Guy Debelle: The global code of conduct for the foreign exchange market

Address by Mr Guy Debelle, Assistant Governor (Financial Markets) of the Reserve Bank of Australia, to the FX Week Australia conference, Sydney, 17 March 2016.

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Today, I will talk about the Global Code of Conduct for the Foreign exchange market. I will reiterate the motivation for the work we are doing, then update you on where we are at with the process and outline the way forward.

Why is the work going on? As I have stated on previous occasions, the foreign exchange (FX) industry is suffering from a lack of trust in its functioning. This lack of trust is evident both between participants in the market, but at least as importantly, between the public and the market. The market needs to move toward a more favourable and desirable location, and allow participants to have much greater confidence that the market is functioning appropriately.

A well-functioning foreign exchange market is very much in the interest of all market participants. This clearly includes central banks, both in their own role as market participants but also as the exchange rate is an important channel of monetary policy transmission. In a globalised world, the foreign exchange market is one of the most vital parts of the financial plumbing.

The Global Code is aiming to set out global principles of good practice in the foreign exchange market to provide a common set of guidance to the market, including in areas where there is a degree of uncertainty about what sort of practices are acceptable, and what are not. This should help to address the lack of trust as well as promote the effective functioning of the wholesale FX market.

To that end, one of the guiding principles underpinning our work is that the Code should promote a robust, fair, liquid, open, and transparent market. A diverse set of buyers and sellers, supported by resilient infrastructure, should be able to confidently and effectively transact at competitive prices that reflect available market information and in a manner that conforms to acceptable standards of behaviour.

The work to develop the Global Code commenced in May last year, when the Bank for International Settlements (BIS) Governors commissioned a working group of the Markets Committee of the BIS to facilitate the establishment of a single global code of conduct for the wholesale FX market and to come up with mechanisms to promote greater adherence to the code.[1]

There are two important points worth highlighting: first, it's a single code for the whole industry and second, it's a global code. It's intended to cover all of the wholesale FX industry. This is not a code of conduct for just the sell side. It is there for the sell side, the buy side, non-bank participants and the platforms; its breadth is both across the globe and across the whole structure of the industry. The Code is intended to apply to all aspects of the wholesale foreign exchange market. In the Code itself, we spell out what we actually mean by the wholesale FX market. The one noteworthy part of the FX industry to which the Code generally doesn't apply is the retail market, as that is generally governed by retail-specific regulation in the relevant jurisdiction.

I am chairing this work, with Simon Potter of the Federal Reserve Bank of New York leading the work on developing the code and Chris Salmon of the Bank of England leading the adherence work. Our Working Group comprises representatives of the central banks of all the

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1 http://www.bis.org/press/p150511.htm.

major FX centres, drawing on the membership of the Markets Committee which is comprised of heads of the market operations areas of the 15 major currency areas.[2] Given our roles, we are all very much interested in the effective functioning of the FX market. Again, it is very much a global effort reflecting the global nature of the foreign exchange market.

This work is also very much a public sector-private sector partnership. In that regard, we are being ably and vigorously supported in this work by a group of market participants, chaired by David Puth, CEO of CLS. The group contains people from all around the world, including Australia, on both the buy side, including corporates and asset managers, and the sell side, along with trading platforms, ECNs and non-bank participants, drawing from the various Foreign Exchange Committees (FXCs) and beyond. Hence all parts of the market are being involved in the drafting of the code to make sure all perspectives are heard and appropriately reflected.

At the outset we decided to split the topics we intend to cover in the Code into two parts. The first phase is the material we intend to put out in two months' time in May. It covers areas such as ethics, information sharing, execution (including mark-up) and confirmation and settlement. The second phase will cover topics such as governance, risk management and compliance, as well as further aspects of execution including e-trading and platforms (including last look), prime brokerage, and the unique features of FX swap, forward, and option transactions.

One factor influencing our choice of which topics to cover in the first phase was our assessment of what issues the market was looking for clarity on sooner rather than later.

One example of this is around information sharing, where many market participants have highlighted that they are unsure what information can be conveyed to counterparties and other market participants. While it is clear (or at least should be) that disclosing the details of a client's order book to a counterparty is not acceptable, market participants have noted that there is much less clarity around what level of aggregation, say, is necessary in order to convey market colour appropriately.

As a result, it appears some market participants are being very conservative in sharing information, which can have implications for the effective functioning of the market. This is notwithstanding the guidance provided in this area in the Global Preamble put out by the global Foreign Exchange Committees, including the Australian Foreign Exchange Committee (AFXC), in March last year.[3] The Global Code takes the material in the Global Preamble and fleshes it out a bit more, including with some examples of what is, and isn't appropriate communication, and why.

Similarly, there have been diverse opinions around what is appropriate behaviour in terms of order handling. While there have been some very public instances of inappropriate behaviour around order handling which have come to light in recent years, in other areas, the market is seeking greater guidance as to what principles should be followed, including the different standards that may apply depending on whether an intermediary is functioning as principal or agent.[4]

This is one area that was not adequately covered in the pre-existing codes of conduct that the various FXCs had endorsed for the FX market. It is an area where we are aiming to provide the sought-after guidance. But we are not writing a procedures manual for order-handling. Rather we are articulating principles that need to be taken into account. Individual firms may then take these principles and reflect them in their own procedures manual. Our aim in

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[2] http://www.bis.org/about/factmktc/fxwg.htm.

