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Printed in the UK by Chris Fowler International, London. Published by Incisive Financial Publishing Limited
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ISSN 1050-0782.

EDITOR'S LETTER: SHOW TIME FOR FOREIGN EXCHANGE

Foreign exchange markets are leading the way in the breakdown of global asset correlations that have characterised financial markets in recent years. And with trading costs rising in traditional asset markets, currency could end up being the best way to express a trading view.

Certainly this is the conclusion drawn by a growing pool of platforms, vendors and asset managers, which have piled into the market with a series of new products and services aiming to take advantage of the anticipated rise of foreign exchange. In *Tailored trading*, we speak to new entrants aiming to ensure their survival by introducing a unique way of trading that could bring in uncorrelated flow.

Meanwhile, as the relationship between China and the African continent expands, we look at the role of the offshore Chinese renminbi in settling the rising cross-border trade, in *The Chinese way*.

However, the major shake-up this year comes in the form of implementation deadlines for the Dodd-Frank Act. As of April, end-users will have to report any inter-affiliate swap trades to swap data repositories. In our cover story, *Balancing the books*, we look at how far corporates have come in preparation, and what impact the act will have in the use of derivatives for risk management.

SAIMA FAROOQI, EDITOR

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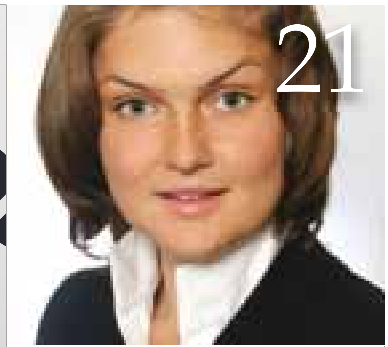
INSIDE



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NEWS

Publication of active funds list causes furore

The publication of a list of active funds by sister publication *Risk* caused a furore in February, after some of the named institutions complained the information was supposed to be confidential, and others realised they had incorrectly classified themselves via an industry portal run jointly by Markit and the International Swaps and Derivatives Association. Active funds were one of three classes of over-the-counter derivatives user caught out when mandatory clearing for OTC swaps started in the US on March 11.

After the publication of the list – which was provided to *Risk* by a bank and named 77 fund managers that own 215 self-classified active funds – on February 15, Isda, Markit and *Risk* received calls from funds claiming they did not belong on the list. In two of these cases, *Risk* was able to establish that firms had incorrectly selected the active fund option from a drop-down menu on the portal – known as Isda Amend – which allows buy-side firms to adhere to documentation necessary for dealers to comply with Dodd-Frank Act business conduct rules.

Those two managers are Manulife Asset Management and Salient Partners. The State Teachers Retirement System of Ohio also contacted *Risk* saying it was not an active fund, although it could not clarify how it had ended up on the list.

If there was confusion about the status of some of the managers on the list, there was also anger that the list had been leaked in the first place. After the story appeared, Markit sent an email to all users of Isda Amend, reminding them that information exchanged via the service must remain confidential.

> Isda, Markit and *Risk* received calls from funds claiming they did not belong on the list

"Markit is also concerned by the potential impact on clients using Isda Amend, as we have received numerous calls from concerned clients about their data not being held confidential. If this concern becomes widespread, it could hinder further adoption of Isda Amend and push clients towards a paper solution, adding to your operational burden," the email warned.

After removing the funds that contacted *Risk*, the active funds list now includes 209 legal entities belonging to 74 funds, rather than the 77 initially thought, including well-known managers such as Capula, Bluecrest, Soros Fund Management, Moore Capital and Tudor. That reflects entities that had classified themselves as active funds as of February 7, and their numbers may have grown since then.

On February 13, Markit had sent a note to Isda Amend users highlighting the importance attached to active fund status and urging users to provide a response if they had not already done so. "In order to minimise the likelihood that your trading with swap dealers could be interrupted, it is advised that you consider responding 'Yes' or 'No', as appropriate, to the question well in advance of March 11, 2013."

An active fund is defined by the Commodity Futures Trading Commission as a private fund – other than the third-party sub-accounts belonging to big asset managers – that executes an average of 200 or more swaps per month over the 12 months leading up to March 11, 2013.

Lukas Becker and Matt Cameron

CME launches three-year CNH futures contract

CME Group has announced it will offer CNH futures contracts with tenors of up to three years, to meet demand from offshore dim sum bond investors looking to hedge their foreign exchange exposure.

Before the launch of the standardised exchange-traded futures contracts, market participants had used the offshore RMB deliverable and non-deliverable forwards (NDF) market to hedge their RMB exposure or speculate on RMB movement.

As part of a broader expansion of renminbi risk management tools, CME Group launched physically delivered futures contracts on offshore Chinese renminbi (USD/CNH) on its Globex platform on February 25.

CNH refers to the pool of offshore renminbi circulated in Hong Kong. The exchange now offers two contract sizes, $100,000 and $10,000, which will allow for more flexible hedging, CME says.

The launch of USD/CNH futures on CME is the second exchange-traded currency futures contract settled in renminbi to be launched. Hong Kong Exchanges and Clearing (HKEx) launched its CNH futures contract in September last year.

Speaking at a media briefing in Hong Kong on January 28, KC Lam, CME Group head of FX products Asia, said part of the reason for CME's CNH futures contract's longer tenor was to meet offshore RMB bond investors' hedging needs, as typical dim sum bond tenors are around three years.

In addition to tenor, time-zone considerations were a key differentiator from HKEx's offering.

"The three-year tenor is a key distinguishing feature from HKEx's CNH product, which only has a one-year range. In addition, we are able to offer trading hours of 23 out of 24 hours compared with HKEx's trading hours of 9am to 4:15pm, Hong Kong time," says Lam. In terms of initial margin requirements, CME said it will accept all forms of acceptable margin including cash, gold, US Treasuries and letters of credit, in contrast to HKEx's offering for which at least 50% of initial margin must be in CNH.

Lam said market-makers for its offering included Bank of China Hong Kong and Celestial Commodities.

Justin Lee

> *We applied the threshold at an entity level and I haven't spoken to any banks that did it differently. The missing margin could be anything from 25% to 75% of the submitted totals for individual firms.* **ERIK LITVACK, SG CIB**

Banks claim €300 billion hole in margin study

Dealers are calling for a new study of proposed margin rules for uncleared derivatives trades, after it emerged the industry may have significantly understated collateral requirements for the original quantitative impact study (QIS) last year.

Banks were asked to estimate initial margin requirements under a proposed new global regime, assuming posting threshold levels of up to €50 million – exposure below the threshold would not need to be collateralised. But many banks applied the threshold to each entity they faced, while regulators wanted it to apply to each consolidated group.

With dealers booking their trades in anything from one entity to 10 or more, that mistake could have a big effect on the €700 billion margin demand projected by the study, banks claim – one estimate suggests the QIS would have come up with a figure of €1 trillion instead. Others say the true figure could have been 25% higher – around €875 billion. Those figures are all based on the €50 million threshold being applied, as proposed in near-final rules published alongside the QIS results on February 15.

"We applied the threshold at an entity level and I haven't spoken to any banks that did it differently," says Erik Litvack (pictured), head of regulatory strategy at Société Générale Corporate & Investment Banking in Paris. "The missing margin could be anything from 25% to 75% of the submitted totals for individual firms, depending on how they are organised. I don't know – no-one does – because the research hasn't been done. I think it's important for the people writing the rules to know what the actual impact will be."

That sentiment is echoed by others. "We believe a further QIS needs to be undertaken. We think there are a number of issues – one of which was the consolidation issue. We've spoken to other banks and some have said they applied the threshold at a group level, while others have said they didn't realise that was the intent and have estimated a 20–30% increase," says one industry source.

In total, *FX Invest*'s sister title *Risk* spoke to five banks – all of which applied the threshold at an entity level. Two of them also call for a rerun of the QIS – and that was expected to be repeated in comment letters filed before the close of the one-month consultation period on March 15.

The margin rules are being drawn up by the Working Group on Margining Requirements (WGMR), which comprises regulators from 15 countries and was jointly convened by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions. The aim is to supplement clearing requirements for over-the-counter derivatives with a margin framework for trades that are not standardised enough to clear – with the uncleared margin requirements set at a level high enough to provide an incentive for firms to clear wherever possible. Critics fear the combination of the two regimes could soak up too great a share of the financial system's stock of liquid assets.

Regulators accept the QIS may have understated the collateral requirements, but say it is still a good guide. "The WGMR is aware of the solo-versus-consolidated issue, and this is actually acknowledged in the QIS appendix of the second consultative paper, in footnote 17. Nevertheless, for several reasons, the group considered that the QIS estimates, while possibly understating the impact of the final rule, provided a good estimate of the range of the impact. In any case, respondents to the consultation are invited to show if, and to what extent, the QIS estimates are understated," says an emailed statement provided by Iosco.

That may be difficult, given the length of the comment period. A capital expert at one large UK bank says his institution had to apply the thresholds at an entity level because it did not have the data to do so at a group level.

But regulators are also under pressure. The WGMR is trying to finalise the rules prior to a September deadline imposed by the Financial Stability Board (FSB), which will have to report at that point on the progress of the various post-crisis reforms demanded by the Group of 20 nations.

There are other criticisms of the original QIS. According to one regulatory liaison at a US bank, the WGMR asked participants to include a period of stress when calculating margin requirements, but the instruction was passed on during a one-hour briefing and was not included in written guidelines for the study. As a result, some banks did not apply stress to their numbers, while others modelled the impact using volatility scaling or exponential weighting to calibrate to current conditions – meaning that if markets genuinely had been jumpy, the margin numbers would have been materially higher.

