



FMR Advisory Round Table: “Last Look v2.0”

Some argue that last look is a necessary protection in order to provide broad customer pricing, whilst others suggest it encourages unfair advantage to the price makers. Recent responses to the Bank of England led Fair and Effective Markets Review has highlighted the split in opinion, both within the industry and within the customer base.

Introduction

Over the last few months the topic of conduct risk, behavioural risk and general management concern around how to demonstrate to the regulators that a given business is behaving correctly, has come up again and again. As the conversations have focused in on areas of concern, the topic of “last look” and how price makers are managing the risk of e-distribution of prices is attracting attention. Following the report of the last FMR Advisory Round Table, which looked at some of the details around Last Look implementation, a follow-up Round Table took place on 20th February. This round table was set up specifically to follow on from the previous discussions, cover additional important areas and to tease out concrete examples and the requisite details to the current implementations, some potential issues such as they are; and any potential remedial approaches. Given the current sensitivity of this topic, most participants preferred to remain anonymous within the quoted report.

In particular the participants dug more deeply into multi-bank pricing environments and how price makers can best manage the range of pricing venues through which a range of customers request to see their streams of price.

It was apparent that whilst the typical vernacular used by the wider press and regulatory text often splits pricing into only two formats (firm and indicative). The FX market uses a variety of intermediate steps during trade formation, with a tradeable price stream that is not technically firm, but which is far ‘stronger’ than a simple indicative price, as one example.

Behaviour as defined in the Bank of England’s NIPS code: “Participants should also not deliberately place orders that they have no intention of honouring or accepting to be traded on, even just for price discovery, by using a ‘last look’ mechanism as a control to prevent any possible subsequent trades. Using a ‘last look’ mechanism is within best practice when showing genuine interest at specific price levels or when providing a support price, in order to mitigate technological anomalies and latencies.”

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Jon Healey – Head of global FX & FI eCommerce, BBVA

Hugh Whelan – Head of Liquidity Management, EBS Direct

John Estrada – Global head of eFX, Credit Suisse

Anonymous – Investment Manager

David Woolcock – Head of Committee For Professionalism, ACI

(There were three last minute no-shows due to market volatility that afternoon)

Summary of first Round Table on Last Look, held in December 2014

In December the first stage of looking at the wider situation around Last Look was completed. In summarising, a number of key points were emphasised. Last look is a protection mechanism for price makers that has evolved over many years and continues to evolve. The main market operators are already further evolving their approach to how last look is implemented and managed, acknowledging that a group of clients who are of significant importance to the wider market are actively requesting last look implementation. The two main points around current understanding of best practice is that the clients whose price stream is affected by last look should have consciously selected that implementation and that the use of last look in general is not used as a profit-generating mechanism per se, but is rather a pricing tool that allows tighter spreads for those relevant clients and as a protection mechanism for ePricing. One participant suggested the following: *“Summarising – we see last look as a safety mechanism yes, not as a mechanism to generate profit. No front running/pre-hedging in principal based trading. Without last look, the price layering that currently operates across the venues would not be able to persist in its current form. Customers would be faced with fewer and wider prices.”*

A wide range of market price-makers are actively examining their policies to find a default approach to price distribution where last look is enacted in a controlled and defined manner. Its use as an error capture mechanism is key, as a protection that allows better pricing to a wide range of clients, however the consensus was that clients should have to opt in to this as an active choice, with a default to the wide mass of SME clients being no last look pricing. Being a market leader in any evolution carries its own risk.

Discussion on 20th February

Before opening up the core discussion the group recognised that already since the previous Round Table, there was heightened interest in the area of Last Look, not least given the specific mention in question 8 of the Bank of England-led Fair and Effective Markets Review, the inclusion of Last Look within a US-based Class Action suit and the investigation by Mr Ben Lawskey, New York State’s Superintendent of Financial Services. The participants thanked FMR Advisory for having had the foresight to organise the Round Tables ahead of this regulatory focus, to help the industry debate this topic and to find some consensus.

Areas of discussion

Customer segmentation

When discussing the correct use of Last Look one of the most important elements is customer classification. Some customers actively request last look in order to receive closer bid/offer spreads and understand they will achieve a lower execution success rate, or as one participant put it, “The sophisticated professional traders who are actively requesting last look are the firms least in need of protection”. The wider customer base may or may not be aware of Last Look as a concept and what the implementation means for their pricing and execution.

