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Comment

Regulators must ensure forex market stability

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Last month there were record volumes in foreign exchange markets as a result of announcements coming out of China.

Periods of high volatility are becoming more commonplace, such as the Swiss move to unpeg its currency from the euro in January and the Bank of Japan quantitative easing programme extension last October.

Both caused "black swan" events. Many participants' trading screens went blank and price discovery became difficult, leading to a lack of liquidity, and with participants struggling to lock in a price or trade out of a position.

On those days the FX market, which has long sought out alternative trading venues and models, returned to established central limit order book (CLOB) platforms such as Thomson Reuters' Matching and ICAP's EBS Market, highlighting the important role they play in ensuring a well-functioning marketplace.

Yet over the past 15 years, technological advances, the proliferation of high frequency strategies and the increased cost of participation in the public or "lit" markets have led to a continuous departure of quality order flow away from these venues and into alternative models like dark pools.

At the same time banks' own systematic internalisers, which use very short term proprietary trading models, have also gained tremendous economies of scale, offering effective "dark" and cheap liquidity. The bank tries to capture the entire bid-ask spread, with which the trading platforms simply cannot compete.

As a result less sophisticated market participants, who tend to have non-aggressive trading interest (often referred to in the industry as "benign"), are taking their business away from public venues and into dark ones.

As that business leaves, what is left on exchanges is concentrated among fewer and larger participants — mostly high-frequency traders and bank's own platforms — and is becoming increasingly correlated. This tends to result in larger directional moves in the market, putting one side of the trade at increased risk. Ultimately this can lead to market overreaction to smaller events and so-called "flash crashes".

However, the alternative models to central limit order books lack the transparency and depth of the lit market, and are based on voluntary "streaming" of prices by a limited and increasingly concentrated number of providers that can stop at any second. Their flow is inherently less resilient, particularly in times of market stress.

With the Bank of England's recent Fair and Effective Markets Review, and other regulators and central banks turning the spotlight on the FX markets, I am heartened to see a greater appreciation for the CLOB model.

The market relies on them in volatile conditions for their robustness, certainty of execution, two-way prices and, ultimately, liquidity. The problem is that fewer and fewer participants can rely on these platforms at these times as over the years they have left them in favour of alternatives.

The key question is how to maintain the existence and depth of the central lit order book while preserving innovation and entrepreneurship in the market.

The futures industry attempted to address this through regulation — prescribing that futures may only be traded on a lit exchange. This has resulted in global monopolies in specific instruments, with tremendous concentration around a few sophisticated players, and perpetuates the problem instead of resolving it.

Similarly, the heavily regulated and prescriptive equity market has suffered from unintended damage through the introduction of regulations like Regulation National Market System. However, changing such regulation takes years and once the next prescriptive changes are implemented, market participants will naturally seek out and exploit opportunities and loopholes.

In the end the ultra-prescriptive models play into the hands of the most sophisticated participants who learn how to game them, because it then takes so long to change the rules of the game.

The agility and competition that is allowed to thrive in less regulated or prescribed markets, such as FX, is beneficial to the market where new models are constantly developed.

This keeps established players on their toes in the fight for market share, liquidity, fairness and innovation. It is critical that resilience during extreme events must be ensured and that the access to these few, central lit public markets is wide.

Implementing regulation in a lightly regulated sector is clearly a delicate balancing act. As the regulatory debate proliferates over the coming months, regulators must look closely at the intricacies of the FX market and strive to safeguard a fair, open and diverse industry, which can innovate and truly compete for clients' flow.

We must ensure that deep, non-correlated liquidity, able to withstand large events still exists in major lit and public pools to maintain the effective functioning of the market.

A continuous, trustworthy market and price at the end of the day is a public good.

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