Wholesale FX practices in Australia

Report 652 | December 2019

About this report

This report summarises our work in wholesale foreign exchange (FX) markets during 2018 and 2019. It highlights our observations of better practices and some poorer practices used by participants operating in the market.

Executive summary

> **Following our work reviewing wholesale FX markets and participants in 2018 and 2019, we identified several better and poorer practices used by participants operating in the market.**

Important role of FX markets

Australia's exchange rate has an important influence on trade and financial flows between Australia and the rest of the world. The FX market is a key mechanism for Australian companies to access international markets for trade, capital and risk management. Changes in FX rates may directly impact the costs and prices of goods and services produced in Australia relative to overseas, which may influence decisions about production and consumption. The effective functioning of the spot FX market relies on all market participants acting with integrity and fairness.

Poor practices may undermine confidence in the FX market price discovery process and increase execution costs to Australian companies, in turn increasing prices ultimately paid by Australian consumers. Where institutional investors participate in wholesale FX markets on behalf of their clients, investors or superannuation members, it is important they are aware of FX market practices such as mark-ups and last look to ensure they achieve best execution for their clients. Wholesale FX markets are also a primary conduit of international shocks, and poor behaviour may increase Australia's financial exposure to systemic risk, particularly in the use of leveraged FX derivatives.

Our key findings

This report describes our work in FX markets in 2018 and 2019. We were pleased to see a high level of adoption of the FX Global Code and we identified a number of better practices set out in this report. We also identified a number of areas for improvement, including:

- **Governance and supervision:** Not all participants have implemented conduct risk assessments or have an effective conduct risk culture to identify and manage poor conduct.
- **FX mark-ups:** Some participants have opaque and inconsistent practices and monitoring of mark-ups charged to clients.
- **Last look:** Use of last look by market participants is sometimes not disclosed to the client or is difficult to understand, and is sometimes only used to benefit the participant and not the client.
- **Handling confidential client order information:** Some participants have not undertaken regular comprehensive risk assessments to ensure client information is kept confidential, and to ensure there is appropriate segregation of sales and trading staff.
- **Surveillance and monitoring:** It is vital there is clear ownership and accountability of monitoring and surveillance functions, and that there are regular 'fit for purpose' reviews of those functions.
- **Staff training on conduct risk:** Participants should ensure there is sufficient conduct risk training in place for all new starters and ongoing FX sales and trading staff.
- **Staff personal trading:** Some participants undertook no or limited oversight of staff personal trading, and had policies that were vague as to what could be traded.

In our work, participants were not reviewed for all aspects of FX market practices and the observations in this report are not attributable to all the participants that were reviewed.

Foreign exchange markets

FX is a key global market and is of systemic importance to the Australian economy.

To function effectively, the FX market relies on participants to act with integrity and fairness.

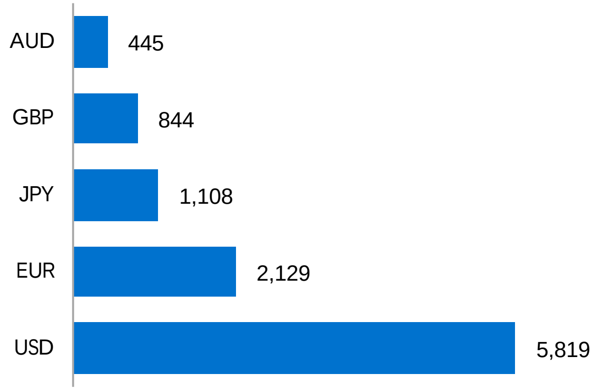
Global FX market

- As of April 2019, total global FX volume was around USD6.6 trillion per day across spot, outright forwards, swaps, options and non-deliverable forwards.

Australian wholesale FX market

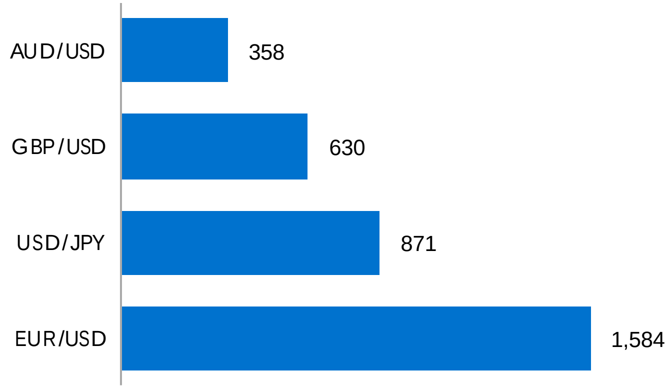
- Around 1.5% of global FX volume occurs in Australia, with the Australian dollar the fifth most traded currency in the world (around 6.8% of global volume). See Figure 1.
- The AUD/USD is the fourth most traded currency pair, trading around USD358 billion daily. See Figure 2.
- FX transactions may be used to facilitate funding or manage risk in the real economy.
- Participants (e.g. banks, investment firms, inter-dealer brokers, agency brokers and hedge funds) intermediate this activity.