"If the numbers were redone, now that we understand the objectives – and the need to be truly sufficient to cover a period of stress – the results may well be much higher. And if one considers the results after application of the thresholds, then it could potentially be multiples of what the QIS has suggested," says the liaison.

But one regulatory source is unmoved. "Banks, not surprisingly, would take this position but I disagree with them. One has to keep in mind that there are limits to the use of QIS data – they provide insight into the range of impact, but are not intended to provide the final word on specific calibration. The idea, rather, is to find out whether we are directionally correct," he says.

Banks may not be alone in their concerns, though. In January, the liquidity coverage ratio – one of two new liquidity measures included in the Basel III framework – was watered down to ensure it would not affect the willingness of banks to lend, and similar concerns may affect the outcome of the WGMR's work. In mid-January, Mark Carney, chairman of the FSB, discussed the uncleared margin proposals with board members from the Global Financial Markets Association, an umbrella body for bank trade associations, and one industry source says the FSB may take a more active hand in the uncleared margin debate as the rules near completion.

Matt Cameron and Duncan Wood

Commodity correlation returning to pre-2008 levels, say analysts

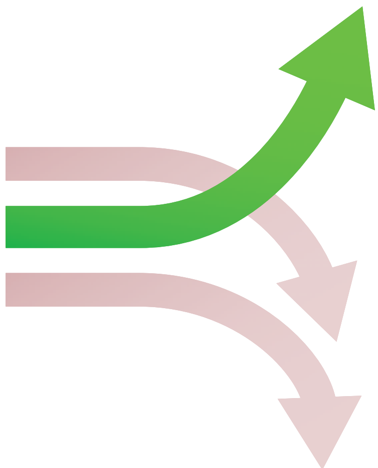
Correlations between commodities and other asset classes are in retreat, say analysts, as the impact of macroeconomic jitters diminishes and prices become more heavily affected by physical supply and demand.

During the past five years, commodity prices often moved in lockstep with those of other asset classes, especially equities, as investor sentiment shot up and down in response to broader financial woes. Fears related to the eurozone sovereign debt crisis, the US debt ceiling and a possible slowdown in Chinese growth fuelled the so-called risk-on/risk-off trade, in which investors piled in and out of risky assets depending on the latest headline. In the past few months, however, correlations between commodities and equities have fallen. By some measures, they have retreated to levels that existed prior to the global financial crisis.

"We're in a period now where exogenous shocks are having less impact," says Kevin Norrish, London-based managing director of commodities research at Barclays. "There are fewer of them, and they're having less impact."

As of February 1, the rolling six-month correlation between the S&P 500 index and the Dow Jones-UBS Commodity Index, which measures a diversified basket of commodities, was 0.47. That is down from 0.88 a year earlier, according to Norrish.

Correlations between individual commodities have also dropped, suggesting that commodity markets are being driven more by fundamental physical factors specific to each market, as opposed to broader trends. Barclays measures cross-commodity correlation by taking the 90-day correlation of daily price moves in different commodity sectors – including precious metals, industrial metals, energy and livestock



– and taking the average of the resulting pairs. In January 2011, cross-commodity correlation was 0.45, according to Barclays. In 2012, this figure diminished to 0.33 and now sits at just 0.19, according to the bank. For the past three months, cross-commodity correlation has been lower than at any point since 2007, says Norrish.

Energy has also shown signs of decoupling from equities. In 2006, the average correlation between the S&P 500 and the price of Brent North Sea crude oil was 0.54, according to data from Société Générale Corporate and Investment Banking (SG CIB). In 2007, this rose to 0.68, before surging to reach 0.82 during 2008. The average correlation between the S&P 500 and Brent crude stayed above 0.8 between 2008 and 2011, before sinking to 0.7 in 2012. This figure was pulled down by a precipitous drop over the past three months – on January 11, the 10-week moving average correlation even hit negative territory, dipping to –0.01.

> "There's less to talk about in terms of tail risk than there was before"
> **Michael Haigh, SG CIB**

"There's less to talk about in terms of tail risk than there was before," explains Michael Haigh, New York-based global head of commodities research at SG CIB. "For that reason, sentiment appears to have improved. Consequently, commodities should start to behave a little more independently than the broader markets."

As tail risks have receded over the past six months, fundamental factors have made a comeback in driving the price of crude oil, says Haigh. In July 2012, macroeconomic factors explained about 60% of price moves in Brent, according to a model developed by SG CIB's quants that seeks to determine which factors are having the greatest impact on commodity prices.

In contrast, macro factors were capable of explaining a mere 20% of Brent price movements in late January, while fundamentals accounted for 66%, according to the bank. The difference between these two figures is made up of "dollar factors", which are related to the value of the US dollar. "The macro has started to take a back seat," notes Haigh.

Nonetheless, some analysts are sceptical and point out that energy prices still tend to move up and down with equities. "Crude oil prices are still being driven by the stock market," says Walter Zimmermann, senior technical analyst at United Icap, the New Jersey-based energy brokerage. "Maybe the correlation has slipped, but where's the evidence that they're going their separate ways?"

Other market observers say the drop-off in correlations could herald a return to an environment in which commodities behave independently of other asset classes. The high correlations of 2008–11 were "unprecedented", notes Amrita Sen, chief oil analyst at Energy Aspects, a London-based research consultancy. "I don't think we are back to normality yet, but at least we're getting to a phase where correlations are starting to stabilise a bit," she says. "We are slowly returning to a more normal world."

Alexander Osipovich

Imran Ahmad hired by JPM AM

JP Morgan Asset Management (JPM AM) has hired Imran Ahmad (below) as a portfolio manager and strategist within its currency and emerging markets debt team in London.

Ahmad joins from Royal Bank of Scotland, also in London, where he was a strategist covering cross-asset class research encompassing FX, credit and rates. In his new role, he focuses on directional and relative value investments in liquid emerging market currencies, supported by the asset manager's proprietary investment models.

Ahmad tells *FX Invest* the decision to move to JPM AM was based on the strong market interest in emerging market debt and currency investments.

"The start of this year demonstrates that FX has made a break and is now leading other asset classes as we slowly shift away from the highly correlated world of the past few years. Emerging market currencies present a huge opportunity as they now play a significant role in the global economy, with some markets now more liquid than G-10 peers," says Ahmad.

He adds that on long-term measures, emerging market currencies are still undervalued, providing structural support for the ongoing development of the asset class, particularly as intra-emerging market trade, foreign direct investment and portfolio flows grow.

"However, we have a strong focus on identifying relative value opportunities, especially as we see more fundamental divergence between regions and countries, alongside idiosyncratic developments that present opportunity to capture alpha," says Ahmad.

"Moreover, with the 'currency wars' en vogue, my experience from RBS meeting senior policy-makers will help gauge central bank reaction functions and resultant intervention patterns or macro-prudential measures."

Prior to RBS, Ahmad worked as an analyst in the institutional trust services at JP Morgan. Before that, he was a research assistant in the engineering systems division at the Massachusetts Institute of Technology.

At JPM AM, Ahmad reports to Nima Tayebi, head of emerging market currencies within the London-based currency group, which is managed by Jonathon Griggs.

He replaces Harry Bazzaz, who is taking a career break.

Fidelity Management and Research hires Hawes

Roger Hawes (below), formerly global head of FX spot trading at the Royal Bank of Scotland in London, has been hired by Fidelity Management and Research (FMR) to head global foreign exchange.

Hawes started in the newly created role on January 7 with responsibility for creating efficiencies in the management of currency exposures across the company's investment portfolios, says an FMR spokesperson in Boston.

The spokesperson adds that while Hawes reports to Mark Flaherty, chief investment officer of UK fixed income in London, he also works with Fidelity's asset management, equity, high income, global asset allocation and Pyrimas investment divisions.

"His role is meant to centralise our foreign exchange capabilities and investment processes, and enhance investment performance and increase submission fees," the spokesperson says.

C-View hires industry veteran to run new rates product

UK-based currency manager C-View has appointed Nick Beecroft to manage its new global macro interest rate programme, which launched in February and looks to apply and expand C-View's experience in currency portfolio and risk management to interest rate markets.

Beecroft (right), was appointed in mid-2012 as non-executive chairman of the board of Saxo Bank's London operations, a position he retains in his new role. He has more than 30 years' experience in fixed-income and currency markets, including five years at Standard Chartered, where he was global head of foreign exchange and a member of the Bank of England's FX Joint Standing Committee.

Before joining Standard Chartered, Beecroft spent eight years at Deutsche Bank, where he became global head of spot and proprietary foreign exchange trading. He began his career at Citi in 1981. Prior to his latest appointment at Saxo, Beecroft had been a senior market analyst at the Danish bank since 2009.

His ongoing role with Saxo takes up six days per month.

"Nick is a very strong complement to our portfolio management team," says Paul Chappell, founder and chief investment officer at C-View in Hertfordshire. "For the past five years, he has managed a very successful interest rate programme on behalf of a family office. We are delighted to be benefiting from his proven track record and to bring his expertise to bear within C-View's range of investment management products."

C-View's currency managed accounts today have more than $250 million in assets under management. Earlier this month, the firm appointed Colin Harte, formerly of Baring Asset Management, as a portfolio manager.

BALANCING THE BOOKS

As Dodd-Frank deadlines loom for corporate derivatives users, treasury desks with sophisticated FX hedging programs should be steadily adapting compliance systems. But with regulatory energy focused on swap dealers, corporates are still waiting for details on final rules before re-tooling their operations. **Joti Mangat** reports

On the surface, it might seem that corporate users of foreign exchange derivatives are not going to be significantly affected by the Dodd-Frank Act. At the asset class level, the first draft of the regulations, published in July 2010, provided an exemption from the clearing rules for vanilla FX forwards and swaps. Moreover, end-users who can prove to regulatory agencies that they engage in derivatives trading strictly to hedge or mitigate commercial risks, and can demonstrate board approval to do so, will not be subject to mandatory clearing for derivatives trades.

