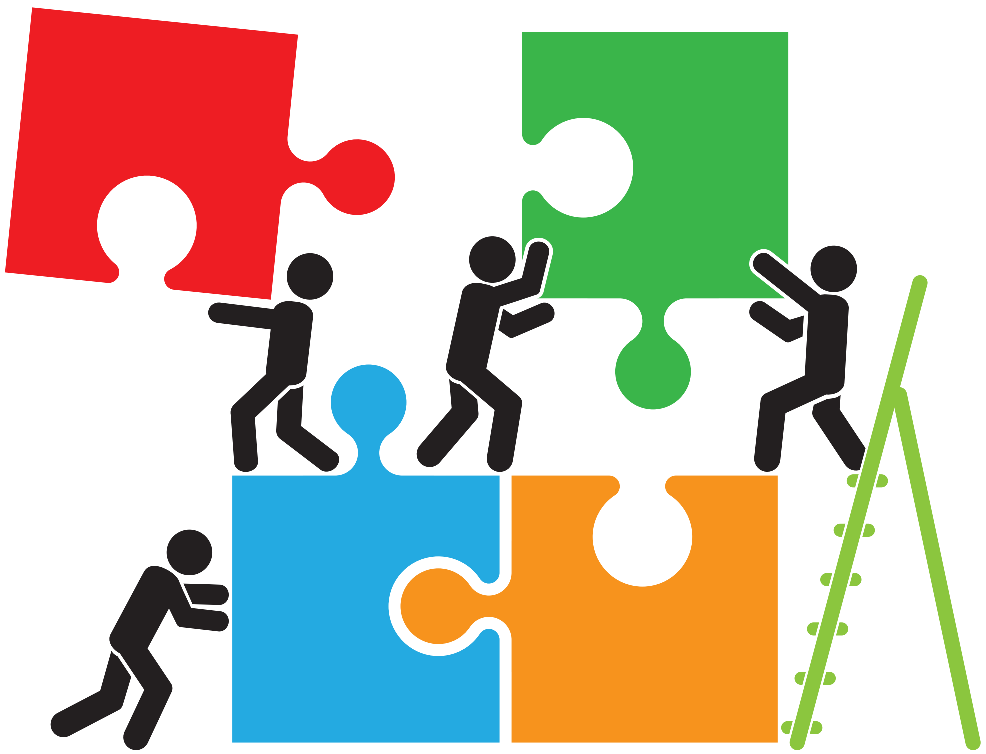


Principles, Actions, Results:

Achieving a more robust process of Best Execution in FX

While the concept of best execution was born in the equities market, regulators are now setting their sights on bringing the FX market up to similar levels on competence, despite the greater fragmentation of trading venues that exists in the FX market. Frances Faulds reports.

The regulatory requirements around the clearing and the reporting of over-the-counter (OTC) derivatives, as well as the move away from bilateral execution, have already led to structural changes to the FX market but this new regulatory pressure to focus on best execution, now means that asset managers must have processes in place to conduct proper due diligence around FX execution, as well as the ability to demonstrate best execution if their clients require it.

