Simon M Potter: The role of best practices in supporting market integrity and effectiveness

Remarks by Mr Simon M Potter, Executive Vice President of the Markets Group of the Federal Reserve Bank of New York, at the 2016 Primary Dealers Meeting, Federal Reserve Bank of New York, New York City, 7 September 2016.

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Welcome to this year's primary dealer meeting, and thank you for joining us today. Primary dealers play several important roles as trading counterparties of the New York Fed in its implementation of monetary policy, as participants in Treasury auctions, and as providers of information on market conditions to support the Desk's monitoring of financial markets.[1] These annual meetings provide us an opportunity to strengthen this relationship and communicate our expectations for you.

The official sector and market participants have a shared interest in ensuring that markets function efficiently, effectively, and fairly in the provision of financial services to all stakeholders, particularly firms and households. To help achieve these goals, the official sector employs a variety of channels, including legal, regulatory, and supervisory. In addition, officials work with market participants to create best practice guidance that complements official-sector initiatives.

Today, I will focus my remarks on how best practice efforts can help support the integrity and effectiveness of financial markets. I will draw upon the New York Fed's experience with the Treasury Market Practices Group (TMPG), the Foreign Exchange Committee (FXC), and the Bank for International Settlements (BIS) Foreign Exchange Working Group (BIS FXWG) in developing and refining best practices for financial markets. The markets covered by these groups are those for U.S. Treasuries, agency debt, agency mortgage-backed securities (MBS), and foreign exchange (FX). Segments of these markets have historically operated under an over-the-counter (OTC) trading model and, as a result, lack a formal central trading venue like an exchange with established rules.[2] These markets are of particular interest for central banks globally, because of their important role in the implementation of monetary policy. In light of these considerations, central banks have made extensive efforts to convene market participants to develop best practices that help cultivate fair and effective markets.[3]

As a participant in these markets, the Desk has a direct interest in their integrity and effectiveness. I hope my remarks will reinforce why the New York Fed and primary dealers as a group should be interested in continuing to support best practices. Your engagement in

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[1] The "Desk" refers to the Federal Reserve Bank of New York's trading desk, which implements monetary policy on behalf of the Federal Reserve System, as directed by the Federal Open Market Committee.

[2] Exchanges, such as those in the U.S. securities and commodities markets, develop standards that promote efficient and fair trading for activity conducted on the exchange, govern the products traded through the exchange, and set minimum fitness standards applicable to members of the exchange; exchanges thus are able to set rules for their participants that touch on many of the concerns that may be addressed by best practices. That said, even markets that feature a great degree of exchange trading may benefit from a consideration of best practices.

[3] The U.K.'s Fair and Effective Markets Review was a critical effort to reinforce confidence in the wholesale fixed income, currency and commodities markets in the wake of serious misconduct seen in recent years. This effort was led by the Bank of England in collaboration with the HM Treasury and the Financial Conduct Authority.

the process is essential and your commitment to abide by best practice recommendations is vital to well-functioning markets. I will begin by describing what I mean by best practices, follow with a discussion on central banks' interest in supporting them, and conclude by pointing to some of the challenges in promoting widespread adoption.

Before continuing, I would like to note that the views I share with you about best practices today are mine and do not necessarily reflect those of the Federal Reserve Bank of New York or the Federal Reserve System. However, remarks on the expectations for primary dealers reflect the policies of the Federal Reserve Bank of New York.

What are best practices?

Best practices are recommendations intended to encourage market participants to adopt principles, processes, or procedures that affirm or raise standards in their sectors or industries. Many sectors, including manufacturing, agriculture, and education, have successfully employed best practices to bring about positive change.[4] In the financial sector, the aim is to design best practices that enhance behaviors or practices that support market integrity and effectiveness. While best practices do not constitute legal or regulatory obligations for market participants – or serve as a substitute for regulatory standards – they can serve as useful guideposts in establishing expectations for responsible market conduct and conventions. Effective best practices – those that are well-designed, consistently applied and upheld by market participants – can produce positive externalities that benefit all industry stakeholders, thereby serving as a public good. If used well, best practices can be adapted quickly as market structures, practices, and participation evolve and thus offer timely guidance to market participants. On occasion, they may also help inform regulation.