However, Dodd-Frank employs very specific definitions of FX forwards and swaps, which regulators have since clarified do not extend to non-deliverable forwards (NDFs), FX options or cross-currency interest rate swaps. These will all be subject to mandatory clearing. "If a corporate is trading an NDF, Dodd-Frank considers that product to be a swap that will be subject to the full panoply of swap regulations," says Allison Lurton, a Dodd-Frank specialist at Washington DC law firm, Covington and Burling.

Moreover, in cases where corporate end-users are trading vanilla FX forwards that meet the swap exemption but are facing a swap dealer or major swap participant (MSP), they are subject to significant documentation and swap data repository (SDR) reporting requirements. "If a corporate is facing a dealer on a straight FX forward or swap transaction, it will still need to make representation to the dealer either via the International Swaps and Derivatives Association Dodd-Frank protocol, or a separately negotiated agreement, and make sure certain disclosures are made with respect to the trade," Lurton says.

Dodd-Frank business conduct rules require dealers to have swap documentation in place with most counterparties from January this year. As part of that, the Isda Dodd-Frank protocol was established as a standard set of amendments to facilitate updating of existing Isda swap relationship documentation for Dodd-Frank compliance purposes.

> "If a corporate is trading an NDF, Dodd-Frank considers that product to be a swap that will be subject to the full panoply of swap regulations"
> **Allison Lurton, Covington and Burling**

For corporate treasurers, this is perhaps the simplest phase of the compliance process, and is typically achieved by engaging a swap dealer to sign a Dodd-Frank amendment to a standard Isda Credit Support Annex. Without this agreement, dealers are barred from trading uncleared swaps, and the end-user will be obliged to trade the swap via a derivatives clearing organisation or central counterparty.

So, after they have convinced the US Commodity Futures Trading Commission (CFTC) that they are not financial entities, and that any FX derivatives trading is hedging or mitigating commercial risk, end-users must establish swap documentation with all in-scope counterparties, report inter-affiliate swap trades to SDRs and reconcile hedge portfolios on a regular basis as of April. This is likely to require most companies to invest in new systems, connectivity and technology to meet compliance requirements.

According to a December 2012 poll of 386 corporate treasury professionals by Reval, a New York-based treasury and risk management technology vendor, while most US corporates have established swap documentation based on the Isda Dodd-Frank protocol or some other bilaterally negotiated agreement in line with the January 1, 2013 deadline, three quarters of the companies polled were not prepared for much of the end-user reporting requirements that become binding in April.

Furthermore, the survey found Dodd-

Frank's requirement for end-users to report inter-affiliate swaps to SDRs is of particular relevance to the FX hedging activities of most major corporates, with a quarter of all companies in the survey saying they enter into inter-affiliate swaps for FX transactions, and 10% use inter-affiliate structures for both FX and commodity transactions as referred to by the rules. "Corporates with foreign currency exposures typically consolidate risk on an enterprise-wide basis, but distribute it for various reasons, including allocation, accounting and cross-border tax purposes. With FX hedging, inter-affiliate structures are a very common format," says Krishnan Iyengar, vice-president of global solutions at Reval in New York.

The 'inter-affiliate' concept in Dodd-Frank terminology refers to a hedging structure in which a corporate headquarters takes exposure to a swap dealer or MSP in a centralised manner, then trades 'internal' derivatives with subsidiaries, so there is no bank or MSP intermediating between the central entity and the subsidiaries. Under Dodd-Frank, the central treasury is responsible for the reporting obligations arising from the trade.

Consider the following scenario. The central treasury of an international consumer products manufacturer enters into a US$60 million vanilla FX forwards hedge with a swap dealer on behalf of its offshore affiliates, and parcels the notional hedge into three $20 million clips among its subsidiaries. Given the product's Dodd-Frank treatment, the transaction is not cleared. In this situation, both the transaction between the swap dealer and the central treasury, and the three smaller inter-affiliate swaps, must be reported to an SDR. While the swap dealer carries the regulatory burden to report the $60 million trade, central treasury now carries an SDR reporting burden, albeit on a non-real time basis.

Similarly, while swap dealers carry the CFTC reporting burden for non-cleared trades transacted with end-users, corporates will be required to reconcile the fair value of their hedge portfolio on a regular basis, with frequency to be determined by the number of swaps they have with a particular swap dealer. For end-users that have more than 500 swaps with a specific dealer, reconciliation must be done on a daily basis, falling to weekly reporting for 50–500 swaps and quarterly if the total number of swaps is less than 50. "Portfolio reconciliation needs both counterparties to a trade to play, which means end-users are going to have to communicate and interact regularly with dealers around portfolio valuations," Iyengar says.

With compliance needs in swap documentation set-up, proof of end-user status, SDR reporting of inter-affiliate swaps and portfolio reconciliation, corporate treasurers are currently wrangling with significant levels of detail, and are still waiting for final rules in a number of material areas. As the Reval poll suggests, while end-users are generally compliant with respect to swap documentation, few are advanced in developing strategies for compliance with the other more systems-intensive reporting requirements.

> *"The biggest impact on pricing in all this is going to come from the CVA charges, especially for complex long-dated derivatives"*
>
> **ROLAND KERN, LUFTHANSA**

"What we see from corporate treasuries right now is an effort to understand the extent to which their derivatives hedging is in the scope of Dodd-Frank. End-users are evaluating the regulations and some are hiring consultants to help them understand what new compliance processes should be," he adds.

In Europe, the largest companies

could be impacted by both Dodd-Frank and European Market Infrastructure Regulation (Emir) reporting requirements. Most, however, direct US dollar cashflows to domestically domiciled treasuries, which they trade with banks in London or Frankfurt. Like Dodd-Frank, Emir offers a broad exemption from clearing and margin-posting obligations for end-users hedging commercial risk, but requires them to be able to value and report derivatives trades. European regulators expect Emir's reporting requirements to become binding until the second half of 2013, starting with interest rate and credit derivatives, with FX and commodity reporting standards phased in a year later.

Roland Kern, vice-president and head of treasury at Lufthansa in Frankfurt, says the airline's use of hedge accounting has prepared the treasury to operate under closer regulatory scrutiny. "Under Emir, we will be obliged to provide transaction data to trade repositories, and be able to mark-to-market our portfolios. Our treasury system is already able to provide a lot of the necessary information," he says. Lufthansa subsidiaries transfer currencies to central treasuries in London and Frankfurt, through which they transact hedges centrally.

"For most corporate treasury professionals, it is still confusing as to what the final rules for end-users will be"
Brian Kalish, Association for Financial Professionals

Kern says Basel III-related credit valuation adjustment (CVA) charges are likely to have a more profound impact on market pricing for European corporates than Dodd-Frank or Emir. "The biggest impact on pricing in all this is going to come from the CVA charges, especially for complex long-dated derivatives," he says.

While Lufthansa treasury systems are largely ready to accommodate Emir reporting and valuation requirements, Kern warns that banks may need to improve response rates under new reporting rules. "Confirmation for the hedges we trade online is fast, but complex hedges like cross-currency swaps take much longer to confirm. Banks will have to improve their workflow and efficiency around trade confirmation under the new rules," he says.

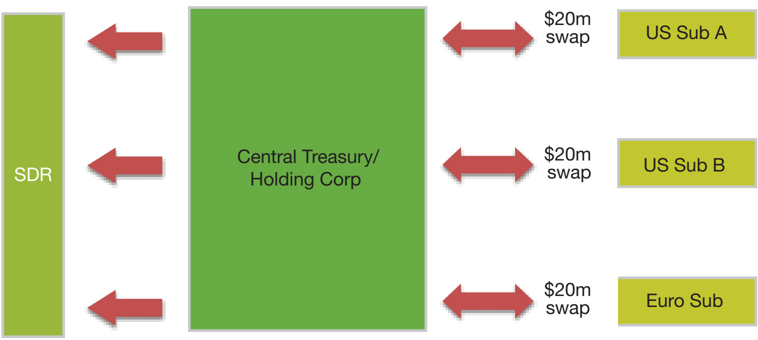
Corporate treasuries with less extensive FX hedging programmes, or a strategic bias towards vanilla products, may see the regulatory burden rise to potentially uneconomic levels versus the hedging benefit, says Brian Kalish, director of the finance practice at the Association for Financial Professionals, in Maryland. "While the Fortune 50 and 100 companies are no doubt looking at how to keep their hedging programs compliant, it's probably a second-tier concern for many of the companies in our network. For most corporate treasury professionals, it is still confusing as to what the final rules for end-users will be," he says.

Kalish notes that for smaller corporates with foreign currency exposure, many companies do not actively hedge FX risk using financial products, but pass the risk through the supply chain as the price of doing business. "Once you get past the blue-chip titans into the nuts and bolts of corporate America and Europe, a major decision to hedge FX will be the outright cost. For those companies that do one hedge a year, it's not clear that it makes sense to invest in all the processes and open themselves up to audit and regulatory concerns," he adds.

The potential impact of Dodd-Frank compliance has mobilised the Washington lobby industry like no other legislation before. According to the Center for Responsive Politics, financial services firms have spent more than $400 million on lobbying to roll back regulations and delay final rule implementation since 2010. As such, a key strategy for corporate America has been to push for further exemptions from financial regulations as compliance deadlines loom.

In addition to the potential impact of Title VII of Dodd-Frank, which concerns derivatives regulation on corporate treasurers' hedging activities, Title I addresses money market funds, another subject close to the heart of corporate treasurers. While they might not have the financial fire-power of the swap dealers and MSPs, non-financial industry associations are also seeking regulatory roll-back. "As long as the issue is live, there will be people in Washington talking to anyone pertinent. Even if a rule gets passed, it does not mean the game is over," Kalish notes.

