KEY POINTS

- Key considerations in determining whether "last look" meets regulatory requirements will be: (i) adequate disclosure before and after the trade; and (ii) whether "last look" operates symmetrically or asymmetrically.
- Under the Global FX Code, knowledge of the client's trading intentions derived from the making of a Request for Quotation (RFQ) is confidential information, exposing the bank to a private law damages claim for misuse of that information.
- From a purely private law perspective, careful drafting of the terms and conditions governing the use of an automated trading platform will reduce the risk that a bank is under a duty to the client in the exercise of a right to reject an RFQ.

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Legal issues arising from the use of automated FX trading platforms

This article considers legal issues which may arise from the use of automated FX platforms, and in particular those arising when the bank seeks to reserve the right not to complete the trade when the client has placed a Request for Quotation (RFQ), or makes use of its knowledge of the client's trading intentions in advance of concluding the transaction. The regulatory and private law implications of such conduct are considered, including in the light of the Global FX Code, as well as the status of contractual terms seeking to maximise the bank's freedom of manoeuvre.

INTRODUCTION

Many banks offer facilities for FX trading on automated platforms. Users of the platforms generally sign up to a set of standard terms of conditions, and then seek to place FX orders through the platforms either with the "host" bank or with third parties who are also trading on the network by submitting an RFQ. However, the operation of some FX trading platforms has resulted in litigation or regulatory intervention. Prominent among the complaints that have been made are:

- The scope and effect of provisions in the terms and conditions allowing the bank not to complete a transaction for any reason after the RFQ has been received.
- The legitimacy of a so-called "last look", under which the bank reserves the right not to complete the order if the spot rate for the currency moves against the bank after the RFQ is received.
- The use which the bank can reasonably make of the knowledge derived from the placing of the RFQ when trading for its own purposes, whether to hedge the client's order or to profit from the move in the spot rate which is expected to result from completing the client's trade.

These issues have surfaced in litigation in the US brought against Deutsche Bank concerning its Autobahn FX trading platform (*Axiom Investment Advisors LLC v Deutsche Bank AG*[1]), and against Barclays concerning its Bar-X platform (*Axiom v Barclay*[2]). District Judge Lorna Schofield issued rulings striking out some of the claims in the *Deutsche Bank* case, but refused to dismiss the claims outright (Order and Opinion of 13 February 2017[3]). The *Barclays* case was the subject of a court-approved settlement, and a consent order with the New York State Department of Financial Services.[4] There are also signs of potential future litigation in the English courts.

This article considers the regulatory and private law exposures which may result from automated FX trading platforms, in particular in the light of the Global FX Code published in 2017.

"LAST LOOK" AND PRE-HEDGING

When considering the issues which can be thrown up by automated FX trading platforms, it can be important to distinguish between "pre-hedging" and "last look". "Pre-hedging" is, in broad terms, where the firm uses the information about its client's prospective trade to manage its own risk in the event that it accepts the client's order. "Last look" is, in equally broad terms, a process by which the firm is given a short time to decide – after a trade request has been submitted by a client at a quoted price – whether to accept or reject the trade. This period may be measured in milliseconds.

Both "pre-hedging" and "last look" can serve entirely legitimate functions. For example, they enable a market maker to offer more favourable pricing, because they do not need to widen the spreads to absorb the risk of movements in the market. They can also avoid latency arbitrage – that is, they can prevent traders using super-fast technology to "snipe" rates quoted on a platform just before the platform can withdraw the price, knowing that the price has already moved. This was the case in *Daniela Shurbanova v Forex Capital Markets Limited*,[5] in which the trader used the latency of a slow FX trading platform to trade on the basis of price-moving news which had been released to the market but was not yet reflected in the platform's pricing. "Last look" can also avoid the risk of larger orders being split between sellers in an attempt to avoid the less favourable unit price charged for large single orders as against smaller orders or collections of smaller orders. However, they can also give rise to concerns. The bank's ability to reject an RFQ which the client is not entitled to withdraw creates an obvious problem: if the client has, for example, indicative prices from three banks with one offering a marginally better rate, it suffers a detriment if it submits a trade request to the bank quoting the most favourable price only to find, once that trade is rejected, that it has lost the opportunity to fill its order from the other banks at only marginally worse rates. The processes can also be operated in a manner which deliberately disadvantages clients. For example, a firm might impose a short delay before deciding whether to accept a trade request – and then accept a trade

where the market has moved in its favour but reject a trade where it has moved against it: a "heads I win, tails you lose" situation.