Positioning the wider outcomes of Last Look Robin Poynder said, “As we understand things - if there is no Last Look at all, the resulting protection against latency and system risk means wider pricing. Let’s say that with Last Look enabled, a firm quotes 2 points, but without Last Look the firm now quotes 5 points. With Last Look the normal price is 2 points and if the Last Look protection is invoked and a new price is sent, that new price is almost always within the 5 point range that would have been quoted originally. Ie the normal price received is normally far better than would be possible without Last Look – and even if Last Look is enacted the resulting price is normally no worse than it would have been!”

The challenge with the above approach is that it is difficult to demonstrate the benefits empirically, as there is seldom a second set of trades against which the customer trades can be benchmarked. As David Woolcock put it, “The counter argument is that whilst this may indeed be correct, there is no empirical evidence to support the position, because you aren’t measuring the slippage”. However when considering the smaller set of actively trading clients who are on top of this mechanism one participant enjoined that we should “...remember the choice of clients. There is a pricing mechanism in place whereby the firm makes a price and the systems are working fine and nothing goes wrong systematically, the customer hits my price and I receive that potential trade and at that point the underlying market changes – so the firm then rejects the trade. This is last look as a market move protection and there are clients who request this pricing mechanism because they understand that it means a narrower spread for the prices they receive. It is an informed choice.” The participant added, “What we can say in that regard is that we introduced Last Look some time after it was implemented elsewhere and the two outcomes we noticed were that our P&L didn’t change but that our pricing narrowed across the board”

The discussion then moved on to cover how clients are made aware of Last Look and how to ensure that clients are making informed decisions. “Onboarding new clients is not so much of an issue.” Said one participant, “The challenge is for the thousands of existing clients. Repapering all of them is a huge task.” The new standard for client documentation includes an explanation of Last Look and allows the customer the choice to opt in or out to that pricing. However banks are faced with a significant number of existing clients who are currently receiving Last Look on the streaming prices that they use. Talking about how to approach this client set one participant explained, “We are writing a document for the wider set of clients right now to explain how last look works and the effects on their pricing by opting out or in – it is really hard to explain in every

day terms – and for sure we will refer to the ACI Model Code, published in February 2015, as a default approach that they should all read!”

Whatever the challenges involved in ensuring that the wide set of existing clients have understood and signed any new documentation, the reality is that new regulations in flight for implementation, or being planned down the road, will have this as a requirement. As David Woolcock pointed out, “One imagines that regulators will accept some form of grand-fathering for this and will look at the intention and related actions of the firm” and he went on to say “Onboarding a client, particularly with MiFID, will have to cover this as a part of investor protection.” Robin Poynder then explained how the investor protection rules within the MiFID would profoundly affect so much of the trade workflow between banks and clients. “The documentation and demonstration of how a customer has been marketed, priced and then traded with – through the entire life cycle from initial marketing contact to settlement of a trade – will mean that this kind of client disclosure becomes the norm.” As David Woolcock put it, “The eligibility of clients will be history. Following implementation of MiFID, all clients seemingly will be covered.”

Rounding off this topic one participant said, “Banks have a duty to explain Last Look to their customers in an accessible way”. Or as another summed up, “So much of this is down to transparency. If the clients understand that this is how the market operates they can plan how to trade appropriately”

Pricing mechanisms

Thinking about the wider trading environment and the way in which pricing is used by clients, the discussion moved on to examine the limited way in which some external commentators seem to restrict themselves to only two sorts of price; indicative and firm. The participants were clear that there are several variations on that theme within the FX world. One observed that from his experience, “Most of the time the clients are using the tradeable price to understand exactly where the market is and do not in fact trade – it is price discovery”. Aside from the tradeable price that this Round Table looked at, one participant highlighted a variation on this theme, “Interestingly we have some clients on our system who use the opposite end of the scale to the active firms consciously using Last Look. This is where the customers ask the price maker for a 100% firm, executable price and the price maker says it is coming, and will take slightly more time and maybe with some slippage when compared with a normally variable price. That is one approach that works for some clients.”

The key point that was evident around the table was that in the FX world there are a number of pricing conventions that are actively used by clients aside from simply firm or indicative.