SDR REPORTING AT 'XYZ CORPORATION'



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TAILORED TRADING

New trading platforms are being created to fill the gap between incumbent providers and the more niche areas of the market. **Saima Farooqi** looks at some of them

The decade-old debate over platform consolidation in foreign exchange has been reignited as a wave of new trading systems enters the market. But with volumes still on the up, and regulation likely to pull in new traders facing prohibitive margin costs in traditional asset classes, the case for niche providers is growing stronger.

For the past few years, the platforms that have dominated the electronic multi-dealer spot market have remained largely unchanged. FXall and FX Connect continue to be a mainstay of institutional investors, while electronic communications networks (ECNs) Currenex and Hotspot FX retain a stranglehold on proprietary traders and retail aggregators.

But with some $4 trillion turned over a day and growing, as collateral refugees from fixed-income markets look to replicate fundamental strategies in foreign exchange, demand for new initiatives to resolve pre-existing weaknesses is bringing alternative models to the market.

Among them is LiquidityMatch-owned FXSpotStream, which acts as a FIX API-price aggregator, pooling liquidity from Bank of America Merrill Lynch (BAML), Citi, Commerzbank, Goldman Sachs, HSBC, JP Morgan and Morgan Stanley. The platform launched bank-to-client trading in July last year, with one of its key principles being no brokerage fee for market-makers as well as takers.

Liquidity-providing banks on the platform say it offers transparent price aggregation, reduced cost of execution

"One of the things asset managers have always needed is an end-to-end process automation"
Vikas Srivastavas, Integral Development

supported by a single API to trade with clients. The set-up also allows for bespoke streams between the client and the bank, on a fully disclosed bilateral and transparent basis, as clients must have a direct relationship with one or more liquidity providers prior to joining.

Meanwhile, last November, interdealer broker Icap announced plans to launch EBS Direct, a relationship-based disclosed liquidity pool this summer. The platform leverages existing connectivity to EBS's flagship anonymous matching platform, enabling liquidity providers to stream tailored prices direct to liquidity consumers.

It will be integrated within the same screen, so users can hit either a disclosed or anonymous price. Icap says price granularity will be in one pip and tenth pip increments.

Banks that have committed to provide liquidity include Bank of Tokyo-Mitsubishi UFJ, Barclays, BNP Paribas, BAML, Citi, Commerzbank, Credit Suisse, Goldman Sachs, HSBC, Jefferies, JP Morgan, Morgan Stanley, Nomura, Nordea, RBS, Société Générale, Standard Chartered and UBS. And, at least 100 customers have signed to use it.

However, Jim Kwiatkowski, global head, transactions sales, marketplaces, financial and risk division at Thomson Reuters in New York, says rather than offering a complete end-to-end solution for the lifecycle of a trade, many of the new platforms have focused only on particular features of the lifecycle, primarily execution. "As clients look to rationalise their trading, our experience shows that they require end-to-end workflow solutions

> *If you are a massive asset manager, with complex risks ranging from centrally cleared derivatives, to FX and fixed income, and multiple interrelationships between the asset classes, why would you go for four/five platforms?*
> **PHILIPPE BUHANNIC, TRADINGSCREEN**

covering the entire transaction lifecycle, while improving efficiency, controlling costs and minimising risk," he says.

To that end, Palo Alto, California-based technology vendor Integral Development introduced InvestorFX in February. InvestorFX is an institutional, fully disclosed bank-to-client platform that layers on automated netting capabilities over its execution management system, which in turn is backed by the algorithmic execution and liquidity available through its ECN, FX Grid, say officials.

"One of the things asset managers have always needed is an end-to-end process automation, which means not only the ability to trade spot, but being able to start with a large list of trades, including spot, forwards, swaps, and go through the whole process of first netting it, then figuring out what spot exposure you have and what needs to be done. Once you've done the spot trades, you need to work out how you roll them out to the forward dates, making sure everything gets booked correctly to the correct funds in an automated fashion, so you can achieve scalability," says Vikas Srivastava, head of business development at Integral Development.

"The asset management business is largely about scale, given how thin the fees are. Scalability means being able to manage huge numbers of funds and huge amounts of assets in a way that you can achieve best execution, deliver superior returns, and yet not make a mistake."

However, Philippe Buhannic, chief executive at multi-asset trading platform TradingScreen in New York, goes further to say that a need for a holistic view of risk counters the value of using an FX-only platform. "If you are a massive asset manager, with complex risks ranging from centrally cleared derivatives, to FX and fixed income, and multiple interrelationships between the asset classes, why would you go for four/five platforms?" he asks.

He says that not only does TradingScreen calculate a cross-asset view of risk, similar to InvestorFX, it goes beyond the reval rate and position calculation offered on incumbent multi-asset order management systems to offer global clients a global view of all their trades, "so they can cross their trades internally if they want to".

"We do a lot by way of order routing from one desk to another within a client. It's almost like an infrastructure to them," says Buhannic. "It's not plugging FX transactions into the system and revaluing them. We allow them to manage them before that process. We can net the transaction globally if needed; we can do that by construction because we are in all data centres."

He also highlights TradingScreen's independent trading analytics. "It's not simple to do this, because FX is fragmented; you have different prices for different quantities; you can get very different prices via phone than from a pricing engine; you can have a price on the futures market which is equivalent to cash; you can have a price through the crosses, through the forwards market. If you really try to determine what the best available price is, it is extremely complicated to start," says Buhannic. "It's a minefield, whereas with equities there is a tonne of market data."

In the past year, Buhannic says that while it has made some big client wins from rival multi-dealer FX systems such as Axa Investments from FXall, the majority of clients have come from single-dealer platforms, where he claims best execution is hard to prove to end investors.

That in some respects might explain the introduction of the FXSpotStream system, and in February, Barclays' smart order router for clients, Barx Gator. Barx Gator brings multiple spot venues as well as the bank's own liquidity together on a single screen, combined with its algorithmic execution product suite,

>

"It's more about how you find a way to differentiate yourself, to find those clients, to find the products or regions to focus on"
Stephane Malrait, Société Générale

PowerFill. The smart order router converts all fills into one spot ticket, with users being able to choose between anonymous trading, trading with the bank, or externally.

The bank says it uses algorithms that work for clients to get them better fills, particularly on non-standard crosses. Clients are able to see the shape of the market at a glance with a clear graphical representation of price and volume through the proprietary Gator Liquidity Model.

The bank charges an all-inclusive service fee onto the aggregated price of each executed order, which is displayed to the user. In so doing the bank reflects a continuing trend among dealers to shift towards a fee structure in foreign exchange as margins erode.

"How do you find a way to make money if every bank has a similar price? You call it aggregation and you charge a fee. That's the evolution of going to an agency model; it will not work on all products, but on the very liquid, it's a natural route," says Stephane Malrait, global head of fixed income and currencies e-commerce at Société Générale in London. He says that additionally, dealers are looking at innovative ways to expand their service electronically, be that through algorithmic execution, structured products or multi-asset trading.

"Certainly there's a theme there across all banks both at the back end as well as the front end, to present a shop front that is more consistent," agrees Mark McCall, product manager, electronic trading spot FX at Royal Bank of Scotland in London. "Not all customers want to trade every single product, but having consistency means you can meet the needs of that segment of clients that are interested in multi-asset trading, particularly leveraging the back-end systems, as everyone's looking to cut costs. Banks are asking the questions 'why do I have a similar team in various product silos? Is there a way I can find efficiencies and synergies there?'"

That said, McCall reiterates that only a specific segment of clients require such a strategy. As a dealer, the strategy however is to have as many touch points to clients as possible, to generate uncorrelated flow that improves internalisation rates and therefore price.

"As a bank, we are plugging into clients in as many ways as possible to find the right liquidity. We meet them in ECNs, we meet them direct in APIs, we service aggregators, we have a single-dealer front end; some have voice. It's important to have that diversity," says McCall. "Some clients want STP, they want ease of transactions. It's about having a broad offering if you want to service the different needs of clients."

Targeting the proprietary trading community is Lmax Exchange, which aims to bring exchange-style transparency to the opaque over-the-counter market. While it employs the same central prime broker model used by Currenex and Hotspot, which in its case is BNP Paribas, David Mercer, chief executive in London, says its differentiator is its open order book with full depth of market, and no last-look.

"Most prominent venues, apart from the interbank side, stream prices, not limit orders. So we bring an open, anonymous order book, full pre- and post-trade transparency, and what you get there is no last look, which means better consistency of execution for clients," says Mercer.