Figure 1: Daily volume by currency 2019 (USD billion)



Note: See Table 1 for the data shown in this figure (accessible version).
Source: BIS Triennial Central Bank Survey of FX & OTC Derivatives Markets (PDF 558 KB).

Figure 2: Daily volume by currency pair 2019 (USD billion)



Note: See Table 2 for the data shown in this figure (accessible version).
Source: BIS Triennial Central Bank Survey of FX & OTC Derivatives Markets (PDF 558 KB).

ASIC's market supervision focus

> **We have increased our focus on wholesale fixed income, foreign exchange (FX) and commodities (collectively 'FICC') markets. We are addressing threats to these markets which may cause harm to the real economy and consumers. We have expanded our oversight to drive behavioural change.**
>
> **FX markets have been a particular focus in 2018 and 2019.**

Our oversight of FX markets in Australia

Our expectations of behaviours by participants in FX markets are informed by the FX Global Code. We note the Global FX Committee will be undertaking its first review of the code during 2020.

Our oversight of FX markets includes behaviour in spot FX markets, which is a financial product in Australia. Report 525 *Promoting better behaviour: Spot FX* (REP 525) outlines some drivers for this conduct and provides good practice principles. We also analysed some features of high-frequency trading in FX markets in Report 597 *High-frequency trading in Australian equities and the Australian–US dollar cross rate*.

This report highlights our work and a range of better and poorer practices we have observed which supplement those in REP 525. Participants should review these observations and practices and consider how the better practices may be applied in their own FX businesses to enhance their approach to managing conduct risk.

> 'We want to see a strong commitment from market participants to substantially improve their systems and controls.
>
> Cathie Armour | ASIC Commissioner

Ongoing monitoring of CEUs

In 2016–17, we accepted court enforceable undertakings (CEUs) from ANZ, CBA, Macquarie, NAB and Westpac for failing to ensure that their systems and controls were adequate to prevent, detect and respond to inappropriate conduct. The CEUs require the participants to develop programs to improve their FX systems and controls. These programs are reviewed by independent experts during their design and implementation phases. Once implemented, the participants must ensure the systems and controls are operating effectively on an ongoing basis.

Our FX work in 2018 and 2019

We reviewed the disclosure on and charging of mark-ups to clients by 11 participants. We also reviewed 'last look' to better understand market practices, trade rejection frequency and clients' awareness of this practice.

We went onsite to four participants to review their FX businesses. Our focus included handling confidential client information, surveillance capabilities, staff training and staff personal trading. We reviewed policies and procedures and a sample of surveillance alerts. We sat with control functions and sales and trading desks to review their live operations. The participants we reviewed are listed in Appendix 1.

Governance and supervision

Participants must have a sound and effective governance and supervisory framework to ensure responsibility and accountability for comprehensive oversight of their wholesale FX businesses and to promote responsible engagement in the FX market.

Focus of our work

We have closely considered the governance and supervisory arrangements of the FX businesses of the participants subject to the CEUs.

We also have a good insight into the governance practices of a broad range of participants through our broader participant supervision work. This section provides examples of practices drawn from all our work.

Poorer practices

No conduct risk assessment undertaken on the FX business to proactively manage conduct risk and compliance obligations.

Compliance and audit functions not effectively engaged in oversight, control framework design, review and assurance.

Monitoring and surveillance function undertaken by the front office with limited independent oversight and challenge.

Lack of clarity in roles between various functions.

Better practices

A strong conduct risk culture, including a 'speak-up' culture, embedded at all levels to actively identify, escalate and manage poor conduct—which is monitored through a conduct risk committee and continually reinforced (e.g. at staff 'town halls').

A formalised governance and control framework that addresses conduct risks across all FX and electronic FX businesses.

Clear delineation of responsibilities and accountability between front office, compliance and audit.

Robust compliance and audit functions that focus their reviews on risks to the Australian business and clients, that actively challenge the front office and have a strong voice that is heard by senior management.

Supervisors that are accountable for their areas of responsibility, are appropriately trained to monitor the conduct of their staff and have access to relevant and timely management information.

Strong technology and operational risk governance, with tight controls and accountability over the deployment, change and validation of electronic FX trading technology.