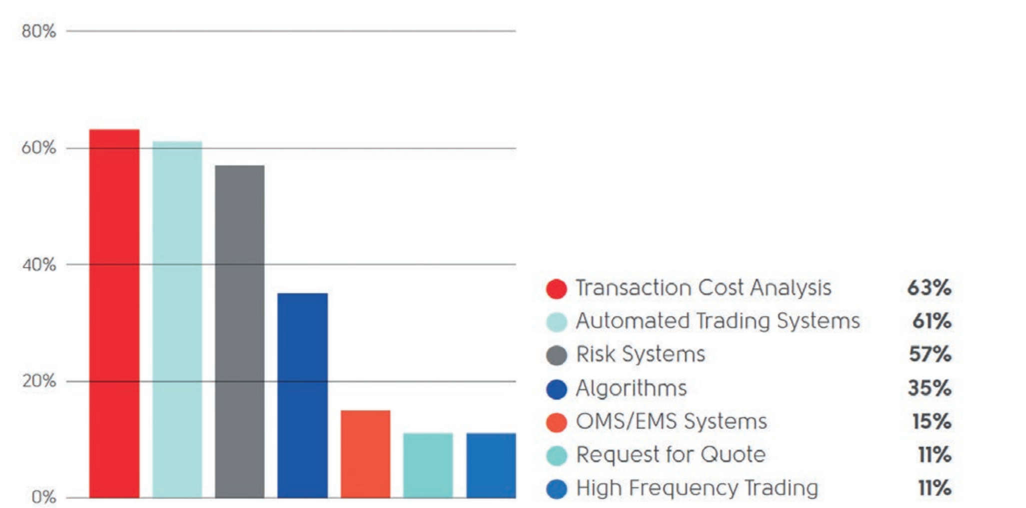
Anna Pajor, Principal Consultant at GreySpark Partners, says that the focus on best execution in FX began soon after execution quality was tackled in the equities market. This was coupled with the fact the growing use of electronic trading in the FX market, and a greater number of benchmark providers, has made comparison between trading venues, for the purposes of best execution, easier to achieve.

For Pajor, there are two parts of the problem in achieving best execution in FX. She says: "While most of the focus has been on measuring the cost of execution, namely finding the best price at the point of execution, or about measuring the performance of a given execution strategy or algorithm there is a second component. This one is much more important and much more difficult. It involves gaining an understanding of a trade in context - the underlying need for a particular trade, the sources of liquidity available at a particular time, the given timeframe in which the trade was executed and the prevailing average market price."

She believes that more in depth analysis of the context in which trades are executed is becoming much more important in the FX market than in the equities

TOP LEVEL FINDING:

The top technology that most respondents **(63%)** are planning on investing in over the next 12 months is 'TCA', closely followed by 'Automated Trading Systems' **(61%)** and 'Risk Systems' **(57%)**



Source: WBR

FX Industry Benchmarking Survey 2015

Principles, Actions, Results

> "We are now seeing increasing numbers of traditional equities providers of TCA moving into the FX space, and bringing the techniques and expertise learnt from the equities market to FX."

Anna Pajor

market, due to the greater fragmentation of liquidity that exists in the FX market, and the lack of a benchmark price for execution.

Pajor says the reason it is important to view average performance over longer time horizons as well as individual transactions is because the longer trend can identify problems in the sufficiency of the liquidity provision, along with any inefficiencies that are occurring on the clearing side as these can have an impact on the overall cost structure of the trade. "A longer view will also show whether or not the algos or strategies being used for execution for certain currency pairs are suitable in the markets they are being used. So, individual executions, especially in FX, must be viewed in the context of long-term performance in order to identify patterns and liquidity trends," she adds.

SHOWING BEST EXECUTION

An essential component of a best execution process in FX is the need to justify a given trade execution via a chosen method, venue or counterparty. Due to the complexity of the execution methods used today – whether it is the choice of liquidity sources or the decision to use a particular algorithm on a particular market – Pajor believes it is becoming increasingly essential to use transaction cost analysis (TCA) tools.

Additionally, she believes, it is becoming increasingly important for banks to seek independent post-trade TCA, especially where they are providing algo trading. She says: "We are seeing an interesting number of new entrants now providing TCA services for FX emerging. Additionally, we are now seeing increasing numbers of traditional equities providers of TCA moving into the FX space, and bringing the techniques and expertise learnt from the equities market to FX. This is driving an interesting number of solutions."

Banks providing algorithms want to be able to also offer justification of their quality, or some way of measuring their algos, but when it comes to independence, Pajor says the choice facing the buy-side is still between choosing independent vendor-led TCA solutions and conducting TCA in-house.

For Pajor, the focus is less upon the risk entailed in using one execution method over another, but rather on measuring the effectiveness of a chosen strategy, and being able to

Being able to measure the performance of an algorithm during trading is now a critical component of FX trading,

Principles, Actions, Results

compare the different execution methods, using execution advisory for algorithmic or strategy selection. Being able to measure the performance of an algorithm during trading is now a critical component of FX trading, and part of the reason there is a growing use of best execution advisors, as well as the impending regulatory requirements.