[3] Available at http://www.rba.gov.au/afxc/about-us/pdf/global-preamble.pdf.

[4] I am not using these terms in the legal sense that is sometimes the case in particular jurisdictions, but rather in terms of common market parlance.

articulating these principles is to provide market participants with the framework in which to think about how they handle stop-loss orders. The emphasis here is very much on the word 'think'. The Global Code will not provide the answers to all your questions, but it should help you ask the right questions.

In a similar vein, I will repeat a point that I have made a number of times in the past. One of our most central aims in drafting the Code is for it to be principles-based rather than rules-based. There are a number of reasons why this is so, but for me, an important reason is that the more prescriptive the Code is, the easier it is to get around. Rules are easier to arbitrage than principles. If it's not expressly prohibited or explicitly discouraged, then it must be okay seems to be the historical experience. Moreover, the more prescriptive and the more precise the code is, the less people will think about what they are doing. If it's principles-based and less prescriptive then, as I just said, market participants will have to *think* about whether their actions are consistent with the principles of the Code.

So where we are up to in the process?

Last week we circulated for comment the second draft of phase one of the Code via the various FXCs including the Australian FXC (and central banks in those countries on the Working Group without an FXC). This second draft incorporates comments on the first draft of the Code that we had circulated at the beginning of February. The first draft attracted over 1,400 comments. The comments were almost universally constructive and very supportive of the whole endeavour. I would like to thank those who took the time to provide them.

In writing this second draft, we and the market participants group took full account of all of these comments. Those who provided them can rest assured we have taken heed of them. But in saying that, you may not see your comment directly embodied in the redrafting. This in part, reflects the diversity of views on some issues in the Code. That said, we have sought to incorporate the overall feedback in a manner that best reflects the objectives for the Code that I set out above, namely that the Code should promote a robust, fair, liquid, open, and transparent market.

The comments on the second draft will be gathered over the next week or so. We will then take account of them and produce a revised draft early in April. There will be one final round for 'fatal flaw' comments after that before seeking endorsement by the various FXCs of a document we can take to the Global Foreign Exchange Committee meeting in New York on 25 May. For example, in Australia, we will be looking for the AFXC endorsement of the Code at our next meeting in early May. Following the meeting of the Global Foreign Exchange Committee, the first phase of the Global Code will be publically released.

We have already started on the work of drafting the material in phase two of the Code. We will continue with that over the next year, again having a number of rounds of comment from market participants through the FXC process.

Our intention is that the complete Code will be released following the Global Foreign Exchange Committee meeting in London in May 2017. At the end of that process, for the code to be effective and for it to achieve what we want it to achieve, it will need to be accepted and endorsed by the FXCs and market participants more generally.

That said, the process does not really end, because as the foreign exchange market continues to evolve, the Code will need to evolve with it. I will have more to say about how this ongoing evolution of the Code might occur in due course.

Adherence to the code

At the same time as we have been drafting the Code, we have also been devoting considerable time and effort to develop adherence mechanisms which promote and incentivise widespread adoption of the Global Code by market participants. Clearly, that has been an issue with the various existing industry codes that have been in place in a number of markets over many years. It is very evident that they were often ignored, wilfully or otherwise. For an industry code to have value in affirming appropriate norms of behaviour, it has to become effectively adopted in the marketplace.

While adherence to a single, consistent code of good practice is widely regarded to be in the interests of the market, the Global Code will be voluntary. As I said earlier, we are working with the industry to produce a voluntary, principles-based code of conduct rather than a set of prescriptive regulatory standards. It will not impose legal or regulatory obligations on market participants, nor will it supplant existing regulatory standards or expectations.

There is already a substantial body of law and regulation that applies to the FX activities of many market participants, and this varies significantly across jurisdictions. This variation, coupled with the diverse nature of FX markets globally, means that a 'one size fits all' approach to adherence would not be appropriate. The final framework for adherence will need to strike the right balance between respecting the existing diversity across different markets, and maintaining consistency with regard to what is a global initiative.

In that regard, we have articulated three principles which underpin our overall approach to adherence.

- Universal: The Global Code should apply to all wholesale FX market participants, based on the activities they undertake and subject to compliance with any applicable regulations. We have been working hard to incorporate the perspective of all types of wholesale FX market participants into the draft Code, and we want it to be widely applicable across the market.
- Proportionate: How wholesale FX market participants adhere, and demonstrate their adherence, to the Global Code should be proportionate and appropriate to the type of participant and the context of the local financial markets.
- Transparent: the mode of adherence should be transparent, to enable monitoring and market discipline.

It is worth stressing that the "proportionate" principle is not designed to lower the bar – it is designed to reflect the differences in the type and volume of market activities of certain market participants and the variation in FX markets worldwide.

The concrete details of the adherence mechanisms remain a work in process. We will have more to say on this in New York in May. At this stage, our thinking is that there is unlikely to be a single adherence mechanism but rather a suite of mechanisms.

Conclusion

That, I trust, gives you a reasonable overview of the state of play on the Global Code.

A lot of work has been done to get us to this point. There is still a lot of work to be done.

The work to date has reflected a very constructive and cooperative effort between the central banks and market participants. All of us recognise the need to restore the public's faith in the foreign exchange market and the value of the Global Code in assisting that process and also in helping improve market functioning and confidence in how the market functions. I expect that cooperative relationship will continue as we see this process through to its conclusion in May next year.