On its face, a pre-hedge, in which the bank looks to cap its exposure on the client's trade and "lock in" a profit, seems unobjectionable. But what happens if a bank has executed a "pre-hedge" during the period of delay before the client's order is confirmed, but still rejects the trade where the market has moved against it – taking for itself the profit on the "pre-hedge" and thereby trading risk-free at the client's expense? Further, in certain cases, the "pre-hedge" (or even attempt to pre-hedge) could itself move the market against the client whose order has been rejected, leaving it in a worse position than before it placed the order.

> ... the "pre-hedge" ... could itself move the market against the client whose order has been rejected, leaving it in a worse position than before it placed the order.

THE REGULATORY IMPLICATIONS

Spot FX is generally outside the FCA's regulatory perimeter – such trading is not generally a "regulated activity" for the purposes of the FCA Handbook, although these transactions can constitute "ancillary services" when connected to the provision of investment services (eg when selling currency to buy a regulated financial instrument, such as a bond).

However, the Principles do apply to FCA-authorised persons when acting in FX trades, especially:

- Principle 5: a firm must observe proper standards of market conduct;
- Principle 6: a firm must pay due regard to the interests of its customers and treat them fairly;
- Principle 8: a firm must manage conflicts of interest fairly, including as between itself and its customers.

The Principles do not give rise to a right of action under s 138D FSMA 2000, even in respect of a private person. It is notoriously difficult to rely on the Principles as giving rise to any other form of civil law claim. However, failure to adhere to them can lead to very substantial penalties – as was the case with the penalties totalling £1.1bn issued by the FSA in November 2014 relating to voice trading on the FX markets.[6]

A real difficulty is the limited guidance available as to how those Principles will be applied to electronic FX trading – particularly because there are no *specific* rules, as would apply to regulated instruments. However, there are indicia as to the FCA's likely approach.

The FCA issued a Final Notice to Morgan Grenfell in 2004 which concerned (non-electronic) trading in shares where, having provided a quotation in a blind bidding exercise, Morgan Grenfell pre-hedged in a manner which significantly moved the price prior to the strike time. The FCA concluded that Principles 6 and 8 permitted a firm to have *reasonable participation* in the market prior to executing the client's trade, but found that:

- the firm is constrained in the use that can be made of the information provided by the customer;
- it must have in place systems and controls that seek to minimise the impact of pre-hedging on the client; and
- it must ensure that customers are adequately informed of pre-hedging and the impact it may have.[7]

The key considerations with "last look" are likely to be:

- fairness; and
- transparency.

Adequate disclosure will be key – both pre-trade (of the existence of "last look") and post-trade (regarding the rejection of trades due to the application of "last look"). The FCA are likely to look at whether the information allows an informed choice as to which market marker/platform to use. Algorithms will need to be carefully "tuned" to balance legitimate protection against excessive rejection rates, for example as regards:

- the period of delay before "last look"; and
- the "tolerance" in terms of movement. Differentiation by type of customer and trading history may well be appropriate.

For example:

- "last look" to verify that the price has not moved significantly during the delay between putting a price up on the platform and receiving the trade request may well be justifiable; but conversely
- having a relatively long "last look" period to allow the firm to place a series of passive buy orders at rising prices in an attempt to maximise the firm's profit may well be objectionable.

Symmetrical "last look" – where a trade will be rejected if it has moved beyond a tolerance either for *or against* the firm – is likely to be far more easily justified than asymmetrical "last look". An example of regulatory action in this sector, albeit in the US, is the Consent Order concluded between the New York State Department of Financial Services and Barclays in November 2015, with a substantial fine for the use of asymmetric "last look".

Key findings were that:

- "last look" was not applied merely defensively to address, eg latency arbitrage but, effectively, to reject unprofitable trades and keep profitable trades; and
- the process was not used transparently (eg "last look" was not mentioned when trades were rejected).

"Pre-hedging" during the "last look" window is, perhaps, the most difficult area facing banks now. In September 2017 HSBC Holdings Plc was fined US$175m for "unsafe and unsound practices" in its FX trading business. The Federal Reserve Board concluded, among other things, that HSBC had failed to detect and address its traders misusing confidential customer information to conduct FX trades in a manner that benefited the bank and caused detriment to the client.