She says: "First and foremost in achieving best execution performance in FX is in understanding the context of the trade. It is important to understand why a given organisation is using a particular liquidity source or execution method is being chosen – whether an execution strategy is being used purely to gain access to the market, or if it is part of a longer-term strategy. It is through a greater understanding of the trade context that an effective solution for how each and every trade should be executed, for best effect, can be built."

FIDUCIARY DUTY

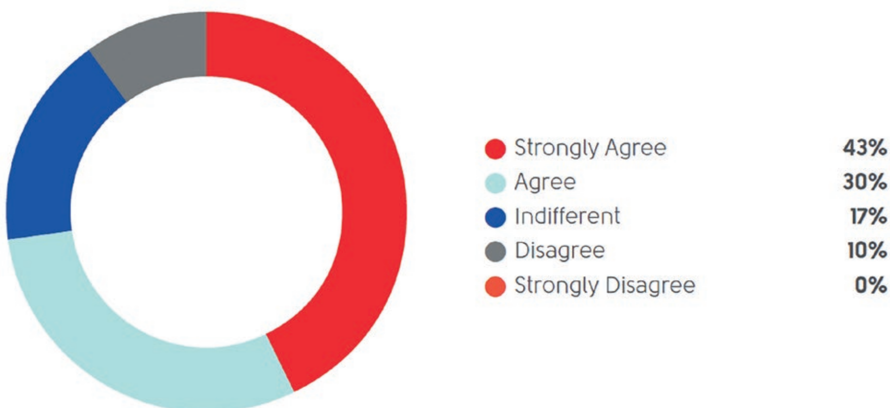
According to Howard Tai, Senior Analyst with Aite Group, focusing on derivatives products across multi-asset class investments, risk management strategies, as well as the role of electronic trading in currency, equity derivatives and global equities, the greater awareness of best execution in FX has risen dramatically in the past three or four years, on the back of the investor lawsuits and then the WMR scandal.

He says: "As a result, the general education of asset managers and asset owners has been stepped up, and the message of fulfilling fiduciary duty to customers in terms of best execution across all asset classes, including FX, has been getting louder. The market has become better educated. There is a greater awareness of the liquidity fragmentation of the FX market today. In fact, market fragmentation has been indirectly caused by the search for best execution."

For Tai, what is central to building robust principles around best execution is the need to get away from the

TOP LEVEL FINDING:

43% of respondents 'strongly agree' that TCA is the most important technology to improve their execution performance in foreign exchange.



Source: WBR

FX Industry Benchmarking Survey 2015

focus simply on best price. He says: "A greater examination of the complex investing process is needed; starting with having the right research coverage, that will generate the investment ideas, to allow the asset manager to implement their ideas, and then execute the trade at the most optimal venue, by taking liquidity into consideration and to obtain the best possible outcome. And when this process is completed, it still has to be continued downstream until the trade is properly settled, without error. If any part of this process goes wrong, it fails the litmus test of best execution. It is a continuous process that has multiple parts; there is a danger that people over-simplify it in a rush to just get to the best price. Price is just part of it."

He adds that tools such as transactional cost analysis are simply there to verify that the process involved to obtain best execution is robust. Further, the increasing use of multi-dealer platforms, even by the less sophisticated players, is proof that there is a greater awareness of the best execution process in FX.

