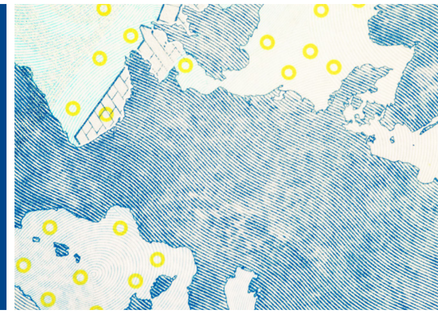
Mesirow

Currency solutions Q&A: Fiduciary FX



1. What is fiduciary foreign exchange?

Fiduciary foreign exchange is an enhancement of the agency foreign exchange approach for trading foreign exchange to settle international trades, to convert foreign income such as dividends, and to hedge currency risk.[1] An agent trades on behalf of its client (typically an institutional investor such as an asset owner or asset manager), seeking the best terms at the time of the transaction. The agent is compensated with an agreed-upon fee for its service. An agent who is also a fiduciary has an ethical and legal responsibility to act in the investor's best interests. Agency and fiduciary roles contrast with principal dealing, the traditional means for trading foreign exchange.

2. What is principal trading?

A principal, or market maker, uses its own capital to trade with its customers. Because the principal is dealing from its own account, it has an incentive to get the best deal for itself. Unfortunately, a good deal for the market maker is a bad deal for the customer.

3. What is the fee for Fiduciary FX and how does that compare to fees for principal trading?

A fiduciary will trade for a fully disclosed nominal fee. The fiduciary will provide trading reports so that customers can verify the fiduciary's pricing. Principal trading can vary broadly from just a few basis points to double-digit basis points, depending on certain factors such as the type of trading (e.g., converting dividends is more expensive than trading to settle a security transaction) and whether the investor negotiates the transaction or allows the principal to trade without oversight.

4. Given the wide range in costs, why trade with a principal and not the fiduciary?

An investor might trade with a principal because of convenience and simplicity. Given the profits in trading, principals make it easy for investors to trade with them. It's much like shopping at a convenience store: efficient, but expensive.

5. How does Fiduciary FX work?

At its simplest, an investor sends an order to the fiduciary. The fiduciary manages the trading and settlement of the order. At the end, the fiduciary sends the trade results back to the investor so that the investor can update its systems and accounts.

More specifically, agents will net the order with other investor activity, minimizing the amount that has to be traded in the market and keeping costs low. The fiduciary will seek the best price possible given constraints with the order. When the deal is done, the fiduciary sends an electronic message to the investor's custodian so that the custodian is prepared to exchange currencies on settlement day. The fiduciary manages the settlement process, addressing issues that might arise. Periodically, the fiduciary provides a third-party transaction cost analysis report, giving the investor an objective assessment of the fiduciary's effectiveness.

The investor doesn't participate in the process except to deliver orders and receive the execution results.

6. Sounds straightforward. But what if something goes wrong?

Assuming the order was accurate, the fiduciary is responsible for issues that arise from its trading and settlement efforts. That responsibility extends from order receipt to settlement to delivery of the execution results to the originator of the order.

7. Getting back to the differences between principal and fiduciary; maybe a principal's convenience and simplicity makes trading with it worthwhile. What trading complexities do Fiduciary FX participants face?

Fiduciary FX trading can be more complex because the fiduciary trades with many banks on behalf of several customers. However, fiduciaries can appropriately manage that complexity (and thus decrease operational risk) by investing in technology, systems and staff and designing its trading processes to minimize the risk of error. The fiduciary has an incentive to manage complexity and risk because customers will typically hold the fiduciary responsible if an error occurs.

8. So a fiduciary can offer low costs and keep risk under control. What are some other benefits?

One benefit is reporting. Reporting is a key component of a well-managed trading program. Quality reporting describes how much has been traded, with whom the fiduciary traded, and at what cost. More detailed information shows each transaction and the associated cost. Comprehensive information helps investors manage an important component – foreign exchange trading – of its overall trading program. Some agents may provide their own transaction reports, but clients should require a report from a third-party for an unbiased and objective view of the fiduciary's trading expertise.

9. What else is important in currency trading?

We believe agency trading is superior to principal trading, and many other investors do too.[2] Principal traders have responded to the loss of business to agency trading by developing an agency offering.[3] That may be a legitimate service, but investors have to be careful because banks that offer agency and principal trading services may have conflicts of interest. That is because the bank is managing its own risk as well as the risk of its clients. Make sure to read the fine print in the agreement. Ask questions to ensure that the agent is a 'pure' one (meaning the agent doesn't trade with an affiliated desk) and that clear barriers exist between the principal and agency trading units to avoid information leakage and or market manipulation.

10. The potential conflict between agent and principal sounds a bit worrisome. What can I do about it besides reading the fine print?

We think agency trading is popular because it improves the trading experience. Investors might gain additional confidence that their investment requirements are being handled with the investor's interest foremost in the service provider's mind by hiring an agent who is also a fiduciary. By choosing a fiduciary to manage assets, asset owners can be more confident that the service provider has an ethical as well as legal responsibility to put the asset owners' interests before the interests of the service provider.

Investors should also require foreign exchange service providers to be signatories to the FX Global Code, globalfxc.org/docs/fx_global.pdf, a set of global principles of good practice in the foreign exchange market.

About Mesirow

Mesirow is an independent, employee-owned financial services firm founded in 1937. Headquartered in Chicago, with locations around the world, we serve clients through a personal, custom approach to reaching financial goals and acting as a force for social good. With capabilities spanning Global Investment Management, Capital Markets & Investment Banking, and Advisory Services, we invest in what matters: our clients, our communities and our culture.

To learn more, visit mesirow.com or contact Joseph Hoffman at 312.595.7019 or joseph.hoffman@mesirow.com.

1. As an example, suppose a foreign investor buys a Japanese security on a Japanese exchange. The investor would need to pay yen for the security and so would sell its home currency (say euros) and buy yen. The fiduciary manages this trade (sell EUR and buy JPY) on behalf of the investor. When the investor sells the security, the fiduciary would do the reverse trade: sell JPY and buy EUR for the investor's account.

2. Bakie, John. "Benchmark Change Drives FX towards Agency Model." The Trade, 16 July 2015, www.thetradenews.com/Asset-Classes/Foreign-exchange/Benchmark-change-drives-FX-towards-agency-model/.

3. Baert, Rick. "Shadow of MiFID II is Falling on FX Trading Transparency." Pensions & Investments, 11 December 2017, http://www.pionline.com/article/20171211/PRINT/171219956/shadow -of-mifid-ii-is-falling-on-fx-trading-transparency.