FX mark-ups

A mark-up is the spread or charge that may be included in the final price of an FX transaction to compensate the participant for the risks taken, costs incurred and services rendered to the client.

Mark-ups should be fair and transparent.

Focus of our work

We reviewed the mark-up practices of 11 participants, including:

- disclosure of mark-ups made to clients
- internal mark-up procedures and practices
- the methods used and steps taken to apply mark-ups
- analysing FX spot and forward transaction data for a sample period in May and June 2018 to consider the reasonableness of mark-ups charged
- performed calculations aimed at identifying mark-ups on transactions that appeared to be statistical outliers.

Poorer practices

Opaque and inconsistent mark-up practices applying to clients.

Ad hoc and manual monitoring of a sample of mark-ups.

Automated trade surveillance with no capability to identify inconsistent and unexplained mark-ups.

Better practices

Clear internal policies on when and how mark-ups may be applied.

Transparent disclosure to clients about mark-up policy and practices.

An accessible audit trail of any mark-ups applied to transactions.

Automated monitoring of trading that triggers alerts when mark-ups are outside policy/pre-identified parameters. Alerts are reviewed, escalated and appropriately remediated.

Clear procedures to deal with client complaints about mark-ups and to quickly rectify mark-up errors.

Last look

Last look is a practice in electronic FX trading where a participant receiving a trade request from a client has a final opportunity to accept or reject the request against its quoted price.

There may be increased costs for clients in re-executing a trade rejected due to last look.

There has been debate about whether last look provides an opportunity for participants to take advantage of client trading intentions.

Focus of our work

We held over 30 meetings with industry. There was generally limited understanding of last look among clients, with the practice often considered to be a ‘cost of doing business’.

During the reviews, we assessed the disclosure documents provided to clients on last look and analysed the trade request rejection statistics during calendar year 2018. We found last look rejection rates for Australian clients were around 1.5%, with high-frequency traders receiving the most trade rejections.

We will continue to monitor the practice of last look.

Poorer practices

Disclosure of last look practices to clients that was difficult to access, complex and legalistic.

Trade rejections that were limited to circumstances that benefited the participant not the client.

Long hold periods before a client was informed of a trade rejection.

Better practices

For those participants that use last look:

- clearly disclosing last look practices to clients, including the way orders are executed or rejected
- a ‘symmetrical’ last look rejection logic (i.e. a time-based throttle that rejects trade requests irrespective of whether the participant or the client receives the pricing advantage)
- making trade rejection statistics available to clients
- monitoring the use of last look, including to identify where a client’s trading intentions may be inappropriately used and taking appropriate action to discipline relevant staff.

Handling confidential client order information

There is a risk of client harm where the interests of a participant or its staff conflict with those of the client. The trading intentions of clients are sensitive, and participants must have adequate arrangements in place to manage any conflicts.

Participants should handle client FX orders in an efficient, honest and fair manner.

Focus of our work

As part of the reviews, we sat in the trading rooms of the four participants and reviewed:

› live time displays of the FX sales and trading functionality (including both voice quoting and electronic quoting)

› how order books interacted with changing market prices

› the flow of client information available to FX traders.

Through our CEU monitoring, we reviewed how the five participants are improving their controls for managing confidential client information.

Poorer practices

Sales and trading staff sitting in such close proximity that they can view one another's screens and overhear telephone conversations.

Permitting use of personal mobile phones on the trading floor without appropriate surveillance controls.

Better practices

Periodic and comprehensive risk assessments of confidential client information, who should have access and how it will be protected.

Physical segregation of sales and trading staff (e.g. enough distance that conversations cannot be overheard or computer screens seen).

System-based controls to mask client names and to limit access to client orders. Robust administration of system access permissions.

Audit trails to record who has accessed client order information.

Orders feeding into the 'fix' are handled in isolation from any influences (e.g. in a 'dark room' with no communication devices).

Maintaining a list of monitored and approved communication channels that may be used to correspond with clients, colleagues and others, including the use of personal mobile phones where there can be appropriate surveillance of communications from these devices.

Surveillance and monitoring

We expect participants to have robust systems in place to quickly identify, assess and escalate suspicious activity.

A surveillance and monitoring framework should ensure complete and accurate capture of orders, trades and communications that are traceable and auditable.

Focus of our work

During our reviews, we analysed all alerts on trades and electronic and audio communications for a quarter in 2018. We considered the surveillance methodology and selected a sample of alerts to examine how they were managed by the surveillance teams.

Through our ongoing monitoring of the CEUs, we reviewed enhancements being made to surveillance and monitoring capability.

Poorer practices

Uncertainty about ownership and accountability of monitoring and surveillance to ensure independent oversight and challenge.

Some communication channels not recorded, not monitored and not retained for a suitable period.