LONGER TIMEFRAME

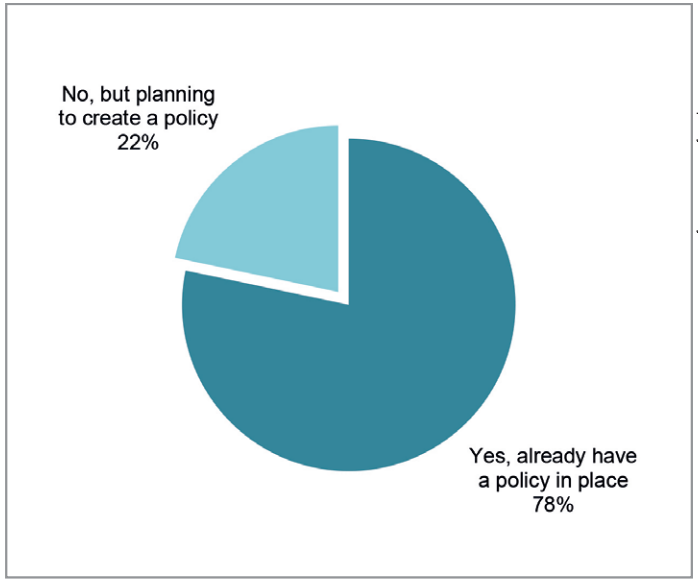
Central to a robust best execution process is the timeframe under examination and the need to view average performance over longer time horizons as well as individual transactions. Tai says: "If you keep it to a very short time period, you may not have a big enough sample size, or you may end up over-emphasising one or two outliers in the process, giving them more importance than they deserve. A wider timeframe is needed to get a better overview of the pattern of execution." Furthermore, demonstrating that best execution has been achieved, including the trade execution venue selected, is simply the due diligence process that asset managers should be delivering to the customer, and an essential part of their fiduciary duty, according to Tai.

A greater examination of the complex investing process is needed

However, there are many other considerations to be taken into account as it is clear that some execution methods and products create more risk than others, with the associated implicit costs to bear. For example, the use of a multi-dealer platform, when limited to only in a request-for-quote model, inevitably shows the trader's hand to the marketplace and there is no certainty that the execution will take place at the quote provided, as 'last look' pricing can negate this. But, at the same token, by using a simple algorithmic strategy (TWAP or VWAP), the immediacy of execution can be sacrificed for more variation in pricing over time.

"The longer you stretch out the execution time horizon, the more variation in trade outcomes and prices that may occur. It is always possible that if you act sooner, you would get a better price than stretching it out over a long period of time, but that is the risk you take," says Tai. Also, the possibility of being front run by unsavoury players in the market, on venues where your footsteps can be detected, is, and continues to be, a potential risk involved in a simple algorithmic execution strategy.

It is hoped that as FX industry starts to move away from using the Reuters/WM fixing rate as the daily benchmark rate, then the focus on a single point in time in a 24 hour cycle becomes less popular, and a new era of best execution in FX will begin.



Source: Aite Group buy-side FX survey, Q4 2014

Do you have an in-house "best execution" policy with regards to FX trading? (n=23)

SPECIALIST ADVICE

Already over the past two years, a growing number of FX trading firms have enlisted transaction cost analysis specialists and best execution advisers for better due diligence, but Tai cautions that greater consistency is needed in following up the advice, and of understanding and better using the data analysed. He says: "Some do this already, but hopefully in time, the majority of firms that use TCA will look to accurately utilise this information, and actively seek advice beyond their internal organisation, in order to work on ways to improve better execution."

Howard Tai

"It will take an industry-wide education effort to change the old habits of some asset owners, their pension fund consultants, and investment managers..."

While the predominant use of TCA is post-trade, the more progressive players are increasing their capability to use pre-trade TCA, and the most sophisticated not only do pre-trade, but also have the tools to do real-time TCA. According to Tai, they can change gears and strategies on the fly, and switch execution methods during trading by responding in real-time to the TCA data, but it is only a small number of firms that have such capability at the present time. But while the trend is going towards managing FX execution more actively, Tai says it needs to become more widespread amongst buy-side firms and their corporate peers before the FX industry can move more rapidly towards best execution. "Those with index money are slow to adapt to change, and will want to hang on to their current methods. It will take an industry-wide education effort to change the old habits of some asset owners, their pension fund consultants, and investment managers, and this transformation process will take time," he adds.

