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A New Global Code in the FX Market

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The Bank for International Settlements in late May released the first phase of its "Global Code of Conduct for the Foreign Exchange Market," which will establish a uniform and heightened set of global governance and risk management standards.[1] Crucially, the new code will apply to all participants in the wholesale FX market, going beyond sell-side dealers to include buy-side investment managers, nonbank liquidity providers, trading venues, and other entities providing brokerage, execution, and settlement services.[2] It will also supersede all FX codes of conduct currently in place.

The new, principles-based code is the culmination of a joint regulatory and industry initiative to reform the FX market, following the allegations of benchmark manipulation and improper sales practices that came to light in 2013.[3] It is intended to promote the fairness, integrity, and smooth functioning of the market. The principles in the first phase cover general ethics, information sharing, execution, and confirmation and settlement processes; the second phase, which is expected in May 2017, will include principles on governance and risk management, as well as further standards for execution and electronic trading. The new code goes beyond current guidance in its emphasis on establishing a sound risk culture in the conduct of FX activities, the promotion of rigorous standards for the management of conflicts of interest, and the handling of confidential client information.

Regulators across the globe have in the past two years made conduct issues in FX markets a supervisory priority, and have required a number of large banks to undertake extensive remedial programs. While the code itself does not carry the force of new regulation, its framework and guidelines may form the basis of future regulation in various jurisdictions.

Regulators in any event will expect firms to adhere to the new code. Indeed, central banks may explicitly require their FX trading counterparties to adopt and observe the code. More broadly, market-conduct regulators are likely to consider provisions of the code when undertaking supervisory examinations of FX activities. All major participants in the FX market will want to review their governance, sales and trading practices, and risk management frameworks for their FX business, and make improvements as necessary to align with the code's requirements.

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1 http://www.bis.org/mktc/fxwg/gc_may16.pdf
2 The code is not intended to apply to the general retail public or money-transfer and money-changers businesses.
3 See Promontory Sightlines InFocus, "Managing Risks in FX Trading," November 2013, http://www.promontory.com/News.aspx?id=3229.

Standards to Restore Confidence in the FX Market

Trust in the FX market was severely damaged by allegations of manipulation of daily FX benchmark fixings. Subsequent regulatory reviews uncovered broader issues of questionable sales and trading practices, including front-running customer orders, misuse of confidential customer information, and collusive activities. Some major dealers have already been subject to regulatory enforcement actions, resulting in significant fines and penalties, as well as ongoing private litigation.

The FX markets in general, and the spot FX markets in particular, have so far remained outside the scope of the major regulatory initiatives on conduct in the securities and derivatives markets. Rather, the FX market has relied upon a number of voluntary codes of conduct[4] that provide guidance and standards for trading and sales activities, and for managing operational risks. These codes generally address the same types of activities, with distinctive features based on local factors. However, they have differing areas of emphasis and lack strong mechanisms to ensure adherence. In this most global of all financial markets, the need for consistent, universal standards is now evident, as is agreement among regulators and industry participants across jurisdictions to apply and monitor adherence to such standards.

For the last three years, international regulators have worked with industry participants to address market abuse and the lack of consistent business and operational standards. The International Organization of Securities Commissions took a significant step in 2013 by publishing its "Principles for Financial Benchmarks."[5] The Financial Stability Board soon followed in 2014, endorsing recommendations to reform the FX benchmark processes and calling for a broader review of practices in the FX markets.[6] In 2015, the Fair and Effective Markets Review, undertaken jointly by the U.K. Financial Conduct Authority, the Bank of England, and the U.K. Treasury, pointed to the need for improvements in the controls and transparency around FX market practices, and called for the development of a single global FX code of conduct.[7]

The BIS last year established[8] a foreign exchange working group,[9] composed of central banks and financial market regulatory authorities, to develop a new consolidated code of conduct. A market participants group drawn from leading institutions across sell-side, buy-side, and intermediary firms in the FX market supported the group.

4 Including the ACI — The Financial Markets Association, ACI Model Code; Hong Kong Treasury Markets Association, Code of Conduct and Practice; London Foreign Exchange Joint Standing Committee, the Non-Investment Products Code; New York Foreign Exchange Committee, Guidelines for Foreign Exchange Trading Activities and Management of Operational Risk in Foreign Exchange; Singapore Foreign Exchange Market Committee, the Singapore Guide to Conduct and Market Practices for Treasury Activities; and Tokyo Foreign Exchange Market Committee, Tokyo Code of Conduct.

5 https://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf

6 http://www.fsb.org/wp-content/uploads/r_140930.pdf

7 http://www.bankofengland.co.uk/markets/Documents/femrjun15.pdf

8 http://www.bis.org/press/p150724.htm

9 http://www.bis.org/about/factmktc/fxwg.htm

Standards in the New Code

The new code is organized around six principles, four of which are addressed in the first phase. The second phase will cover the remaining two.