At one end of the spectrum, ongoing risk management in a liquid currency pair

by reference to the overall exposure of the market participant – actual and anticipated – is unlikely to be objectionable. At the other end of the spectrum, "pre-hedging" the specific RFQ and then rejecting a trade is likely to give rise to real difficulties: this is certainly likely to be perceived by the FCA as "front running".

THE GLOBAL FX CODE

This was a topic of controversy in the run-up to the finalisation of the Global FX Code published by the Bank for International Settlements' Foreign Exchange Working Group in 2017.[8] The Code sets out broad principles rather than detailed rules. It sets out three general principles under the heading "Ethics", and four under the heading "Governance", but the most relevant parts for present purposes appear in the section on "Execution".

Principle 11 provides that:

> "a Market Participant should only Pre-Hedge Client orders when acting as a Principal, and should do so fairly and with transparency."

The accompanying commentary says pre-hedging is permissible:

> "for such purposes and in a manner that is not meant to disadvantage the Client or disrupt the market."

There is a strong emphasis on market participants communicating their pre-hedging practices to clients.

Principle 17 addresses "last look". Contrary to some expectations, it does not seek to prohibit the practice altogether but provides that:

> "Market Participants employing last look should be transparent regarding its use and provide appropriate disclosures to clients."

At a minimum, this requires disclosure of whether and how changes in price in either direction may impact the decision to accept or reject the trade, how long it is expected to take to reach the decision, and the Market Participant's purpose in using "last look".

The Code identifies an acceptable purpose of "last look" as a risk control mechanism in order to verify validity (that the transaction details are operationally appropriate, that there is sufficient credit available to the client to enter into the transaction) and price (whether the price at which the request was made remains consistent with the current price available to the client). By contrast, "last look" is not acceptable when undertaken for the purpose of information gathering, with no intention to accept the client's request to trade.

The Code addresses the issue of "last look" as involving the handling of confidential information. It provides that "Confidential Information" arises from the receipt of a trade request at the start of the "last look" window, which information must be handled in accordance with Principles 19 and 20 on Information Sharing. It states that during the "last look" window, trading activity utilising that information, *including hedging*, is likely to be inconsistent with good market practice because it may signal the client's trading intentions to other market participants, and move the market against the client.

The Code does not, in and of itself, have any legal status. However, many regulators and central banks have made it clear that they are going to seek to force adherence in practice. It is likely to be taken into account by the FCA in applying the Principles. Further, the FCA have made it clear that they expect such codes to be embedded into firm's internal controls. The FCA said that it sees such codes as evidence of "proper standards of market conduct" (COCON 2.1.5R), with which senior managers are required to comply as part of the Individual Conduct Rules which apply to all activities, whether or not regulated. COCON 4.1.15G goes on to state that compliance with relevant market codes will tend to show compliance with COCON 2.1.5R. The FCA statement welcoming the publication of the FX Code noted that "standards can be a useful way for the industry to police itself" and that it expected "firms, Senior Managers, certified individuals and other relevant persons to take responsibility for and be able to demonstrate their own adherence with standards of market conduct".[9]

> Classification of the bank's conduct as an abuse of the client's confidential information will open the way to restitutionary as well as loss-based remedies.

PRIVATE LAW CLAIMS

The classification by the Code of the knowledge which a bank acquires through an automated FX trading platform of the client's trading intentions as confidential information provides a possible basis for a private law claim for damages for loss caused by a bank's (mis)use of that knowledge. There is support for that approach in existing case law. In *Brandeis (Brokers) Limited v Black*,[10] Toulson J described front-running as "a particular form of misuse of confidential information". In the recent decision in *The ECU Group Plc v HSBC Bank Plc*,[11] pre-action disclosure was ordered in respect of a potential claim for front-running against the bank. The potential causes of action referred to at [30] included breach of confidence, breach of contract and conspiracy.

There is something to be said for the view that the real vice of front-running lies not so much in the use of the information *per se* but in the act of disloyalty inherent in the causing of deliberate harm to the client, and there may be a residual use for an implied term of loyalty or good faith in those cases in which the knowledge of the client's trading intentions loses its confidential character, but the bank deliberately acts contrary to the client's interests. However, particularly in the light of the Code, a claim based on the misuse of confidential information is likely to be the principal cause of action used.