GREATER TRANSPARENCY

For Tom Murphy, Head of FX, Futures and Equity Options Sales at Bloomberg Tradebook, the cost in terms of alpha generated, or lost, in FX has become a significant factor in overall portfolio performance. He says: "Historically, asset managers that were most sensitive to FX performance within their respective portfolios were those that viewed FX as a separate asset class. Electronic trading has brought more transparency to FX pricing and transactions. As a result, the ability for asset owners to measure the 'cost' of FX transactions has become prevalent and thus better understood. By facilitating the comparison of trading methods and performance on one platform, Bloomberg is helping to bring greater transparency to the costs of trading."

According to Murphy, the ongoing regulatory discussions across various jurisdictions, such as MiFID II in Europe, are another driving force behind today's heightened attention on best execution amongst the buy-side. "This will only continue driving greater accountability as definitions become clearer," he adds.

When considering what constitutes a robust best execution process for FX, Murphy says: "FX is first and foremost a credit-based product. Historically, asset owners did their FX trading only with a handful of FX counterparties where they had a direct credit relationship. In this scenario, best execution is relative, and because the FX market offers no single benchmark or liquidity pool, what constitutes good performance is dependent on a participant's specific objectives, trading style and tolerance around selected benchmarks. "For example, if the objective is to get out of a position quickly at the least cost, best execution is likely achieved by completing the whole trade to one counterparty, at the best available price through a disclosed multi-dealer platform like FXGO. Equally, if the prevention of market leakage is the goal, best execution is more likely assured with an anonymous FX ECN offered by a centrally cleared model like Bloomberg Tradebook."

Murphy also adds that performance measurements over a longer and larger sample size of trades will smooth out both positive and negative market impact, while also revealing patterns that allow better analysis of trading strategies whereas shorter time horizons or smaller samples of trades will exacerbate the market impact. For instance, if the market is rallying while an asset manager is executing a sell order, the market impact relative to the arrival price will be positive for the asset manager. However, if in the short run, the asset manager is selling when the market is going down, the execution relative to the arrival price is quite negative. "This has nothing to do with the arrival price or execution methodology but rather is an example of the market direction impacting the best execution measurement," Murphy says.

BETTER DATA

Murphy also believes that the key is measurement as execution methods and products associated with a particular asset class are path dependent on the information and data available at the time of execution. He says: "In US equities, where there is a consolidated tape, the ability to analyse best execution post-trade is more straightforward. In an asset class which is an OTC credit dependent product, the measurements are more challenging. The more difficult the measurement, the more opaque the implicit costs are."

He adds that while, historically, awareness of FX costs among certain market segments was lower, the role of technology today in increasing access to information has made it easier to assess options for best execution based on the particular trading objectives. To this end, rather than one method of execution being viewed as riskier than another, Murphy says the choice depends on the variable that the trade is looking to optimise.

"For example, if the objective is to execute a full trade with one known counterparty as quickly as possible, an always-on service like FXGO might be more suitable, whereas if anonymity is more important, using an FX ECN like Tradebook's to tailor an order and optimise execution price makes more sense," he says.

> "At the end of the day, not all best execution needs are the same so it's important that brokers are able to tailor the liquidity they provide to the particular needs of their clients."


Tom Murphy

Furthermore, Murphy believes that the analysis of trade data using tools like Bloomberg's pre-trade cost analysis (BTCA) that allow clients to assess transaction costs and optimise trading performance for equities and FX transactions is the most important step in securing best execution for clients.

"Understanding the client's specific view of best execution is also imperative. Does the client want to minimise market impact on a large execution or do they have a directional bias which will impact the execution time frame? At the end of the day, not all best execution needs are the same so it's important that brokers like Bloomberg Tradebook are able to tailor the liquidity they provide to the particular needs of their clients."

Bloomberg offers its subscribers two ways to source liquidity in the currency markets via the Bloomberg Professional service.