Large volumes of false positive alerts, suggesting that the eComms lexicon and trade surveillance algorithm required calibration.

Underdeveloped trade surveillance systems. Manual voice surveillance, with small sample sets and not risk based.

Better practices

Regular, holistic and independent surveillance 'fit for purpose' reviews.

Real-time automated surveillance of all orders, trading and communications, with the alerts monitored by well-resourced, appropriately skilled and non-conflicted staff.

Staff prohibited from using communication channels that are not approved, recorded and monitored.

Communication monitoring that captures a broad range of languages, abbreviations and commonly misspelt words. Lexicons are reviewed periodically to identify new keywords.

Random sampling of electronic and audio communications, in addition to automated surveillance systems.

Periodic review of the logic behind surveillance alerts against changing market dynamics and evolving threats to conduct.

Case study: Internal audit quality assurance

Internal audit conducted quality assurance exercises such as re-running FX order and trade data over a specified period on a different server to validate trade alert functionality. However, as the **only** review function undertaken, it was a weak review for assessing whether the surveillance capability was fit for purpose.

Staff training on conduct risk

Staff training refers to the initial and ongoing guidance that a participant mandates their staff to complete across a range of code of conduct issues.

FX training should include the legal requirements for handling confidential client information and dealing fairly for the client, as well as the FX Global Code and broader regulatory obligations.

Focus of our work

As part of the reviews we:

- assessed all internal FX-related training documentation, including exam modules
- cross-referenced the documentation against the FX Global Code, each participant's code of conduct and other relevant documents
- analysed the training logs of all FX staff.

We also reviewed how the participants subject to CEUs are enhancing their staff training.

Poorer practices

Limited FX market-specific conduct training for staff, or not refreshed for extended periods.

Better practices

Ensuring that new staff complete all mandatory training before commencing FX sales or FX trading activity.

Tailoring training to the participant's FX business and the roles of the relevant staff participating.

Ensuring training emphasises the importance of confidential client order information and the expectations on all staff to identify, monitor and escalate concerning conduct.

A learning needs assessment framework to regularly evaluate the efficacy of training materials which covers any updates in regulations and standards, risk assessments, management information and monitoring and surveillance reports, including metrics around training testing results, conduct and compliance-related incidents.

A formal program of ongoing regular face-to-face interactive workshops based around scenarios, case studies and recent FX investigations across the industry to clarify grey areas to help employees understand how to make appropriate decisions.

Steps to validate staff understanding of training, which are measured and monitored through results that are tracked and escalated.

Staff personal trading

Participants should set clear boundaries for staff personal trading to manage the potential conflicts of interest between the staff, the participant and clients.

Participants should consider the full range of information FX staff have access to and how it may inform the performance of other financial products (e.g. the share price of corporate clients).

Focus of our work

As part of our reviews, we analysed:

- staff personal trading policies
- physical layout of the dealing floors
- the personal trading records of all FX sales and trading staff.

We also reviewed how the participants subject to CEUs are enhancing their controls around staff personal trading.

Poorer practices

No monitoring or oversight of staff trading.

Staff trading policies that were vague or ambiguous as to what products could be traded, by whom, and as to holding timeframes.

Better practices

Trading policies precluding the trading of FX financial products by FX staff, any other front office staff within the proximity of the FX sales and trading desks or with access to client order information, and middle and back office staff who have system access to live FX orders.

Clear staff dealing policy requirements supported through personal attestations of compliance, pre-trade approval and post-trade reconciliations, reinforced through appropriate consequence management.

Retaining staff personal trading records.

Prohibiting any personal devices on the trading floor that may be used to place an order.

Appendix 1: Participants reviewed

The participants reviewed as part of our onsite reviews and our review of mark-up practices, as well as the participants from whom we accepted CEUs, are:

- ANZ Banking Group
- Citigroup
- Commonwealth Bank of Australia
- Deutsche Bank
- Goldman Sachs
- HSBC
- JP Morgan
- Macquarie
- National Australia Bank
- Royal Bank of Canada
- UBS
- Westpac Banking Corporation.

Appendix 2: Accessible versions of figures

This appendix is for people with visual or other impairments. It provides the underlying data for the figures in this report.

Table 1: Daily volume by currency 2019 (USD billion)

Currency	USD net notional
AUD	445
GBP	844
JPY	1,108
EUR	2,129
USD	5,819

Note: This is the data shown in Figure 1.

Table 2: Daily volume by currency pair 2019 (USD billion)

Currency	USD net notional
AUD/USD	358
GBP/USD	630
USD/JPY	871
EUR/USD	1,584

Note: This is the data shown in Figure 2.