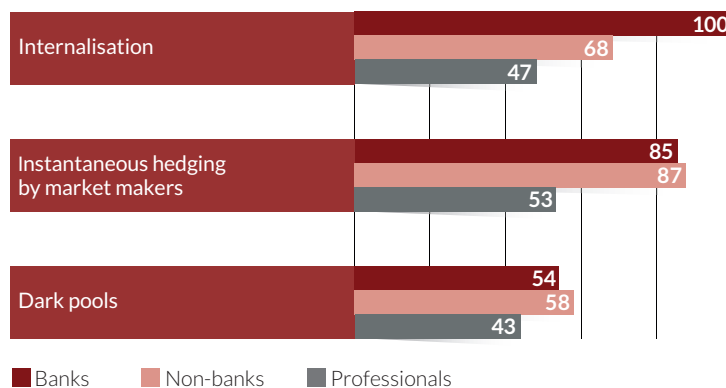
% of respondents agreed



Interestingly, practices that have come under scrutiny in recent years, such as internalisation, instantaneous hedging and dark pools, were considered acceptable by the majority in the institutional segment. This was in contrast to the professional traders, who were more concerned about the lack of transparency and fairness inherent in these practices.

### **Acceptable FX market practices**

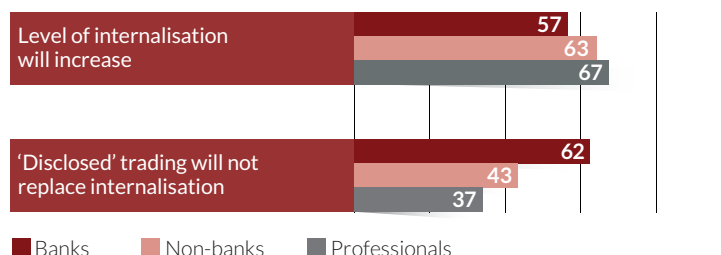
% of respondents agreed



A majority of respondents believed that the internalisation levels are likely to increase. Unlike other segments, the bank respondents did not believe that disclosed trading could be a fair alternative to internalisation.

### **Expected internalisation changes**

% of respondents agreed



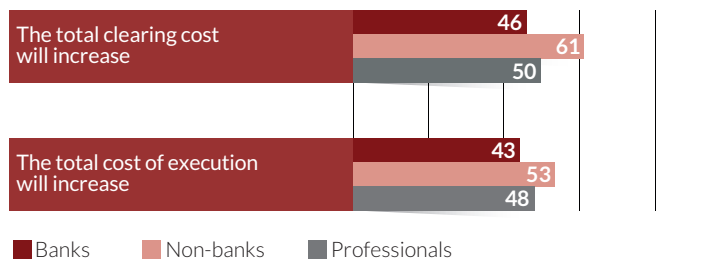
## IV. The future of FX

### Cost of trading

The expectations on whether the execution and clearing costs are likely to increase in the future varied by segment. Taken as a whole market, the findings did not demonstrate a particularly strong sentiment.

#### Expected changes in trading costs

% of respondents agreed



### FX industry benchmarks

The establishment of industry benchmarks was welcomed by the majority of participants.

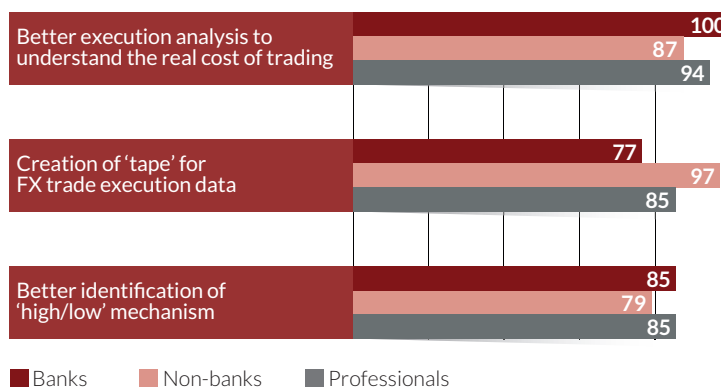
**“Lack of time & sales data is the biggest disadvantage along with ‘last look’ when comparing with regulated futures markets, like the CME”**

Professional respondent

However, differences of opinion emerged across the different segments on which should take priority. Banks unanimously thought that better execution analysis is needed; by contrast, non-banks were most focused on the creation of an FX tape for trade execution data, which was the banks’ lowest priority.