Bloomberg FXGO

FXGO is Bloomberg's multi-dealer FX trading platform that provides fully-disclosed and commission-free access to pricing for spot, outrights, swaps, deposits, NDFs or FX options from more than 300 electronic and manual liquidity providers globally. FXGO is accessible to both sell-side and buy-side market participants that subscribe to the Bloomberg Professional service (aka the Bloomberg Terminal).

Bloomberg Tradebook FX ECN

Bloomberg Tradebook, Bloomberg's agency brokerage business, operates an electronic communication network (ECN) for currencies that is used by both the buy side and the sell side to trade anonymously using a variety of trading strategies. The platform displays bank and non-bank liquidity that enables investors to leverage trading anonymity while seeking best execution with total discretion and minimal market impact.

Where it concerns best execution, both of these solutions offer benefits. In some situations, investors may want to leverage the anonymity and trading tools available in the Tradebook ECN.

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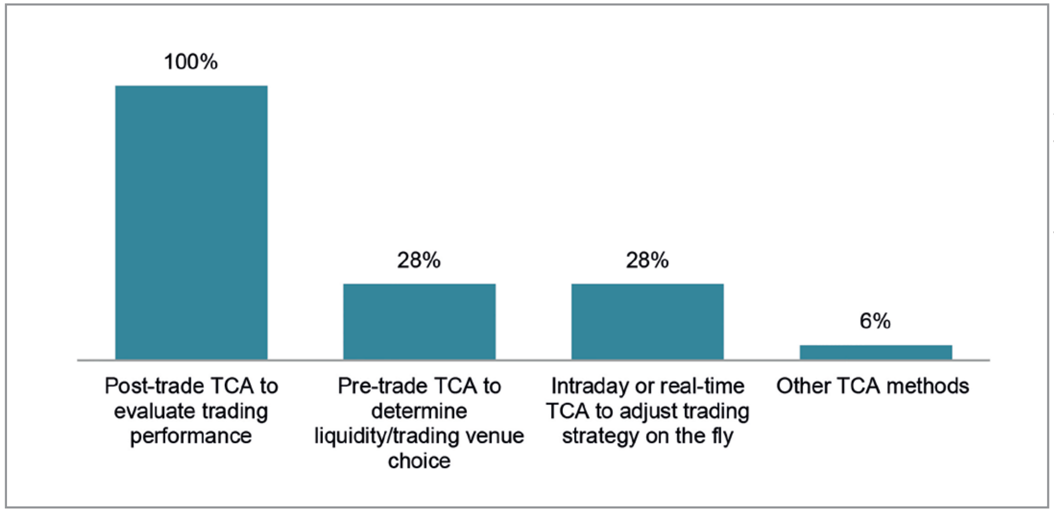

Source: Alte Group buy-side FX survey, Q4 2014

What type of FX TCA study do or did you use? (Among companies that are planning to pursue a TCA study regarding FX in the next year or have already done such a study and are not planning to conduct another; n=18)

CATALYSTS FOR CHANGE

According to Andrew Cromie, Global Head for Product Management for Institutional Investors, at 360T Group, there were two pivotal moments in post-global financial crisis history which shone the spotlight firmly on FX, which had been seen previously as more of an operational headache rather than an asset class in many cases for investors where FX was and is an exposure derived from another transaction or hedge.

The first was in October 2009 when the California attorney general's office charged the State Street Corporation with fraud, accusing the company of cheating the state's two largest pension funds of at least $56.6 million by overcharging them for a series of foreign exchange trades. "This resulted in many other asset owners both questioning archaic FX practices and well as taking further legal action in many cases," says Cromie.

The second was news reported in 2013 that currency dealers said they had been front-running client orders and rigging the foreign exchange benchmark WM/Reuters rates by collusion. Cromie says: "Given institutional investors were the main users of this service, this would mean that behaviour from members of the FX market would be brought to the attention of regulators and the public not just the banks that were facilitating the orders.When combined with the structural changes in the wider market that are still evolving today as a result of the GFC, it means that anyone executing FX on behalf of another has a legal, regulatory, reputational and fiduciary risk and responsibly to show best execution. Institutional audit and compliance are adjusting to monitor and influence this very real risk."