Best practices can be broadly categorized into those that are quite narrow, targeting very specific conduct or processes, and those that involve broad principles. Those that are narrow in scope are usually more straightforward to implement, and relate to outcomes that are easier to measure. For example, it is fairly easy to assess adherence to the best practice recommendation to implement a fails charge when a seller fails to deliver a Treasury security, or to use a payment-versus-payment settlement mechanism for FX transactions.

In contrast, best practices that propose broad principles can be implemented differently across institutions and have outcomes that do not lend themselves to easy measurement. For instance, it is difficult to gauge the extent to which an individual market participant behaves in a manner that supports market liquidity or whether market participants as a group apply this recommendation consistently. Nonetheless, such principle-based best practices can be quite powerful in motivating market participants to think carefully about their internal policies and procedures and consider whether they are consistent with broader principles. Both types of best practices are important.

Successful best practices are almost always developed using a collaborative and inclusive approach. Ideally, with respect to financial markets, the process should include a wide range of market participants, including dealers, banks, buy-side firms, and market infrastructures, representing different areas of expertise, including the core business lines, legal, compliance, operations, technology, and custody. A public consultation process may be helpful in further enhancing the development process.[5] These types of approaches can bring a wide array of

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4 Some examples of best practices in these sectors include: the National Education Association, which develops pedagogical standards based on its research; the Best Manufacturing Practices Center of Excellence, which helps businesses identify, research, and promote exceptional manufacturing practices, methods, and procedures; and the Food and Agriculture Organization of the United Nations, which develops and shares "good agriculture practices" for a range of commodities.

5 During the development of the first phase of the BIS FX Global Code, a large number of detailed comments and useful suggestions were received from market participants that were integral to the drafting process. In April 2015, the TMPG solicited comments on its proposed best practice updates related to automated trading

diverse perspectives to bear on the design of best practices, helping to ensure the best practices developed are more effective.

Central banks' role in supporting best practices

Central banks have an interest in ensuring well-functioning markets – as market participants and for efficient transmission of monetary policy. We also have a stake in enhancing the strength and stability of the financial system as a whole. Moreover, central banks can play an important role in the creation of effective best practices by serving as a convening body for market participants, by signaling the importance of best practice efforts to the market, and by encouraging the inclusion of a diverse set of market segments in the development process.

First, particularly where OTC markets predominate, a central bank can bring together market participants to discuss and address issues collectively. There is a rich history of collaboration between the official sector, the academic community, and industry participants to analyze existing issues, identify emerging risks, and develop guidance for financial markets. Over time, the New York Fed has led a number of such efforts. For example, the OTC Derivatives Supervisors Group addressed emerging risks of inadequate infrastructure for the growing credit derivatives markets. The New York Fed and the Board of Governors convened the Alternative Reference Rates Committee, which is currently working to identify a set of alternate reference interest rates for financial products and contracts that are more firmly based on transactions from a robust underlying market and that comply with international standards.[6, 7] Similarly, the U.K. official sector worked with a panel of market participants in developing the recommendations in the Fair and Effective Markets Review.

The New York Fed also sponsors two industry groups that have long-term missions focused on best practices. The TMPG is, as you know, a group of market professionals committed to supporting the integrity and efficiency of the U.S. Treasury, agency debt, and agency MBS markets. To that end, the Group develops guidance to promote market liquidity and transparency, robust control environments, efficient market clearing, and managing large positions with care.[8] The New York FXC examines similar issues in the FX market. It has a long history – more than three decades – of publishing documentation to facilitate FX transactions and market functioning and to articulate best practices.[9] The New York Fed is also involved in the BIS FXWG to help establish and promote adherence to an FX Global Code, a single set of guiding principles for the FX market. These groups have confronted collective action problems where an individual firm may want to raise concerns, but be unable to drive market-wide improvements.

Second, when central banks partner with private-sector participants to develop best practices, it can send a powerful signal to the market. For their part, private-sector

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in TMPG-covered markets and received feedback from firms active in electronic trading and an industry association of proprietary trading firms. This feedback helped refine the proposed best practice updates.

6 The OTC Derivatives Supervisors Group originated in 2005 when the New York Fed hosted a meeting of major OTC derivatives dealers and their domestic and international supervisors. The Alternative Reference Rates Committee was convened by the Federal Reserve in 2014 in a meeting with representatives of major OTC derivatives market participants, their supervisors, and central banks.