Classification of the bank's conduct as an abuse of the client's confidential information will open the way to restitutionary as well as loss-based remedies. This might involve an

account of the bank's profits from using the information (*Peter Pan Manufacturing Corp v Corsets Silhouette Ltd*[12]) or, in cases where the use was inadvertent rather than conscious, payment of an amount which reflects the market value of the information used (*Seager v Copydex Ltd (No 2)*.[13]

In some cases at least, the relatively low level of losses (or disgorgable profits) which are likely to result from misuse by a bank of its knowledge of a client's trading intentions may make civil actions for such relief an unattractive venture. An alternative approach might be to advance claims based on express or implied representations as to how trading on the automated platform would be conducted, which could be said to be falsified by general practices within the bank as to the use of client information or a "last look" feature. This would provide a basis for seeking to recover any loss incurred in the transaction under s 2(1) of the Misrepresentation Act 1967 (at least for so long as the controversial decision in *Royscot Trust Ltd v Rogerson*[14] that all loss sustained in a transaction entered into in reliance on a misrepresentation is recoverable under the Act remains good law). This has been the basis on which claims relating to the alleged fixing of LIBOR have principally been advanced, although successful recovery depends not only on establishing the representations and reliance (cf. *Property Alliance Group Limited v Royal Bank of Scotland Plc*[15]); it may be open to the bank to show that, if the client had not completed the spot trade through the online platform, it would have entered into a similarly loss-making transaction in any event (*Yam Seng Pte td v International Trade Corp Ltd*[16]).

THE SIGNIFICANCE OF CONTRACTUAL PROVISIONS

In order to preserve some form of "last look" opportunity for the bank, the terms and conditions regulating the use of the automated FX trading platform may expressly preserve a right on the bank's part not to execute a given trade upon receipt of the client's RFQ. In the action brought by Axiom against Deutsche Bank, the bank's terms provided that it could execute or reject a customer's trade "at its discretion in accordance with the criteria set forth in this agreement". Those criteria included (among other things) that "the price shall have expired or has been withdrawn" in the time gap between receipt of the RFQ and the decision whether or not to execute. In the electronic trading context, the gap is measured in milliseconds.

The contractual provision might be analysed in two ways. It might be treated as a provision which defines the point at which any form of contract comes into existence – in much the same way as a "subject to contract" provision might do, making it clear that there was no contract between the bank and the user of the platform until a trade was executed. Alternatively, it might be said that some form of contract comes into existence as a result of the client using the system in the knowledge that terms and conditions attach to its use, and that the bank's right to complete or reject the trade is a form of contractual discretion. In this regard, it is interesting to note that the Code describes the bank who has a "last look" provision as having "sole discretion, based upon the validity and price check processes, over whether the Client's trade request is accepted or not" (Commentary to Principle 17). Forms of wording which point to one or other of these analyses are set out below.

> "Prices communicated on our website do not constitute offers to trade but are indications of interest only. Your electronic trade request constitutes an offer. The firm may accept or reject that offer."

This wording would suggest that the process involves no more than a simple decision whether or not to contract. It does not of course mean that the bank would be freed from its regulatory obligations, but as a matter of contract it is probably as close as the bank could get to securing the right to engage in last look for whatever reason it may wish to do so.

> "We may execute or reject your trade instruction at our [sole] discretion … in accordance with the criteria set forth in this agreement. Such criteria include that the price shall have expired or has been withdrawn, intervening price moves, market disruptions or other unusual market conditions."

This language would suggest that an existing contract between the parties has conferred a discretion on the bank. The discretion might be untrammeled (which would be arguable if the provision contains only the first half of the above example), or it may only be exercised if particular circumstances have arisen (as in the remaining part of the example). In the former case, sometimes referred to as an absolute right, a court is unlikely to imply terms limiting the reasons why the discretion might be exercised.[17] In the latter case, the exercise of the contractual discretion is likely to be subject to common law controls: in summary that it must be exercised in good faith and not arbitrarily, capriciously, perversely or irrationally, or for an improper purpose, to adopt different phrases employed in the cases.[18]

There is some indication in *Braganza* (though a case decided in a different factual context, that of employment) that the courts may be willing to police whether the decision-maker has taken into account all relevant factors and ignored irrelevant ones. If a bank had taken into account price movements with a view only to benefiting itself and regardless of the consequent detriment to the client, that would open up an argument that this is an improper exercise of discretion.

Finally, in this context, there may be room for doubt in a given case as to whether the preconditions for the exercise of discretion have been met in the first place – for example, whether market conditions which have arisen are "unusual" or constitute a "disruption". These are objective questions, the assessment of which will not typically involve any discretion on the part of the bank, but an objective question for the court.