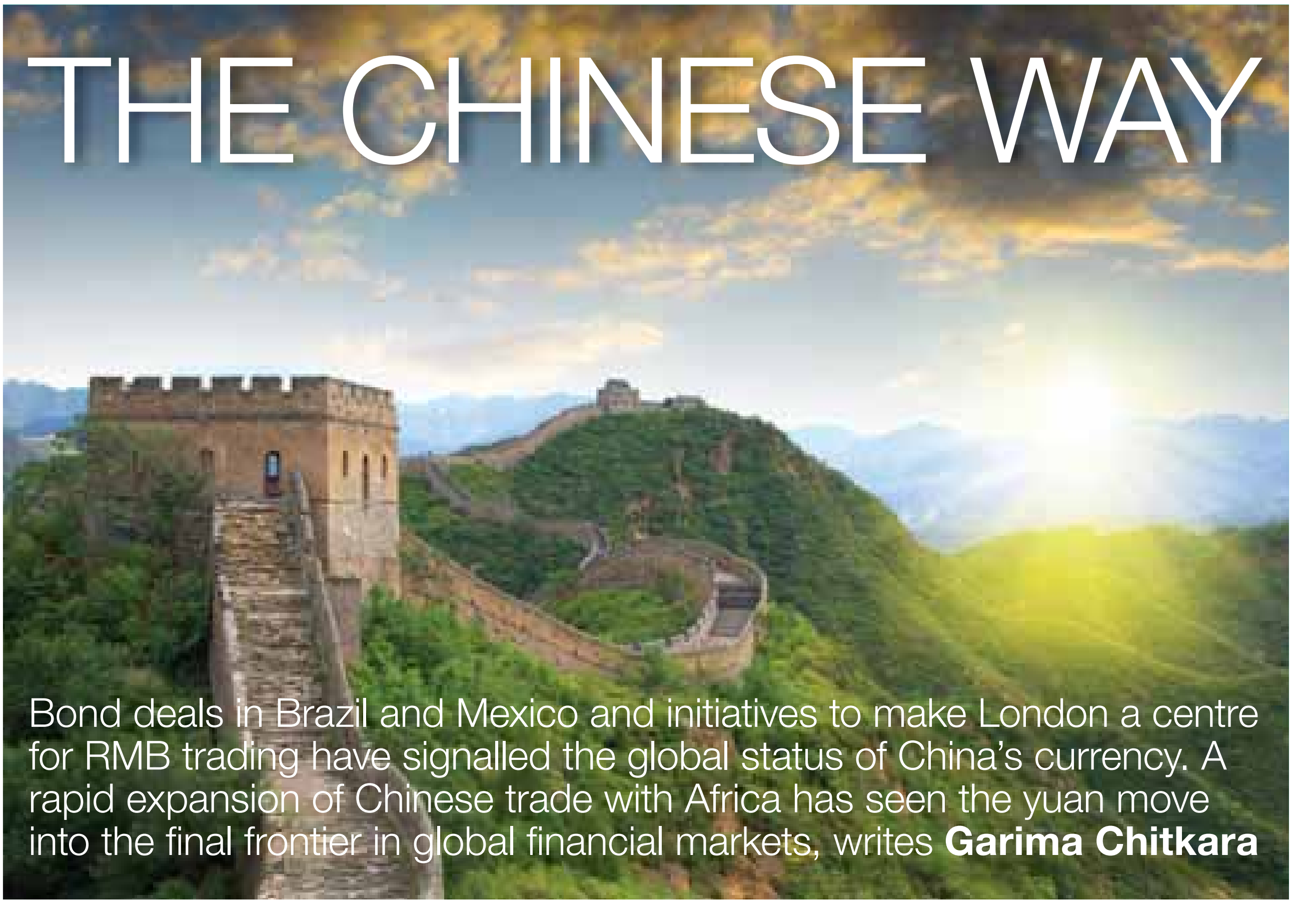
To protect liquidity providers from the possibility of latency arbitrage, market-makers and liquidity providers can cancel and replace prices in 1.5 milliseconds, while on the buy side, average trade latency is three milliseconds. "At times, using nonfarm payrolls as an example, we would stream 1,000 orders per market-maker per second. We can do 11,000 per second and that will grow to 100,000 within the next year," says Mercer. "So what you get is a mixture of scale of orders and speed."

He adds that Lmax assesses the strategy of traders before adding them to the platform. "If every high-frequency trader is just looking for news trading opportunities, or latency arbitrage, or platform arbitrage, there's no benefit for the overall industry, so why bring them on? It's about people who have real money and real trading strategies," says Mercer.

Certainly, in the past, the success of a platform has been its added value to the market as a whole. FXCM and Saxo Bank succeeded in opening up the market to retail traders, which provided uncorrelated flow to dealers the same way Currenex and Hotspot brought in proprietary flow. The decade before, Dresdner Kleinwort electronified second-tier Japanese banks, having initially been feared by EBS in Asia for its superior technology, say market participants.

"We've been saying platforms will consolidate for 10 years, and more platforms are coming in every year, and not that many closing down," says Malrait. "A lot of the small platforms that have emerged in the past few years have found their niche and are surviving. It's more about how you find a way to differentiate yourself, to find those clients, to find the products or regions to focus on."

McCall agrees: "The key is diversity. There are cost pressures with venues as there are with banks. So there is expiration to these different business models, and the ones that will succeed are the ones that find unique client flow."



THE CHINESE WAY

Bond deals in Brazil and Mexico and initiatives to make London a centre for RMB trading have signalled the global status of China's currency. A rapid expansion of Chinese trade with Africa has seen the yuan move into the final frontier in global financial markets, writes **Garima Chitkara**

Unlike the majority of the global economy, trade between China and Africa is booming. Two-way trade stood at $166 billion in 2011, triple its 2006 amount, and making China Africa's largest trading partner. Standard Bank estimated in April 2012 that African imports of Chinese goods are up 24% since 2008, and account for 4% of China's total exports. A trade network of more than 1,500 Chinese corporates operate in 18 African nations.

This is reflected in a rapid increase in renminbi use in Africa. According to Swift's RMB tracker, 8.7% of total payments between Africa, China and Hong Kong were in RMB last July, up from 5.2% just six months earlier. A number of local and international banks have stepped in to serve the growing renminbi business in the region. While trade settlement still forms the bulk of demand for RMB, forex hedging activity has grown rapidly in the past 12 months, according to Erwin Pon, Johannesburg-based business development director, China-Africa investments at South African firm, Rand Merchant Bank. "The hedging side is definitely coming up," he says.

This view is backed by the Bank of China – the main clearing bank for South African and Mauritian banks and one of the first Chinese bank in the continent – which expects a 30% increase in renminbi-related business in the next three years. And it won't just be in South Africa. According to Vanessa Yam, vice-president for client relations at Bank of China in Johannesburg, the bank is working on establishing clearing relationships with banks in Zambia, Congo, Kenya and Tanzania.

Two-way street

African banks are also looking to China. Johannesburg-based Standard Bank, the largest financial institution in Africa – and since 2007 20% owned by China's ICBC – has set up operations in China and Hong Kong, with teams working specifically on providing trade and hedging solutions for mainland corporates seeking to hedge cashflows from their African businesses.

Despite this uptick in interest in renminbi, trade and investment in Africa is still dominated by the US dollar: much of the Africa-China trade is resource based and therefore traded in the greenback. And despite the apparent existence of exotic currency crosses such as between the Zambian kwacha and RMB, most are structured with the dollar as a go-between currency, according to Jeffrey Yap, managing director of fixed-income trading Asia at Mizuho Securities.

Other market participants agreed there is a lack of direct dealing between African and Chinese currencies among the full range of spot, forward and swap transactions. But this intersection of the dollar – or less commonly the euro – in hedging contracts between RMB and African currencies does have a positive attribute by reducing Basel III capital exposures.

Market participants say this means pricing concerns are less of an issue than would be expected, and that capital charges for cross-currency swaps are not much more onerous for renminbi/African currency pairs than for more mainstream transactions.

According to Peter Poon, who heads renminbi product development at Standard Bank in London, the credit valuation adjustment (CVA) issue is counterparty driven. "When banks write cross-currency swaps, they break it down into two components, with the US dollar in the middle so there might be some

leakage in terms of capital because of the credit exposure. To reduce the capital charge, banks do ask for credit support annex and netting agreements," he says.

"From a pricing perspective, the currency pairs of the derivative do impact the CVA, and it has more to do with the volatility element. CNY is relatively stable, as it is still a managed currency. So compared to some major currencies, the volatility is relatively smaller and therefore so is the impact on CVA," he says.

Another Africa-focused RMB source says CVA charges have made cross-currency swaps more expensive for both the bank and its clients, but doesn't see this as a major issue. "For cross-currency swaps, we incorporate higher CVA charges under Basel III into the client pricing. We do run risks on some of these transactions and rely on our internal credit valuation processes on deals involving African currencies, which allow us to load additional charges based on their respective risks.

"However, we have seen a significant increase in client interest in the past 24 months. [Higher CVA charges under Basel III] will be less of a hindrance at this stage, as the objectives these transactions meet carry far more weightage for the clients. The market needs to grow much further before corporates start getting concerned about how expensive these products are," he says.

According to a branch executive of a Chinese bank in Johannesburg, a large amount of the volume for trade settlement through his branch comes from smaller traders who exclusively trade with Chinese counterparties importing consumer goods. According to this executive, these traders, and Chinese corporates in the region with renminbi costs, account for the bulk of the demand for hedging products for the renminbi.

"Many Chinese companies bring in capital inputs and personnel from their parent companies in the mainland. They need to pay their costs in renminbi with their rand profits. They normally build the currency fluctuation into the product price, but that leaves them vulnerable to bigger movements. A number of these companies are now moving to alternative ways to mitigate this risk," he says.

In Africa, local importers trading with Chinese entities are increasingly turning to the offshore renminbi markets to hedge their exposures. Chris Paizis, head of corporate sales and risk solutions group at Absa Capital in Johannesburg, says: "There has been quite a substantial increase in the number of transactions this year in hedging the renminbi. Year-to-date, we have handled more than 20 clients, across a spectrum of products including spot and forward."

> In Africa, local importers trading with Chinese entities are increasingly **turning to the offshore renminbi** markets to hedge their exposures

A large amount of hedging activity among banks' clients takes place through plain vanilla instruments such as forwards and to a lesser extent options and cross-currency swaps. Standard Bank also provides dual currency deposits to its clients who have exposure to both renminbi and local currency deposits.

According to Poon, the dual currency deposits are designed to meet clients' hedging needs in an environment where the renminbi is appreciating.

Standard Chartered also provides a similar offering with a footprint in South Africa and a large number of sub-Saharan nations, including Nigeria, Kenya and Zambia. According to Rajat Kumar, regional head, fixed income, Africa at Standard Chartered, the bank provides plain vanilla spot and forward products as well as interest rate and cross-currency swaps in the renminbi and local currencies. All these products require the US dollar as the in-between currency and require counterparties to want to or be able to maintain US dollar exposure in the transaction.