7 Outside of New York Fed-sponsored groups is the Group of Thirty (G30). The G30 was established in 1978 and is an international body composed of senior representatives in the private and public sectors and academia. It has a broad mandate and works on various issues relating to international economic and monetary affairs.

8 The current version of TMPG's *Best Practices for Treasury, Agency Debt, and Agency Mortgage-Backed Securities Markets* is available here.

9 Such documentation includes, but is not limited to, FX master agreements, FX non-deliverable transaction documents, and FX master give-up agreements.

participants contribute their expertise and have a sense of ownership in the process. By integrating best practices within their own institutions, private-sector participants support market adoption.[10] Central banks – with their public orientation and interest in the integrity and effectiveness of markets – can further encourage broad adoption of best practices.[11]

Third, central bank support can also help broaden the composition of those engaged in designing best practices. The New York Fed strives to have all important segments of the market represented in the membership composition of the groups it sponsors. For example, the TMPG recently added individuals who have experience at a regional broker dealer and a high-frequency trading firm to broaden the views and perspectives on the committee. FXC membership has also evolved significantly since the group's inception. Both committees include institutions from the sell-side, buy-side, as well as infrastructure providers, such as trading venues.

Central banks, and their counterparts, also encourage international collaboration. Such collaboration has increased over time and has reached a significant milestone through the work to develop an FX Global Code. This work spans sixteen different central banks, covering major financial centers in advanced and emerging market economies, and it includes a set of private-sector market participants. The BIS FXWG formed a Market Participants Group (MPG) which includes representatives across the globe and includes the sell-side, buy-side, and market infrastructure communities. The regional FX committees are also integrally involved in the work.

Issues addressed by best practices

Let me now highlight how, in my experience working with New York Fed-sponsored committees, best practices can play an important role in addressing a range of issues. For example, best practices can identify emerging risks, solve "first-mover" problems, challenge long-established practices, improve market function, and assist control functions.

Collaboration between market participants and central banks in groups like the TMPG or the FXC can promote identification of evolving or emerging risks and resulting best practices can publicize those risks, and suggest mitigants for them, to the broader market. For example, the FXC, recognizing the risks associated with the increased use of automated trading, published a set of recommendations in 2006 around "auto-dealing" in FX markets. The TMPG provided similar guidance in 2015.[12]

Importantly, best practices can be a way to resolve first-mover problems. For instance, a sizeable portion of the non-centrally cleared forward-settling agency MBS transactions prior to 2013 remained unmargined, posing counterparty risk in the event one trading party were to default, and potentially systemic risk to the overall financial system. Margining such transactions is a common and sensible way to reduce counterparty exposures and systemic risk. However, no market participant wanted to be the first to begin charging margin out of

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[10] Several examples in the FX and fixed income markets illustrate that best practices would not be successful without the undeniable support of market participants. For instance, reduction is settlement risk due to the adoption of payment-versus-payment mechanisms, drop in settlement fails in U.S. Treasury markets after the implementation of the fails charge, and improvements in the derivatives markets infrastructure are just a few examples.

[11] The BIS effort to develop an FX Global Code and the Bank of England's leadership of the Fair and Effective Markets Review are two examples of this public-private partnership.

[12] Automated trading has also been the focus of significant regulatory attention in the United States and elsewhere over the last several years. See, for example, the Commodities Futures Trading Commission's proposed rules on "Regulation Automated Trading," the recent Financial Industry Regulatory Authority (FINRA) amendment to the National Association of Securities Dealers Rule 1032, and the proposed amendments to the U.S. Securities and Exchange Commission's Rule 15b9-1.

fear that their counterparties would stop trading with them and move their business to a counterparty that did not require margin. The TMPG addressed this problem with a recommended practice that all market participants exchange two-way variation margin on a regular basis.[13, 14]