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"The 'last look' process will be applied as follows: the refreshed price is compared to the trade request price. If the refreshed price is within X of the trade request price, the firm will accept the trade request. If the refreshed price is higher or lower than the trade request price by more than X, the firm will reject the trade request."

This wording sets out a single pre-defined criterion by reference to which the bank is entitled (indeed, is required) to carry out the "last look" process. The bank has no discretion one way or another: either it is required to accept the client's RFQ, or it is required to reject it.

STATUTORY CONTROLS

There are two potential sources of statutory control over a bank's terms and conditions. First, s 3(2)(b) of the Unfair Contract Terms Act 1977 Act prevents a contracting party from claiming to be entitled:

- to render a contractual performance substantially different from that which was reasonably expected of it; or
- to render no performance at all in respect of the whole or any part of its contractual obligation.

For contracts concluded after 1 October 2015, it applies only if the client is a professional trader. It would be necessary to determine whether there is any obligation at all, and, if so, what contractual performance (if any) is reasonably to be expected of the bank in circumstances where it decides, as a result of a "last look", not to accept a client's RFQ. This will depend on the proper analysis of the terms, including by reference to the factors considered above.

Second, the Consumer Rights Act 2015. Pt 2 of the 2015 Act applies to all contracts between a "trader" and a "consumer", ie a "consumer contract" (s 61). "Consumer" is defined in s 2 as an individual acting for purposes that are wholly or mainly outside that individual's trade, business, craft or profession. Where it applies, the 2015 Act provides in s 62 that "unfair terms" are not binding on the consumer. A term is unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations under the contract to the detriment of the consumer. Schedule 2 gives as examples of terms which may be regarded as unfair:

- A term which has the object or effect of making an agreement binding on the consumer in a case where the provision of services by the trader is subject to a condition whose realisation depends on the trader's will alone (para 3). A term giving a bank a right to engage in "last look" may have this object or effect.
- A term which has the object or effect of authorising the trader to dissolve the contract on a discretionary basis where the same facility is not granted to the consumer (para 7). Whether the rejection of a trade following "last look" constitutes dissolution of a contract will depend in part on whether the proper analysis is that a contract is formed on receipt of an RFQ by the bank or not until the trade is actually executed.

CONCLUSION

New methods of business invariably bring in their wake the challenge of adapting existing legal rules to new situations, and ensuring that technological advances are not used to procure illegitimate commercial advantage. As is clear from the *Shurbanova* case, this can present a moral hazard for banks operating FX trading platforms as well as for those who trade on them. The experience of automated FX trading to date suggests that regulators will not lack effective tools to sanction unacceptable market behaviour, but that viable private law remedies for clients with legitimate complaints about the operation of such platforms may be more difficult to fashion. ■

1 US District Court, Southern District of New York, No 15-09945.
2 US District Court, Southern District of New York 15-cv-9323.
3 https://law.justia.com/cases/federal/district-courts/new-york/nysdce/1:2015cv09945/451471/86/
4 http://www.dfs.ny.gov/about/ea/ea151117.pdf
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6 https://www.fca.org.uk/news/press-releases/fca-fines-five-banks-£11-billion-fx-failings-and-announces-industry-wide
7 https://www.fca.org.uk/publication/final-notices/m-grenfell_18mar04.pdf
8 https://www.globalfxc.org/docs/fx_global.pdf
9 https://www.fca.org.uk/news/statements/fca-statement-publication-fx-global-code
10 [2001] 2 All ER (Comm) 980 at [30].
11 [2017] EWHC 3011 (Comm).
12 [1964] 1 WLR 96; *ECU v HSBC* at [30].
13 [1967] 1 WLR 923.
14 [1991] 2 QB 297.
15 [2016] EWHC 3342 (Ch), [2018] EWHC Civ 355.
16 [2013] EWHC 111 (QB), [210]-[218].
17 *Shurbanova* at [91]-[93].
18 See for example *Braganza v BP Shipping Ltd* [2015] 1 WLR 1661).

Further Reading:

- The foreign exchange fix: the reality (2014) 6 JIBFL 355.
- Electronic notifications in the foreign exchange prime brokerage market (2012) 3 JIBFL 154.
- LexisPSL: Financial Services: The FCA's FX Remediation Programme.