Hedging for Africa-based entities is difficult for exposure to any currency, but more so for the renminbi as the latter is not fully convertible or freely traded. According to Absa's Paizis, options, for example, see much lower use given the lack of a liquid market for the product in the renminbi.

Poon also sees limited use for the product in structuring hedging solutions for clients. "We use some options in structuring dual currency deposits for some clients who want to hold the deposit in renminbi but also want exposure to one of the local currencies. But in the grand scheme of things, the market is not as liquid or highly traded as in the more mature currencies," he says.

Another challenge is the lack of liquidity in both regional African and renminbi markets, which prevents banks from putting on longer-term hedges. "The

> *The renminbi* ***is not as widely accepted*** *as a trade settlement currency in Africa as in, say, Europe* **CHARLES FENG, STANDARD CHARTERED**

liquidity of the offshore renminbi market is mainly short term and hedging long-dated exposure poses a problem. If you have a renminbi loan with a 10-year maturity, for example, it is difficult to construct a hedging instrument," Poon says.

However, Paizis is optimistic about the growth of longer-tenor hedging capability on the offshore renminbi side. "Globally, the demand for longer-term hedges is growing, so there is a market for RMB swaps beyond five years. This is developing and there is a lot more investor appetite on that front," he says.

Reforms needed

In Africa, most regions are growing their markets at a much slower pace. Apart from South Africa, which boasts a deep and liquid interbank market, most other countries in the region have been slower to adopt market reforms, forcing financial institutions with footprints in these regions to take on higher risks. Standard Chartered's Kumar highlights the importance of banks' internal risk management as a key determinant of the range of products they are able to offer.

"We have seen a significant increase in client interest to hedge interest rate and cross currency exposures in the past 24 months. Given the nascent markets, most clients are happy to be able to hedge their exposures in an efficient manner," he says.

Market participants see the increasing relationship between the two regions as playing a role in deepening the regional markets in Africa. Andrew Dickens, head of markets for Absa Capital, says higher demand from hedgers for longer-tenor products will serve to create a more liquid market on the continent.

"The number of Chinese buyers transacting in Africa is getting higher. The offering of products in these markets currently is not especially comprehensive. But as more and more corporates engage in Africa, the tenor and duration of the yield curves of the debt products is growing, resulting in greater opportunities for the industry," he says.

According to Poon, local regulations in Africa encouraging the use of domestic currencies is a key step towards a larger hedging market in the region. Nigeria, Angola, Zambia, Kenya, South Africa and Ghana are best placed to take advantage of growing trade relations with China. However, Poon believes hedging demand will grow slowly in these regions unless

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local businesses have incentives to transact in domestic currencies.

"Executing a deal in Tanzania or Kenya is harder because the liquidity of the local currencies is much lower. Most local traders invoice in the US dollar. Some African countries are trying to promote and encourage use of their local currency versus the dollar by introducing policies or rules that mandate the use of their currencies. Zambia, for example, mandates the use of the kwacha for domestic trading, and this will lead to more hedging demand in the country.

"If the local currency is not in demand, more corporates will want to use a more liquid currency to trade to avoid being exposed to liquidity problems. Until these rules are in place and local currencies develop an easily tradable market, there is a long way to go for the suite of hedging products to completely mature," he says.

Some believe the internationalisation of the renminbi via Africa is still a long way off. According to Anthony Desir, Hong Kong-based partner of Strategic African Mineral Investment Fund, for China to truly internationalise its currency through trade, renminbi exchange must take place between cross-border counterparties, which he doesn't see as being the case today. Renminbi settlement between China counterparties who are covering payments for transactions between themselves outside of China is not the same as internationalisation of the renminbi, in his view.

"Projects that are financed by China, and supplied by China in Africa or elsewhere can easily be settled in renminbi between Chinese counterparties paying each other in home currency. There is nothing wrong with this, but we are not convinced these domestic transfers should ever be booked as international transactions, even when the project is offshore. The renminbi can only become an international currency when it is freely traded. When that happens, it will not matter to the African side or non-China party if they get paid in dollars, euros, or renminbi. We just don't see it happening now," he says.

Charles Feng, regional head of FICC trading for northeast Asia at Standard Chartered, partially echoes this view, saying the market has a way to go before it becomes more readily accepted in the continent.

"The renminbi is not as widely accepted as a trade settlement currency in Africa as in, say, Europe. There is not as much activity with direct crosses of local currencies with the renminbi just yet. This could be a longer-term trend, as trade between the two continents is set to grow substantially. China is very actively promoting its currency in the region, with African central banks actively diversifying their reserves into renminbi. The condition seems ripe for some of the companies to adopt this currency as a settlement currency, and that should significantly promote the cross-currency activity. So far, however, the scale of this activity is still quite limited."

Mizuho's Yap believes political will in China will be the main driver for renminbi growth in the continent. "China wants to develop the currency markets in line with what's happening with the underlying physical trade to avoid speculation in the renminbi. A number of professionals in the trade finance industry often cite anecdotal evidence of foreign traders preferring renminbi payments, as they find settlement in US dollars from Chinese counterparties coming in too slow," he says.

Standard Bank, in its 2011 report, projects that 40% of trade, or $100 billion, between China and Africa will be settled in renminbi by 2015. This is equivalent to the total trade between the two regions in 2010. As international banks move into the continent to take advantage of imminent growth in cross-border ties, market players expect to see further development in the markets in Africa and the introduction of a wider suite of hedging products available to investors.

Feng also adds the importance of risk management culture and infrastructure in Africa as a contributor for the market.

"Adoption of renminbi hedging is driven foremost by commercial need. But it also depends on the sophistication of the hedger. For example, European corporates use far more renminbi-based derivatives versus Japan or South-east Asia, even though the latter two have very large bilateral trade relationships with China. Africa is further down the scale in terms of sophistication and discipline of the risk management approach of local corporates. Therefore, this market will take some time to grow in the region," he says.

Absa's Dickens believes the process has begun in earnest in the past 12 months. "As the appetite globally grows for issuing or investing in renminbi, the debt market has developed and is becoming broader and deeper. We have begun to see longer-tenor issues and the ability to perform longer-tenor hedges in the region. There is a concerted effort to bring opportunities in the renminbi markets to our potential issuers in Africa," he says.

MAURITIUS: THE GATEWAY TO AFRICA

The small island nation of Mauritius, situated in the middle of the Indian Ocean, has historically provided a gateway to Indian and African markets through the development of an offshore financial industry, and it has been the vanguard of the RMB trade in the continent.

It was the first African nation to receive regulatory approval from China to invest in the onshore renminbi debt markets. It also has renewed importance for Chinese businesses looking to enter Africa.

AFRICAN/RENMINBI CURRENCY CROSSES

Country	Currency	Symbol
Angola	Kwanza	AOA
Botswana	Pula	BWP
Ghana	Cedi	GHS
Kenya	Kenyan shilling	KES
Mauritius	Mauritian rupee	MUR
Nigeria	Naira	NGN
S Africa	Rand	ZAR

Q&A BUY-SIDE PERSPECTIVE

FX Invest asks industry experts to describe their experiences during 2012, and what they are looking forward to in 2013

Q What was your best trade in 2012?

Maria Heiden, investment advisory, asset management, Berenberg Bank: In 2012, trends came back to the markets. The first half of the year was dominated by a general euro weakness, that is, opportunities came from selling the euro and buying almost anything else – GBP, USD, AUD, CAD and emerging market (EM) currencies. The second half of the year was dominated by euro strength that still persists, for example, buying euro was a good trade.

Marcelo Saez, investment director at hedge fund Argo Capital Management: We launched our EM FX and rates fund in the fourth quarter last year so we had a small window of opportunity until the year end. Our biggest position was the Russian rouble, which performed strongly towards the year end off the back of strong investor inflows into the local government bond market. This is an economy with very low government debt, a current account surplus, a credible inflation targeting central bank with huge investment opportunities and now opening up to foreign investment. We thought this was a very compelling case and were proven right by the end of 2012.

> "We believe that investments in emerging currencies will be a major theme this year"
>
> **MARIA HEIDEN, BERENBERG BANK**

Q What was the key risk that you faced and how did you manage it?

Heiden: As we are a quantitative trend follower, we always face the risk of sidewards moving markets. Our main business is the dynamic hedging of our clients' currency exposure depending upon market movements, such as sideward moving markets is not a risk for our clients. We are most effective in strongly trending markets as within this environment, risk is greatest for our clients' currency exposure, and as quantitative trend followers this is the market environment that most suits our approach.

Saez: The biggest risk that emerging market FX faced last year was the volatility surrounding the eurozone and in particular the Greece situation as well as the US election and the fiscal cliff negotiations. Emerging market currencies are not immune to these risks despite the lower correlation versus developed markets. How did we manage it? Long volatility strategies in some highly correlated US economies as well as being hedged for the most part in the eastern European currency space. Volatility was high and this helped lower our risk profile versus comparable long only strategies.

Q What are your key themes for this year and how are you positioning for them?

Heiden: We believe that investments in emerging currencies will be a major theme this year. As we cover every freely tradable liquid emerging currency with our dynamic hedging approach we can add value to equity or bond investments within emerging markets.

Saez: We still very much like emerging market interest rates as the talk of a

> *We like to find uncorrelated FX and interest rate plays that do not swing around with the vagaries of the eurodollar and the US equity markets*
>
> **MARCELO SAEZ, ARGO CAPITAL MANAGEMENT**

significant turnaround from the financial crisis is still overplayed in my view. The Italian election result is a case in point, uncertainty is undervalued in the current environment. In the currency space, we are playing some regional themes such as long FDI recipients in Latin America (Mexico, Uruguay). We also like the positive growth momentum in South-east Asia, in particular Thailand, which is benefiting from the reopening of Myanmar as well as the weaker yen policy from the Japanese central bank (Thailand being a key manufacturing centre for Japanese companies). On the short side, we are negative central European open economies, which rely heavily on exports to the eurozone for growth.