Technical issues

As discussed in the previous Round Table (see [Report](#)), Last look protects the process and any aberration in a client system or third party systems within the trade flow. Last Look is a process that has evolved over many years, changing along with the underlying technology of the FX market. There are a number of distinct risks within the trade flow that may be mitigated by the implementation of Last Look. Regarding the management

of credit lines on a quasi-live basis, one participant said, “Most prices into multi-bank pricing environments are actually indicative. Most internal credit departments require a credit control through some kind of on the fly credit check using some kind of caching mechanism - Another fundamental reason for Last Look, especially within anonymous multi-bank systems, is for a final credit check before definitely accepting the trade.”

Inevitably this opened up a discussion around the appropriate implementation of Last Look. A non-bank participant said, “The credit check argument holds some water, but that should be taking a small amount of time – as in milliseconds. **Several seconds** is simply wrong. There needs to be a level playing field. At the moment the credit check argument at 7 seconds is laughable”. There was also talk around how some of this risk mitigation could perhaps fall under a different name with one participant stating, “Last Look as a name I don’t like. Most of the control is actually ‘deal validation’ covering things like credit checks or latency protection and I split pricing out along those lines.” Summing up the latency issue on credit checks one participant pointed out that many banks currently have a cross asset class credit system in order to manage the complex client trading patterns. “Credit check can be arranged on an almost live basis within an instrument class however the challenge is managing the credit file across multiple asset classes, where the client may be trading in a completely different asset. That still affects the overall credit availability and this is where the time delay can come from”.

As an overall stance, a consensus was that Last Look is appropriate if implemented appropriately – one participant summing up that line of thought, “Last Look exists for technical protective reasons and as long as it is implemented fairly I feel it is something we need to continue with for safety reasons”

The challenges identified by the participants often revolved around the openness of the implementation. As an example of this, David Woolcock raised the issue of banks acting as principals when automatically transferring the risk from their book, “Automated Deal Cover situations are part of this issue. There are banks that wish to appear as core price makers but who in fact transfer the market risk immediately there is a trade. They are simply reflecting the underlying market to their price recipients, covering any client trades directly and immediately into the market – and using Last Look to protect themselves in case the market moves. They are using Last Look to ensure no market risk resides in their books. This strikes me as less than open”.

Multilateral bank pricing

The previous Last Look round table ran out of time to dig into the multi-bank environment as deeply as the participants wished and so some time was spent focusing on this area. The wider challenge for a price-making bank is that their customer base demands streaming prices into a broad range of trading platforms. The aggregated risk across those streams is significant and if the client demand is to be met without disrupting the clients’ ability to access liquidity, the banks have to mitigate the aggregated risk profile. Last Look is a crucial element in that management. “The challenge for price makers can be that not all systems immediately recognise the new rate that a bank has sent and keep the stale one as live. Technically the bank has updated the rate but the system has not passed this on.” One participant explained. One potential approach suggested by David Woolcock was to change the price streams from tradeable

to indicative and to require an explicit price request when a trade is required. “If you are in a CLOB the system should have pre-screened credit prices. If you are in an RFQ environment and are not certain that you can honour the prices you send, then you perhaps should mark the prices as indicative.” The conversation around the table suggested that from a bank perspective that was workable, however from a client perspective the demand was certainly there for the tradeable pricing.

One of the major challenges within a multi-bank platform is understanding which prices may be subject to Last Look or otherwise. As one participant put it, “interestingly – prior to the meeting I dug through my Currenex and Hotspot contracts to see what they say about Last Look – and there is absolutely no mention of Last Look anywhere. “

Taking a control stance David Woolcock stated that, “The challenge, from a Model Code perspective within platforms, is that the pricing should be disclosed as Last Look or not. It is up to the platforms and liquidity providers to make this clear”. One participant expanded on that theme, saying, “A general disclaimer is not enough. In an anonymous pricing system you don’t know who you are hitting until after the fact, so any user should be able to know if they are accessing Last Look pricing or not.” As in so many areas of good conduct, best practice lies in how the area is approached in the spirit of best practice rather than simply in ticking a regulatory box. As he explained, the implementation of controls is problematic when determining any kind of certainty, “One challenge for customers is that whilst they can request that Hotspot or Currenex remove Last Look pricing from the counterparties whose prices they see, the reality is that the platforms provide an API to price makers that includes a reject message. The banks can choose to use this message or not. After some initial testing the price makers have freedom to alter their pricing mechanism including use of Last Look. Once the testing is complete and the pricing stream is implemented into the live environment, the platform cannot necessarily see whether or not Last Look is in action. It is therefore not as simple as saying that the platforms can control this for the clients”. Whatever the implementation and controls, the over-arching point was summed up as follows, “The customer should have the informed choice as to whether or not they are seeing Last Look liquidity”.