PRINCIPLES — PHASE 1

1 **ETHICS**
"Market participants are expected to behave in an ethical and professional manner to promote the fairness and integrity of the FX market."

Topics: Embedding an ethical risk culture; senior management setting an appropriate "tone from the top," consistent with a firm's risk appetite; and the identification and management of conflicts of interest.

2 **INFORMATION SHARING**
"Market participants are expected to be clear and accurate in their communications and to protect confidential information to promote effective communication that supports a robust, fair, open, liquid and appropriately transparent FX market."

Topics: Expectations for managing confidential information, particularly about clients; prohibitions on the spreading of misleading information or rumors; and the use and monitoring of communication channels.

3 **EXECUTION**
"Market participants are expected to exercise care when negotiating and executing transactions in order to promote a robust, fair, open, liquid, and appropriately transparent FX market."

Topics: Disclosure of the roles in which market participants are acting; fairness and transparency in order handling; and discouraging disruptive market behaviors.

4 **CONFIRMATION AND SETTLEMENT PROCESSES**
"Market participants are expected to put in place robust, efficient, transparent, and risk-mitigating post-trade processes to promote the predictable, smooth, and timely settlement of transactions in the FX market."

Topics: Operational robustness and efficiency in confirmation and settlement processes and in operational and counterparty risk management.

PRINCIPLES — PHASE 2 (expected in May 2017)

5 **GOVERNANCE**
"Market participants are expected to have robust and clear policies, procedures, and organizational structure in place to promote responsible engagement in the FX market."

Expected topics: Requirements for board and senior management oversight of FX activities, commensurate with oversight of other asset classes, as well as fully articulated policies and procedures on risk appetite and the conduct of FX business.

6 **RISK MANAGEMENT AND COMPLIANCE**
"Market participants are expected to promote and maintain a robust control and compliance environment to effectively identify, measure, monitor, manage, and report on the risks associated with their engagement in the FX market."

Expected topics: Monitoring and management of risks related to conduct and the preservation of market integrity.

What Should Market Participants Do Now?

Board directors and senior managers of firms that engage in significant FX activities should take steps now to assess their FX operating and control environment in light of the new principles. Several FX dealer banks and trading-platform operators have already begun programs to enhance oversight of their FX activities. These are typically multiyear initiatives, with significant lead times — particularly to implement monitoring and surveillance systems across multiple global dealing centers. In turn, regulators have transitioned from the investigations of FX benchmark activities to examinations of broader FX business conduct and are reviewing programs designed to improve governance and risk management of these businesses. The code will likely be a key reference standard in these examinations.

Firms conducting a gap analysis of their FX activities against code principles and formulating remedial actions may wish to consider:

- Embedding ethics principles in the firmwide **code of conduct** (or equivalent policy), consistent with the firm's risk appetite and reinforced in communications by senior management on risk culture. Compliance can best be achieved by ensuring that individuals involved in the FX business, as well as those who advise them, such as legal and compliance staff, are **appropriately trained** in the new global code and applicable regulatory requirements.
- Examining existing programs for the identification and mitigation of **conflicts of interests** and, where necessary, extending them to cover FX activities and practices.
- Reviewing the handling of **confidential information** regarding both client activity and their own risk exposures.
- Surveying **channels for communications** both within the firm and with third parties. Processes for retaining communications — both e-communications and audio — should be reviewed, and risk-based monitoring programs established or enhanced.
- Implementing **policies and procedures** requiring that the nature of a relationship with a client (for example, whether acting as agent or principal), as well as legal or regulatory obligations, is accurately documented and understood by those handling any aspect of client orders and transactions.
- Establishing clear policies and monitoring processes for **sales and trading practices in FX**, including the use of "last look," best execution, the prevention of front-running, the management of stop-loss orders, and the handling of FX fix orders.
- Establishing controls to **prevent, detect, and monitor market abuse and disruptive trading activities**, and to monitor the pricing of client transactions for fairness.
- Completing self-assessments of **operational risk** controls that focus on confirmation, settlement, and novation, with a view to risk effectiveness and efficiency.
- Having compliance departments review **compliance risk-assessment programs** to ensure that risks arising from FX activities receive attention at least commensurate with those for other asset classes.

Conclusion

The new code of conduct for FX is poised to play an important role in restoring trust in the functioning of this crucial global market. Even though it is not formal regulation, the code is likely to serve as an important standard for regulators in their supervision of market participants. Board directors and senior management at affected firms should assess how their firms measure against the code, and undertake programs to close any identified gaps and prevent future reputational or compliance risk.

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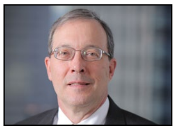

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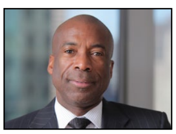

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