#### Advantageous industry-wide benchmarks

% of respondents agreed



Concluding thoughts and recommendations

## Conclusions and recommendations

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### **Transparency and fairness of execution: more urgency needed**

While there has been much work seeking to reform the FX market since we last canvassed industry opinion, the overwhelming sentiment that emerged from our survey was that the pace of progress has been too slow. The market doubts whether greater transparency has been achieved, and is reluctant to credit FEMR and its successor bodies, including the BIS FXWG, with having achieved change.

We believe these findings present a clear challenge to the industry: market sentiment is unambiguously in favour of greater transparency and largely dissatisfied at the progress that has been delivered to date. That a majority of respondents do not feel they are getting best execution or having their interests protected should be a wake-up call to an industry that purports to be focused on restoring trust.

**Recommendation:** *Regulators must take a bolder approach to restoring trust in FX, with a more aggressive timetable for delivering change and a clear focus on enforceability of new recommendations and effective sanctions for those who contravene guidelines.*

### **'Last look': only abolition is achievable**

We explored opinion around the practice of 'last look' in some detail, revealing a complex picture. It was surprising that around half of respondents are still unaware of the practice; less revelatory was the finding that only banks are still willing to mount a case for its defence as an acceptable market practice.

On standardisation or regulation of 'last look', there was clear assent across the board for its disclosure and limiting response times. Less unanimously, there was agreement that minimum fill order requirements and symmetrical use of 'last look' would help ensure fair trading.

Yet the intrinsic problem of any standardisation was revealed by the question of who should be enforcing standardisation of 'last look': the regulator, the venue or the customer. While it is possible to achieve consensus on whether and how the practice should be standardised, the question of by whom shows the practical difficulties that any attempt to standardise would encounter.

Furthermore, the disclosures published by several global banks on their use of 'last look' in response to the Code of Conduct have reinforced the fact that they are able to price sustainably without it, and that is it no longer a necessary component of their market making.

At LMAX Exchange we will continue to drive a campaign to abolish 'last look', as a practice we believe technology has made obsolete. In addition, we will continue our engagement with the industry working groups and regulators as we see a significant appetite from the market for change and a frustration that progress is not being made.

**Recommendation:** *'Last look' must be abolished. It is a practice which has been made obsolete by technology, which undermines trust in the market, and which cannot be effectively standardised to the benefit of market participants.*

Cont'd

## Conclusions and recommendations

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### **Regulation: an unstoppable tide**

When we tested assumptions on the future of FX, one clear theme surfaced: greater regulation and standardisation is coming and it is here to stay. Most thought that a more rules-based and regulated environment is likely to be the future, and that a shift to execution-only venues was likely. It is incumbent on regulators to work towards changes that are tangible, enforceable and which will have credibility among market participants.

**Recommendation:** *All industry working groups should include a wider range of market participants to democratise the process, represent the market as a whole and accelerate progress. It is imperative that regulators establish a transparent process to ensure diverse representation and avoid any perception that established players and those better able to pay are being favoured.*

## Survey methodology

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To ensure representation of the whole FX industry, this survey was distributed to all three market segments, including banks, institutional and professional proprietary traders, receiving over 1100 responses. In the analysis, the respondents were grouped into three categories:

- Banks: dealing and non-dealing banks
- Non-banks: asset managers, brokers, financial institutions, funds
- Professionals: proprietary traders

It should be noted that we experienced a very high engagement with this survey, which demonstrates a clear willingness from the market to engage with these themes and offer their insights.

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A report by LMAX Exchange

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+44 20 3192 2555 | [info@lmax.com](mailto:info@lmax.com) | [www.LMAX.com](http://www.LMAX.com)