Q What is your view on EM and how is this being reflected in your strategy this year?

Heiden: In times of low interest rates in Europe, investors need to diversify to higher interest regions. Emerging markets offer attractive opportunities for equity and bond investments plus adding a further source of return through the currency. However, currency volatility can be high in comparison with the underlying volatility, particularly when it comes to bond investments. Therefore, we see a need for dynamic currency hedging as static currency hedging would systematically pay out the high interest gained within the emerging market, leaving the investor with the credit spread.

Saez: As mentioned above, we remain believers in emerging local bond markets. We think the lower debt levels, higher growth dynamics, younger population and positive real rates offer a compelling case for investing. On the currency side, we are very diversified across the major emerging universe. We like to find uncorrelated FX and interest rate plays that do not swing around with the vagaries of the eurodollar and the US equity markets – African local space for example. Having said that, we are obviously involved in the major emerging market currencies. These continue to benefit from investment inflows (for the reasons already stated) and therefore remain with appreciation pressures for the most part. However, as we are a long/short fund we have strategic shorts in play to mitigate the correlation to the health of developed markets.

Q What impact will regulation have on your investment strategy?

Heiden: Emir will implement an overall collateral management protocol for derivatives, so static hedging will become more unattractive as it requires high liquidity movements. Dynamic hedging needs far less liquidity, so we expect a growth in dynamic as opposed to static currency hedging.

Saez: Regulation is very important within the context of emerging market currency markets. The sometimes overriding appreciation pressures that some currencies face has made central banks and governments much more proactive in the management of their currencies. You have to remember that currencies have traditionally been the major instrument of monetary policy in emerging markets as opposed to the interest rate mechanism. Some central banks have and continue to use capital controls to target short-term capital inflows, while others prefer to use less obvious means via verbal interaction or counterbalancing FX reserve accumulation. Further quantitative easing monetary policy across developed economies will continue to pressure central banks to be much more proactive in regulating their currency markets.

Q What are the risks to your strategies this year?

Heiden: Our risk this year is the same as it is every year: lack of trends in currency markets. However, history suggests that trends will emerge that we can exploit to the benefit of our clients.

Saez: Further upheaval in the European economies will bring more volatility to the European emerging markets. These economies remain weak and for some currency depreciation (where possible) looks like an enticing option. There is a lot of noise around some of these countries and you have to pick your entry/exit carefully. Elsewhere Chinese growth will be a key determinant of whether some Asian economies continue to perform strongly this year. Let's hope the new leadership will follow through on their stimulus promises. Finally and towards the latter part of the year, we could see the re-emergence of inflation pressures and it will be interesting to see how these are managed.

Managing expanding reserves

The Bank of Israel's director of market operations discussed the rebalancing of reserve portfolios at the recent National Asset and Liability Management conference

The renminbi does not "meet the conditions of a reserve asset", and increasing holdings of renminbi reserves by some central banks is more likely a political statement than a genuine reserves asset allocation, according to Andrew Abir, director of market operations at the Bank of Israel.

Abir was discussing the rebalancing of reserve portfolios in the post-crisis world, alongside Feiran Long, a portfolio manager at the Bank of Finland, and Rajendra Pandit, director of foreign exchange management at Nepal Rastra Bank, at the National Asset and Liability Management 2013 conference on March 14.

His comments came following a presentation by Gary Smith, head of central banks, supranational institutions and sovereign wealth funds at BNP Paribas Investment Partners, who extolled the benefits of investing in the renminbi, and said it would become a major reserve currency in the not-too-distant future.

The composition of the Bank of Israel's reserves has changed since the crisis, Abir explained, with the central bank diversifying around 10% of its reserve portfolio into smaller, less liquid, currencies. However, this does not represent a fundamental shift in investment policy, he stressed, as it only involves reserves that are "not needed in the day-to-day activities" of the central bank.

This is not always the case, however. The Bank of Finland, for example, split its management framework into separate portfolios for 'liquidity reserves' and 'investment reserves', with different objectives for each, as its reserves grew.

Abir acknowledged the benefits of using separate tranches, but said the Bank of Israel does not possess enough excess reserves to extract the benefits of such a policy – despite its reserves growing from $28 billion in 2007 to a current $78 billion. Splitting a central bank's reserves, he said, has the effect of removing "one degree of freedom" from its investment strategy, and given the size of the Bank of Israel's reserve holdings, it makes more sense to operate one portfolio under separate liquidity and loss constraints.

But Abir revealed the Bank of Israel started investing in equities last year – partly to hedge against interest rate risk. "It was a reasonably difficult process to get it into the portfolio," Abir said. "[The potential for] headline losses was a concern."

> The renminbi does not "meet the conditions of a reserve asset"
> **Andrew Abir, Bank of Israel**

However, the Bank of Israel invests in equities through an index, and Abir said it is easier for the public to accept an index falling than it is to accept the default of a company in which the central bank holds corporate bonds. For this reason, the Bank of Israel does not invest in corporate bonds.

When choosing which assets to invest in, the relevance of rating agencies has decreased, according to Long. Their debt ratings are receiving less attention in central bank investment decisions, a trend that he said "will probably continue".

Abir suggested, however, that while rating agencies have made some notable mistakes, there are few alternatives available.

Central banks are unable to compete with rating agencies' superior resources, he explained, and there is an absence of practical and affordable alternatives.

Another consideration when allocating reserves is whether to employ external managers to help handle the growing portfolio.

Pandit revealed the Nepal Rastra Bank, which invests in both renminbi and Indian rupee assets, employs external managers to invest some of its reserves, but warned "you have to be careful how much they handle". External managers can provide a combination of experience and independence, he said, but central banks must ensure they follow the investment guidelines, he stressed.

External managers' expertise is most valuable when moving into new assets, Abir said, and there are also economies of scale to exploit, particularly in IT investment. However, he said, the knowledge transfer is "pretty minimal" as it is not in their interest to lose their competitive advantage.

Tristan Carlyle

GAINING WITH MOMENTUM

Momentum strategies are rooted in observable market phenomena, and tend to perform well in times of financial stress, says **Anthony Ledford**

It is well known that price momentum has been present in financial markets data for many years, as evidenced by the long-term track record of trend-following CTAs. Less well known is that CTAs have performed particularly strongly in stressed investment environments that can prove extremely challenging for traditional portfolios.

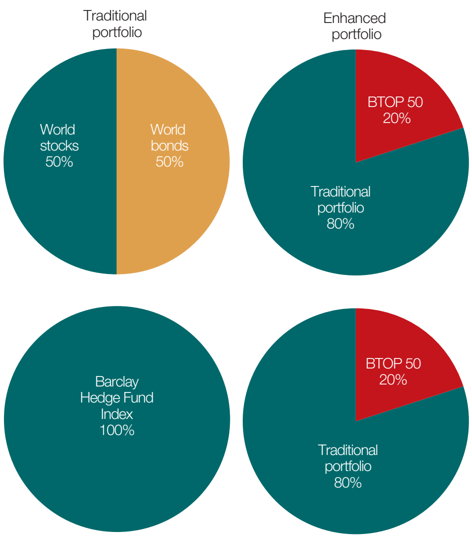
Taken together, many investors believe these two features make a compelling case for long-term CTA investment, past, present and future.

What is less clear is why momentum is present, and why it persists even as markets have become more liquid and efficient. Addressing these questions is key for taking an informed view on whether such profit opportunities are likely to continue into the future.

Some of the strongest trends in futures markets coincide with phases of macroeconomic cycles. The business cycle itself is characterised by momentum: individuals smooth their consumption expenditures, companies make long-term decisions to commit to investment projects, wages and employment are sticky and the government sector explicitly tries to smooth fluctuations.

Likewise, emerging markets take time to emerge, and do so with predictable rises in consumption and demands on industrial commodities. Such macro trends manifest themselves in the prices of many financial instruments, and trending behaviour can arise if the underlying economic factors are not fully discounted by the market.

1. IMPACT OF CTA ALLOCATION ON PORTFOLIO RETURNS



	Traditional portfolio	Enhanced portfolio		Difference
Total return	137.8%	142.3%	3.6%	Improvement
Annualised return	5.6%	5.7%	0.1%	Improvement
Annualised volatility	7.4%	6.0%	1.4%	Lower by
Sharpe ratio	0.33	0.43	0.10	Improvement
Worst drawdown	-25.5%	-18.5%	7.0%	Improvement
Skewness	-0.71	-0.46	0.25	Improvement

	Traditional portfolio	Enhanced portfolio		Difference
Total return	317.8%	278.8%	39.0%	Lower by
Annualised return	9.4%	8.7%	0.7%	Lower by
Annualised volatility	7.6%	6.3%	1.3%	Lower by
Sharpe ratio	0.82	0.88	0.06	Improvement
Worst drawdown	-24.1%	-17.4%	6.7%	Improvement
Skewness	-0.66	-0.32	0.34	Improvement

An allocation to managed futures enhances both traditional and alternative portfolios from January 1, 1997 to November 30, 2012. 20% as an allocation to the Barclays BTOP 50 Index is for illustrative purposes only. The Barclay BTOP 50 Index data over the past may be subject to change. World stocks represented by MSCI World Net Total Return Index hedged to USD. World Bonds represented by Citigroup World Government Bond Index hedged to USD (total return). There is no guarantee of trading performance and past or projected performance is not a reliable indicator of future performance. Source: Man database, MSCI and Bloomberg.