Best practices can also encourage market participants to question long-established trading practices and advocate for change. As an example, in the FX market, concerns were raised about the integrity of FX rate benchmarks, particularly around incentives for potential market malpractice linked to the structure of trading around the benchmark fixings, such as the WM/Reuters 4pm London fix. The WM/Reuters fix is one of the long-standing and dominant benchmarks used in the market. It was structured in a way that created an incentive for dealers to "trade ahead" of clients at the fix and also an opportunity for them to influence exchange rates. The FSB's FX benchmark working group produced recommendations that called for a change in methodology around the structure of the fix and changes in firms' trading behavior at the fix. Guidance suggested that firms establish and enforce internal guidelines and procedures for collecting and executing fixing orders, such as separate processes for handling such orders. In addition, the group recommended that transactions conducted at to-be-determined levels be priced in a manner consistent with the risk borne in accepting such transactions through such methods as applying a bid-offer spread or a direct fee. The Global Preamble, published by the FXC in coordination with other FX committees, supported and reinforced the FSB's FX benchmark recommendations.[15, 16] Since the release of the recommendations, a number of changes have been made. For example, there is a new structure for certain FX benchmark rates, including the WM/Reuters fix. Many dealers have changed how they provide FX benchmark execution, with a growing emphasis on the use of algorithmic execution and a more transparent pricing structure. Such work is, and should be, continuing.

Best practices have been especially effective in improving financial market functioning. In the period prior to 2006, episodes of persistent failures to deliver securities on settlement days were impacting the smooth functioning of the U.S. Treasury market, posing counterparty credit and systemic risk.[17] The introduction of the Treasury fails charge trading practice in May 2009 incentivized sellers of securities to resolve fails promptly and promote efficient market clearing. During the first four months of 2009, Treasury fails averaged a bit over

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[13] The TMPG issued a recommendation to introduce margin requirements for agency MBS transactions in November 2012. It collected data from its members on the progress made towards implementing the recommendation and reported summary statistics to the public, which may have supported wider adoption. The TMPG's elevation of this important issue informed FINRA's amendment of its Margin Requirement rule to establish margin requirements for forward-settling To Be Announced (TBA) transactions.

[14] In the FX market, similar concerns around credit risk came to the fore during the global financial crisis, and the FXC adapted its best practices to encourage widespread adoption of credit support annexes in 2010.

[15] Significant work has also taken place in regards to FX benchmarks with various regional FX committees working together to produce the Global Preamble to support implementation of the FSB's FX benchmark recommendations. See here.

[16] Another example is the market's long-standing use of ICAP's Fed Funds Open (FFO) as a benchmark for various financial transactions. However, ICAP, the FFO publisher, did not consider it to be a financial benchmark and did not calculate it as such, which raised questions about the FFO's suitability to be used in such a manner. The TMPG identified this issue during its work on financial benchmarks and encouraged industry groups to examine possible alternatives to the FFO. This led the Securities Industry and Financial Markets Association (SIFMA) and the Risk Management Association (RMA) to jointly recommend that market participants use the overnight bank funding rate, a rate more consistent with international best practice recommendations. See SIFMA's and RMA's joint announcement here and the TMPG's statement of support here.

[17] The following year the TMPG was established and issued its first set of best practices, with several recommendations to improve the clearing and settlement processes to alleviate fails. See here.

$14.4 billion per day. About a year following implementation of the fails charge, fails declined to only $4.2 billion per day.[18]

Best practices can serve as a tool by which control functions, such as compliance, audit, and legal, can test their firms' procedures and activities against affirmed standards of best practice. The standards can act as a measuring stick that, along with applicable law, regulations, and supervisory expectations, encourages continuous improvement of front, middle, and back offices. For example, the TMPG has a series of practices directed at managing large positions with care. Implementing them requires compliance functions to be thoughtful in determining how to identify large long or short positions, given the uncertainty of tradable float. It also challenges staff to consider which trading strategies may have adverse implications for market liquidity and whether they warrant policies around them. Further, the TMPG's best practices note that responsibility for establishing and maintaining a rigorous internal control environment within an organization rests with its senior management.