Pricing into multiple venues

As was touched on several times during the afternoon’s discussions, there is a significant challenge to price makers in managing price streams across multiple destinations. As one participant said, “whilst a firm may be streaming a price in a given amount to one defined bilateral platform, it is also sending that price to several other platforms. This is a requirement to price various clients as they wish it”. The challenge was set out clearly by one participant, when explaining it thus, “Imagine I am pricing into three platforms and they are anonymous pre-trade pricing. If the same customer tries to hit my price in all three platforms, I won’t know that the credit is being affected until that trade message hits my internal systems. This is where Last Look is crucial as it allows me to show my customer base the potential to trade with me where they are demanding to see my liquidity, but in a way that protects the credit exposure into anonymous platforms. Without Last Look, the potential to breaking credit lines would be unacceptable to any sensible operations management.”

One of the challenges is in the message that reaches the ears of the regulators. As David Woolcock put it, “platforms that use Last Look should tell their clients that they are accessing Last Look. The challenge that banks have is that people are saying things like ‘we have to have last look or we will lose money.’ This is not a sensible response to some parties such as the regulators.” The challenge is not the use of Last Look per se, given the sensible use to which this is put in mitigating a real and demonstrable set of risks. The challenge is communicating that to the regulators in a way that demonstrates the risk mitigation, as opposed to a purely profit-driven motive.

Regulatory approach

As previously highlighted, there is a significant regulatory focus on this area, both as a part of wider conduct risk and as a specific sub-topic that has come to regulators’ attention. The Bank of England Fair and Effective Markets Review specifically asked about Last Look and in addressing conduct risk includes all asset classes, whether investment instruments or not – Spot foreign exchange is included. The aspects that look at market stability take into account all roles, whether acting as agent or principal to the markets. Given the road show that exposed the FEMR to a wider set of regulators and central banks, a subsequent and similar exercise in other jurisdictions would not be a surprise.

The recent preamble published by the Global FX Committees of a range of Central Banks sets out a high level code of conduct and lists the ACI Model Code as the only non-Central Bank Code to refer to, in which Last Look is specifically addressed.

In considering the definitions of price, David Woolcock started with the provocative view as espoused by many commentators whereby, “The regulatory view seems clear – if you are posting a price with no surrounding caveat then it is firm and must be honoured. If it is stated as being an indicative price then that is what it is. The challenge is that what is held out to be a firm price by banks currently is in reality only a quasi-firm price – actually an indicative price.” The following discussion raised the different risks to which price makers are exposed in the FX markets in making prices across different venues. As one participant pointed out, “Actually single bank platforms don’t mention the word ‘firm’. The prices are distributed on a best efforts basis.” Another participant pointed out that from a legal perspective, “this is similar to the business model in any physical shop, where taking the item to the check-out till is an invitation to treat, and the cashier pricing the item initiates the actual purchase.”

Looking ahead to MiFID, Robin Poynder pointed out that many of the algorithmic elements that are currently in use will be far more tightly controlled. “MiFID will require a whole set of controls to be implemented around price making, whether it be minimum time of quote life, execution ratios or trading controls for direct market access clients being the same as that of the sponsoring bank.”

The participants turned to what the core concern may be within the regulatory world, and from where the focus may have stemmed. David Woolcock said, “what really concerns some regulators is the lack of understanding around the algorithm that controls Last Look within pricing engines in some banks – and the fact that in the past it may have routinely disadvantaged the clients.” And then referring to how some price

makers may feel they can remain unaffected by this regulatory focus, “T&Cs aren’t enough to protect a firm. The problem with assuming that T&Cs will cover anything you like is the reasonability check, whereby you can’t excuse yourself from anything unreasonable”.

