

# How Should FX Work?

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## The Standard Business Model

Business models employed in capital markets are designed and constructed for competition. Competition is the key ingredient required to maximize value for clients; remove this ingredient from the trading process and clients will likely be disadvantaged. In order to ensure that competition is a part of the trading process clients should employ an agent with expertise in the field, working on their behalf, and with interests clearly aligned with their goals.

## Serving Two Masters

The single-venue principal trading model for FX is an example of how client value can be eroded when the trading process lacks competition and alignment of interest. In contrast to most securities markets, there is no exchange or common regulator charged with defending the rights and interests of clients when converting currency (FX). As a fully “OTC” market, the commercial, investment and custodial banks need not print trades to the market, or satisfy most if any of the “best execution” practices demanded while trading other instruments such as equities or futures.

Those firms that have large client-facing FX businesses are also the primary participants in the FX market. Without a traditional commission mechanism, the revenue producing part of those firms is the principal or risk based execution desk. This desk makes money from trading, and is conflicted when it comes to offering the best possible execution for client orders. Simply stated, the poorer the execution quality for the client, the more profitable the transaction for the provider. There is no agency structure in place within these firms – the “advisory” element of the service provided is essentially a front end for the trading book, which relies upon making money from trade flow.

This single source principal trading model places the provider’s interest in direct opposition to the client’s interests. As we witnessed years ago in the US OTC equity markets, this principal only market can be challenging for the client, as they can end up with poorer quality execution.<sup>1</sup> It is also challenging for the FX provider, as they are tempted to adopt practices that are profitable in the short term but that might appear less than ideal in the light of day.

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<sup>1</sup> Security Exchange Commission Display Rule, 1996. Code of Federal Regulation 240.11Ac1-4. The Display Rule requires exchange specialists and OTC market makers to display in their quotes customer limit orders that improve the price or add to the size of their quotes. The Display Rule was designed to overcome reluctance of market makers to immediately display eligible customer limit orders. Before the rule, market makers could hold an order, giving the market maker time to determine whether it could profit by executing as a principal. Market makers were also disinclined to display limit orders if the order would narrow the market maker’s spread.

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## Who Speaks For The Client?

The core problem that clients face is simple: At the moment when the price at which an FX trade is set, someone has to be at the table representing the client. They need an agent. This, combined with transparency and disclosure, is the best way for clients to be sure that they are getting the best result possible.

## An Agent: The Voice Of The Client

In active markets, like FX, the agency structure offers significant advantages to the clients, but limits the profit potential of firms trading on a principal basis with their clients. This makes it a very rare model in the FX market today. We believe that the ideal process for FX execution involves the following components.

- **Full third-party process**  
The client is best represented at the point of trade by an agent. No matter how the order is executed it should be done in a clear, arms length way with the client's interests protected throughout<sup>2</sup>.
- **FX execution a value-added exercise not pure administration**  
Firms that invest in currency as an asset class typically devote significant resources to managing FX transaction costs. However, for those firms executing FX simply to settle security trades, the FX execution process must be seen as something more than an administrative part of the settlement process. Executing FX orders is a process that can add (or detract) value, and involves a significant investment in resources (trading infrastructure, personnel and risk management and settlement systems) and the exercise of investment skill in the same way as equity or fixed income execution.
- **Clear audit trail**  
The client should have access to a full audit trail for all orders, so they can track each appropriate stage of the process. One can only manage what one can measure.
- **Total transparency**  
It should be clear to the client exactly what has happened throughout the execution process, and how the execution was handled by the agent during each step. Detailed performance reports provided to the client provide the transparency needed.
- **Full time stamps**  
Clear time stamps should be available indicating exact times orders were received and executed, allowing the client to perform detailed execution quality analysis relative to the market price at the time of the trade.

In Russell's view, a process of this type produces the best value for the client.

<sup>2</sup> Some Money Managers for Russell Funds process their own FX trades and may do so in a manner other than the agency FX model.

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**For more information:**

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