Neither best practices nor laws nor regulations can guarantee a lack of bad behavior. Recent failures illustrate the adverse consequences that behavioral weaknesses can have for those who rely on financial services. It also underscores the importance of adopting a culture that creates an environment in which laws, regulations, and best practices are valued and upheld. To that end, regulators and supervisors in various jurisdictions have heightened their focus on firms' corporate governance programs and emphasized the need for instilling values that promote proper behavior and sound decision-making throughout the firms. For example, the New York Fed has been working to advance industry driven culture reform in the financial services industry over the past few years.[19] We are joined by other official institutions and groups across the globe, such as the Group of 30 and the Basel Committee, in pushing for heightened standards of market practice and behavior.[20]

Promoting adoption of best practices

Ideally, best practice standards should become an integral part of the market, observed consistently and transparently by participants across various segments. However, unlike regulations or supervisory standards, compliance with the best practice standards developed by our committees is not mandatory for the broader market. Furthermore, there may be instances where implementation may vary given the diversity of entities in the market and the different profiles of market engagement. This is particularly relevant for the global FX market, with its range of market participants.[21] Central banks play an important role in convening industry stakeholders to develop high standards of behavior that promote fairness and integrity, and in pushing the industry to affirm them. Nonetheless, central banks are not acting as regulators when they sponsor these committees, even when they have relevant regulatory powers.

Since best practice standards that are articulated by the committees that we work with are not, in and of themselves, binding, promoting their adoption is both challenging and important. We work on a number of fronts in this effort. We strive to engage a wide diversity

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[18] See "The Introduction of the TMPG Fails Charge for U.S. Treasury Securities" for more information.

[19] The New York Fed has organized workshops and conferences on reforming culture in the financial services industry. Additionally, several executives have spoken publicly on the topic. See here for more detail.

[20] The G30, the Basel Committee, the European Systemic Risk Board, and the FSB have issued papers on culture, governance, and misconduct risk. The Bank of England's Fair and Effective Markets Review called for higher conduct standards for the fixed income markets. The central bank of the Netherlands – De Nederlandsche Bank – has developed new approaches for the supervision of corporate culture and decision-making.

[21] The MPG is working with the BIS FXWG to develop market-based adherence mechanisms for the FX Global Code.

of market participants as we develop best practices. This is to ensure that the practices reflect all relevant segments of the market and to promote buy-in and thus foster their adoption. As I mentioned before, both the TMPG and the FXC are expanding their membership such that a range of market participants feels vested in their missions. In addition, we engage with other sectors of the marketplace, such as trade associations and infrastructure providers, to educate them about best practices that have been developed and facilitate their potential adoption of aspects of them.

When central banks operate in the markets ourselves, we expect the best practices to apply. This has two aspects. First, we align our own practices to the best practices, except where it would inhibit our policy functions. As a corollary, we expect those institutions that choose to become our counterparties to comply with the best practices as well, so that when we transact, we do so with the confidence that our counterparties are adhering to these standards of behavior.

Finally, we keep supervisors, regulators and other official sector bodies, inside and outside our four walls, abreast of the work of our committees. In some cases, they may choose to adopt standards first articulated by our committees as part of their frameworks.[22]

Conclusion

Market participants have a responsibility to themselves, their clients, and the financial markets in which they transact to implement best practices within their own institutions and to encourage their clients and other counterparties to do the same. Broad adoption of best practices can strengthen each market participant's existing controls, help reduce market disruptions, and ultimately foster greater confidence in the broader financial system.

Raising standards of behavior begins with creating a culture in which people are motivated to follow good market practices. The primary responsibility for improving the culture in the financial services industry rests with you, your firms, and every other financial institution participating in global financial markets. Best practices can play a role in building a strong ethical culture that improves the behavior of market participants and strengthens the public's trust in the industry.

Central banks have an interest in ensuring that financial markets sustain a healthy and robust economy. As active market participants and for the transmission of monetary policy, we support best practices that promote the integrity and effectiveness of the financial markets. We recognize the usefulness of establishing a collaborative process for identifying and affirming standards of good market practice. We also recognize that the success of best practices relies on the contributions and undeniable support of market participants and primary dealers in particular.

As primary dealers, you play an important role in implementing best practices internally and supporting the integrity and efficiency of markets. The TMPG's and the FXC's best practices are intended not only for dealers or market makers, but for all participants active in the relevant market. Your firms are important first adopters of best practices given your positions as central nodes. We also expect you to be engaged in a process to proactively identify emerging risks and vulnerabilities, and to suggest improvements to best practices as market structure evolves. We highly value your role as responsible counterparties and market participants, and expect your continued engagement and support in maintaining fair and effective markets.

Thank you.

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22 For instance, FINRA recently amended its Margin Requirement rule to establish margin requirements for forward-settling TBA transactions and noted that its proposal was "informed by the set of best practices adopted by the Treasury Market Practices Group."