A second and definite concern to the regulators is how any bad implementation may affect market structure and in particular the way Last Look may exacerbate the ‘liquidity mirage’. As Robin Poynder put it, “Some market users might use Last Look as part of a strategy to put prices into the market without the intention to trade and solely to ‘sniff out’ other trading interest. This is clearly against the interest of open behaviour and the wider market, as it generates a false impression of liquidity and trading interest. The challenge here is that there may also be a genuine intention to trade where a participant is pricing into multiple platforms with the intention to trade, but only allowing one of them to execute. The large number of execution venues in existence makes this the only sensible way of finding liquidity. The outcome however is that the market appears to have a depth of 7 venues pricing at that volume, where in fact only one will ever successfully execute.”

Participants acknowledged this situation with one saying “If we were able to do something about that we may well do so, but we are unable to change that situation.” And with David Woolcock asking, “Perhaps the question is the type of venues into which you are pricing. Does the view of liquidity in the market become distorted because of the pricing you put out there? Collectively the regulators will look to do something about this”. Another rejoined, “The issue is that this is a function of the model that is popular in the market. When it was predominantly RFQ, a price maker could look across the business and the breadth of pricing being made and understand the total risk being offered. We have moved to a model where client expectations are to receive a streaming price 24 hours a day and be able to trade on that stream at any moment they choose. That necessitates the current model whereby multiple price streams are being made available and where the price maker has to be able to control execution across those streams simultaneously. Last Look is an intrinsic piece of that control. I simply can’t see how we could price clients under this model without Last Look.” Or to put it another way - “Pricing 100 bilateral clients who all want a price in \$10mio, without Last Look I have to say I cannot price you all. Is it feasible to say that?”

One participant re-emphasised a point made earlier saying, “One key element around the perception that there is a liquidity mirage is that the idea of many firm prices is incorrect. This is technically an invitation to treat, just as one finds across websites if you are trying to sell a car or whatever. If the client base can understand this, then the misconception of firm pricing disappears.” Or as another participant said “part of this misconception stems from the political drive to equate the OTC market with a centrally regulated exchange price. The two mechanisms are fundamentally different in so many ways”

Further comparing the different asset classes, one participant maintained that a similarity exists between the fragmentation of traditional OTC markets and the fragmentation of current equity markets. Equity markets operate without Last Look and manage well enough. However a different participant pointed out that the latency

involved in trading across most equity trading venues allowed a version of Last Look in effect, if not in name.

David Woolcock was very strong in how the wider area of correct behaviour should be managed, including Last Look, in saying, “The big problem is that at the moment there are a number of banks who are saying that they have recognised the error of their ways and that they will write an internal code of conduct to cover this and wider issues, but which we are not going to show to our clients. Frankly that is the prisoners running the jail and they have to realise how preposterous that will look in the Press when it comes out – and it will come out. That is **likely** not going to be acceptable to the regulators. If the industry goes the way it should do and gets together in a publically available standard with no **ethical** arbitrage then we will be largely there.”

Summary

This second Round Table to examine the topic of Last Look was timely and involved an active participation. In terms of the wider situation Robin Poynder summed up as follows, “As firms implement best execution requirements from MiFID II, I suspect that market forces will start to drive any bad behaviour out of the market. In all the conversations I have had around Last Look, no-one has been saying that this is impermissible and shouldn’t exist. The strong message is that there are places where Last Look is appropriate, but that there is a significant amount of work to be done around communication so that everyone understands where and how it is implemented. That stronger communication will inform change through the more transparent effects.”

Under the topic of Last Look there was strong consensus that Last Look has evolved with the underlying FX markets and provides a necessary element of protection that is intrinsic to the distribution of price across multiple venues. Without Last Look the current set of client demand across multiple venues would simply not be possible to meet. There was however an acknowledgment that in the past there may have been some implementation of Last Look that was not as transparent as would be considered normal today. Publishing open discussions such as this Round Table should foster open discussion and remediation in terms of both how Last Look is implemented but most importantly how its use is communicated to users of a given price stream. Ensuring that customers are aware of any Last Look implementation, and the effects that this will have on both their pricing and execution, is key.

As in so many areas of best practice within good conduct, the emphasis is once more on strong and open communication with the customer base.