Unfortunately there is no one perfect answer to the question of what is the best execution overall process and Cromie says a wide range of different approaches are being taken by asset managers. Regardless of the overall execution policy, a data infrastructure is a fundamental need to be able to put a best execution policy and process in place in order to validate and measure the outcome. Says Cromie: "This can prove to be an expensive exercise but it does not have to be, 360T for example provides this infrastructure to clients who use our services to execute their FX."

MIFID II puts some definition in Article 27 where it sets out characteristics under the obligation to execute orders on terms most favourable to the client, where firms must consider "price, costs, speed, likelihood of execution and settlement, size, nature or any other relevant consideration". This however does not take into account other considerations for FX such as market movement that maybe absorbed from order origination or a netting strategy where on order may favour the other for a better overall outcome, adds Cromie.

Cromie believes like others that it is essential to view average performance over longer time horizons as well as individual transactions. He says: "Performance of an individual transaction will tell you how that order interacted with the market and what the result was for that order against a benchmark or in competition at that moment in time. What it will not tell you is if the order could have got a better result by been split, netted, executed differently or against a different counterparty/s. By constantly looking at the underlying attributes of an order such as currency pair, notional amount, product, tenor, credit available, execution method, speed of execution and other factors and then looking at results over a period, it allows a quantifiable assumption to be made on how to get the best outcome for the next similar order."

> "A robust best execution policy and process is not as difficult or expensive to put in place as some would believe, the key is to find the right un-conflicted partner..."

Of course this is not perfect, as market conditions can have anomalies such as a liquidity event, but Cromie adds that at least this approach means there is a process in place to continually measure and evolve an execution process. "Market events can always be quantified and explained for the result of a particular order, if those conditions persist then the execution process should adjust. Transaction Cost Analysis is a decidedly relevant tool to adjust and consistently improve execution performance," he says.

COMING BACK TO JUSTIFICATION

Justifying a given trade execution via a chosen method, product, venue and counterparty, has become an essential component of a best execution process. In the 2015 FEMA report in the UK, asset managers were criticised for weak market discipline to report misbehaviour in the case of the WM scandal. Amongst the reasons given were incentives, lack of investment in monitoring and 'the possibility that some on the buy-side might be subject to conflicts between their clients' interests and their relationship with their sell-side counterparties'.

Andrew Cromie

Says Cromie: "There are real reasons why an executing trader may choose even a single counter-party in FX, for example credit available for that account or others, but often these decisions are made on 'gut feel', which exposes institutions to risk. However if the decision, on how to execute and with whom, can be justified using quantifiable data such as spread by volume, counterparty and market impact and then measured against an independent sources then it may rule out any suggestion that a quantifiable process of trying to achieve best execution was not adhered to."

Using a FIX benchmark such as the WM4pm certainly has its advantages, such as executing orders at a publically listed price. In the cases of rebalancing often the FX execution can be aligned to the underlying transaction so that proof of best execution is there. However, Cromie adds that in many cases the underlying transaction is not at the same time as the covering FX execution which means that the fund was exposed to market risk for prolonged periods.

He says: "Research we have done for clients on this topic shows that in many cases the market risk absorbed by the fund often exceeds the benefit of not paying spread in under 60 seconds. Of course market risk can be negative or positive but in general the mandate of the fund is not to take FX market risk on transactions which can cause wild profit and losses to the fund. Tolerance levels to market risk that are absorbed by funds are certainly a consideration that we have seen our clients give careful consideration to when building out a best execution process."

While increasing numbers of asset managers are turning to best execution advisers, Cromie believes, for many, the first step is to simply make sure that a best execution process is in place, as often asset managers have solid best execution policies in place for other asset classes but not FX, something that he says is rapidly changing.

He says: "A robust best execution policy and process is not as difficult or expensive to put in place as some would believe, the key is to find the right un-conflicted partner to help analyse processes with the infrastructure and capabilities to help inform and drive a strategy forward."