Information asymmetry is another driver of momentum. Economic and other news disseminates unevenly: different market participants react only when such news reaches them, each potentially having their own reaction rate. For example, high-frequency traders typically react to events almost immediately, whereas large institutional investors may require a lengthy decision-making process and retail investors may take longer again.

Periods of sustained buying or selling therefore develop as news spreads and participants react in similar ways but over different time horizons. This effect leads to persistent trends.

Market participants also exhibit some consistent but seemingly non-rational behaviours. Most studies of these behavioural phenomena – notably Kahneman and Tversky on heuristics, biases and prospect theory – are based on observing trades and portfolios in equities but much carries over to other asset classes.

Some of the more well-known behavioural biases include: holding losing trades too long in the hope they will come good; closing winning trades too soon; underreaction leading to sequences of incremental actions; and crowding/herding where investors buy because everyone else is buying.

Behavioural biases, which lead to individuals losing money or foregoing profits, such as the first two examples above, are effects where a systematic trader uninfluenced by emotion can profit either by taking the other side of the trade or holding onto a winning trade when others have closed out. The second two examples lead to explicit trends as partial reactions and herd behaviour induce sustained price momentum.

Carry is another important driver of momentum. It represents the return earned for holding a financial asset or portfolio if

the world stays the same – in particular if the relationship between spot and futures/forward prices remains constant. For example, if one is holding a forward currency position (say, Korean won vs US dollar), one earns the difference in nominal interest rates between the respective currencies in return for bearing the risk of spot currency movements. Further examples of carry effects include the concepts of roll yield in commodities futures markets and the pull-to-par of fixed-income assets in upward-sloping yield curve environments.

It turns out that carry is a key driver of momentum returns, and is greatest for systems targeting longer-term trends (six months or more) in markets that themselves have strong carry returns. In such circumstances, carry can account for around 50% of the risk exposure in momentum.

To understand how carry finds its way into momentum returns, consider an asset with an upward-sloping forward curve. If the curve retains its shape, the futures price will naturally slide down the curve, creating a negative drift (trend) over time. Conversely, a downward sloping curve can create a positive trend.

Therefore, carry can generate momentum in futures prices even without trending behaviour in the underlying spot price. This phenomenon can have a significant impact: for example, it helps to explain the recent positive CTA performance in fixed-income markets despite the absence of a major trend in yields since 2010.

Tracking down momentum

There is no momentum in momentum. Momentum profits cannot simply be predicted from past momentum profits. However, this does not mean momentum is wholly unpredictable, since we know momentum profits do vary with the economic environment and according to the amount of carry available in particular markets and sectors.

Momentum works best when markets are adjusting to substantial new information, such as news about financial stress. Momentum is least effective in low-conviction, low-volatility (so-called risk-on/risk-off) market conditions. In these market regimes, information is often conflicting, and this leads to short-term reversals. In addition, corporate investment and employment decisions, which can both induce macroeconomic cycles and hence momentum, remain deferred given continued uncertainty about the direction of the market.

Given the lack of predictability shown year-to-year, AHL's deliberate focus is to seek internal diversification in its portfolios rather than attempting detailed sector timing. Since the expected performance of a portfolio is the product of the average performance of its components and the square root of the number of independent holdings, we expect risk-adjusted portfolio performance to increase with the number of traded markets. Put simply, more markets means more diversification, which means more opportunities to capture trends.

At the single-market level, the payoff from momentum has a step-like quality, with long periods of relative stagnation punctuated by sharp upward moves, reminiscent of the payoff from buying an option. The beauty of diversification is that by combining many uncorrelated markets with such jagged returns, portfolio performance can exhibit a relatively smooth upward trajectory over time.

AHL currently trades a portfolio of more than 300 instruments comprising both distinct markets and different maturity contracts in the same underlying market, and so capitalises on both liquidity and diversification benefits.

AHL has a long track record of including new markets in its portfolio, and for many markets has been the first systematic CTA to trade them. Some of these newer markets, such as emerging market interest rate swaps and power futures, show both strong trends and low correlation with conventional CTA markets, making them compelling additions to our core trend-following portfolios.

Streamlined access to new markets such as these provides AHL with a unique edge in the industry, boosting the potential for both risk-adjusted returns and protection in times of financial market stress.

Tail protection and positive skew

The returns from trading momentum across a diverse portfolio of sectors are uncorrelated with holding equities. Indeed, providing diversification to an external portfolio is one of the main reasons sophisticated investors allocate to CTAs. Unlike many other strategies that claim to be uncorrelated, even in extreme events the correlation does not increase.

In fact some crises, notably 2008, turn out to be attractive environments for momentum trading as the flow of bad news accelerates. The timeframe over which the crisis plays out is important, and profits from sudden shock events are much less certain. The benefits of a managed futures exposure also extend to traditional and hedge fund portfolios through boosted risk-adjusted returns, reduced drawdowns and improved skewness properties (Figure 1). That momentum trading can also resemble an insurance-buying strategy that pays off in bad times (Figure 2) – so-called downside or tail protection – is another strong attraction for investors.

Positive skewness, characterised by a longer right-hand tail than left-hand tail of the returns distribution, is a general property of momentum trading that is not found in the majority of traditional or hedge fund investments. Its presence for trend-following strategies has been detailed in academic literature and is observable in CTA returns. But where does it come from?

A common view is that big market trends create it. Without such trends the positive skew disappears. However, this is too simplistic and the connection between momentum trading and positive skew goes much deeper. For example, the return distribution from trend-following a random walk can have a positive skew if calculated over an appropriate time horizon.

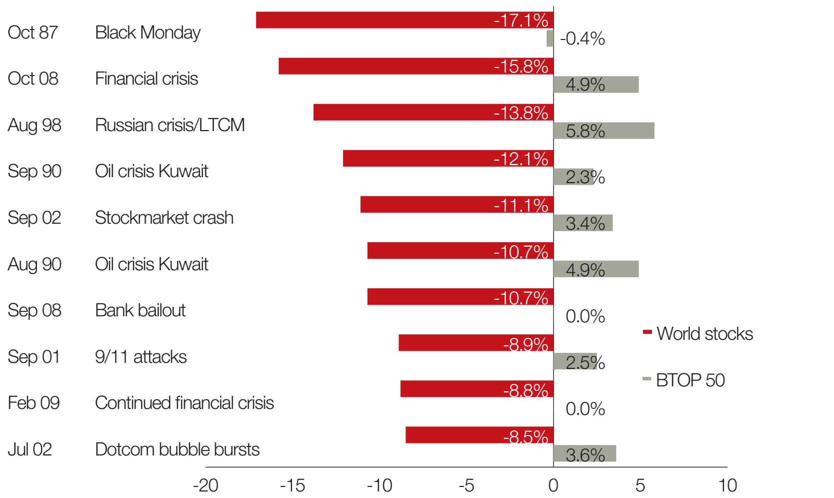
A precise mathematical proof of this result is possible but is beyond the scope of the discussion here. However, the mechanism underlying the mathematics is readily understood: negative skew arises through large sudden drawdowns, and for a momentum strategy to suffer such a drawdown it has to be holding a large position.

Since the only way such a position can arise is from the previous existence of a strong trend, the strategy will tend to have already generated a large profit. Therefore, when a large drawdown becomes a possibility, we expect to have already profited: any price continuation simply increases that profit, whereas a price reversal leads to giving some of it back. Providing returns are measured over a suitable timeframe (eg, monthly) the net effect is a return distribution that displays positive skew.

Option payoffs

A further way of explaining the positive skew and beneficial tail properties of momentum trading is via option payoffs. This is because trend-following has similar properties to replicating a long options position, as both involve buying and selling an asset in the same direction as its price moves.

2. CTA PERFORMANCE IN TIMES OF FINANCIAL CRISIS



January 1, 1987 to December 31, 2012. The Barclay BTOP 50 Index data over the past may be subject to change. The December figures for Barclay BTOP 50 are based on estimates. World stocks represented by MSCI World Net Total Return Index hedged to USD. The periods selected are exceptional and the results do not reflect typical performance. The dates chosen were based on the research and assessment of the fund as explicit start and end dates for these events were not available. To a certain extent, the start and end dates of such events are subjective and different sources may suggest different date ranges, leading to different performance figures. As a consequence, they give no indication of likely performance. Source: Bloomberg and MSCI.

When markets move strongly, both trend-following and long options positions are likely to be profitable, whereas for range-bound markets, both tend to incur modest losses over time.

This option replication heuristic helps to explain trend-following performance over recent years. Strong profits were made in 2008 from both large market moves and increasing volatility, but in recent years many markets have moved sideways, resulting in a proportion of former profits being given up.

Even in this challenging trading environment, however, trend-following still bears scrutiny as an inexpensive and effective form of tail protection, and one that is well positioned to capture profits when markets start trending again.

CTA investors have made attractive long-term profits while also benefiting from tail protection and excellent diversification to their external portfolios. The investable trend-following CTA benchmark, the Barclay BTOP50 Index, has produced returns of around 6% a year, while the most successful CTA managers have fared even better.

This leads to perhaps the key paradox of momentum trading: why would one expect to get paid for investing in a style that has such beneficial profit, risk and diversification properties?

This article provides some answers to this, but a further point is that the momentum effect is so uncertain for individual markets that creating an attractive, broadly diversified medium- to long-term CTA investment vehicle requires in-depth research, process and execution efficiency. In other words, there are significant barriers to entry.

Over short time horizons or with an undiversified portfolio, the risk profile for momentum trading can be far less appealing. By diversifying both cross-sectionally and temporally – by trading a large number of markets and at a variety of 'trend frequencies' respectively – systematic momentum trading provides compelling long-term performance, tail risk protection and diversification.

Anthony Ledford is chief scientist at AHL, a division of Man Group

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