Simon Potter: The Foreign Exchange Global Code - lessons learned and next steps

Remarks by Mr Simon M Potter, Executive Vice President of the Markets Group of the Federal Reserve Bank of New York, at the 2017 FX Week Conference, New York City, 12 July 2017.

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Good morning. It is a pleasure to return to FX Week USA, and I would like to thank FX Week for the invitation. Foreign exchange (FX) market participants play important roles in their interactions with the New York Fed. They act as FX trading counterparties of the New York Fed and they provide information on market conditions to support the Desk's monitoring of financial markets and transmission of policy. I am pleased to have the opportunity to speak with you today. Before I begin, I would also like to note that my comments today reflect my own views and not necessarily those of the Federal Reserve Bank of New York or the Federal Reserve System. However, remarks on the expectations for FX counterparties reflect the policies of the Federal Reserve Bank of New York.

At this event two years ago, I highlighted the important role the FX market plays in facilitating the flow of capital across the globe in support of international trade and investment. It is a critical market that is relied upon by households, corporations, financial institutions, asset managers, sovereigns and many others. In 2015, I called on the industry to help strengthen the foundation of the market and to uphold its integrity. Today, I am pleased to say that the industry answered that call and there has since been significant industry engagement on work to promote the integrity and effective functioning of the FX market. After more than two years of work, the FX Global Code[1] (the Code or Global Code) has been published to serve as a single, global set of principles for the FX market. The Code is accompanied by a set of adherence principles to promote its widespread adoption, and includes a set of illustrative examples to further describe various practices. In addition, a new, formalized Global Foreign Exchange Committee (GFXC) was launched to engage an even broader set of regions than past efforts and to continue a more defined work program across jurisdictions for upholding the Global Code.

In my remarks today, I will share reflections on the Global Code, including some lessons learned in its development and the various steps underway to help promote and support its adoption. I will then discuss the Global Foreign Exchange Committee's (GFXC) objectives, which include the ongoing evolution and maintenance of the Code. Finally, I will spend some time discussing particular areas where the market is evolving and where the GFXC is currently soliciting additional input, including on "last look."

Development of the Code and its principles

The Foreign Exchange Working Group (FXWG), led by Guy Debelle of the Reserve Bank of Australia, was established under the auspices of the Bank for International Settlements (BIS) Markets Committee in July 2015.[2] It was tasked with facilitating the development of a single, global set of principles for the FX market and accompanying tools to promote adherence to those principles. I had the pleasure of leading the work stream to write the Code, while Chris Salmon of the Bank of England led the effort to create tools to promote adherence. The work of the FXWG was supported by the Market Participants Group (MPG), led by David Puth of CLS, which included members from all corners of the FX industry.

As made clear in the foreword, the Code is not regulation—it is a set of voluntary, global best practices. The development of successful best practices requires active engagement from a diverse spectrum of market participants, which we were fortunate to have throughout this effort. The FX Global Code is intended for *all* FX market participants engaged in the global wholesale market. This includes sell-side institutions, certain market infrastructures, and buyside institutions as well. The spectrum of buy side institutions active in FX is particularly complex and varied, encompassing hedge funds, high frequency trading firms, asset managers and corporates among others. The size and complexity of their FX market activities and the nature of those activities may differ significantly. Hearing the viewpoints of many different institutions was critical to delivering a relevant Code for this diverse landscape, recognizing that while the Code applies to all, the details of precisely *how* it applies may differ. I found that the series of frank debates and discussions that we—market participants and central bankers alike—had over the past two years was an important process in itself, and not just a means to an end. The result was multiple drafts of the Code and, ultimately, a product that more clearly articulated principles and defined terminology.

The 55 principles within the Global Code focus on promoting transparency, fairness and mitigating risk across six primary areas–Ethics, Governance, Execution, Information Sharing, Risk Management and Compliance, and Confirmation and Settlement. I would like to highlight a few of these principles to provide a sense of the Code's content, and use these examples to illustrate some of the fundamental building blocks of a fair, transparent, and efficient market.

The Code begins with principles on ethics. The very first principle states that Market Participants should strive for the highest ethical standards. While this is a basic concept, the principle is fundamental and underpins each and every principle that follows. Market participants should both *have the right tools* to make the right choices and *want* to make the right choices. The various principles on governance then build upon that ethical foundation. They highlight some of the key structures that a firm should have in place to support responsible behavior by its individual employees and as an organization overall.

The principles within the execution section were those that occupied the most hours of focus during the last two years. Principle 8, for example, is the first execution principle and is quite short: "Market Participants should be clear about the capacities in which they act." Although short, this principle generated very active discussion. Reaching consensus on how to describe various roles in the market was unexpectedly challenging. Terms relating to these roles, like principal and agent, may be used differently across different regions and by different entities. Moreover, they may have legal definitions, and the Code is not intended to interfere with legal definitions.

Within the Code, acting as an 'agent' is described roughly as executing orders on behalf of a client without taking on market risk in connection with that order. Acting as a 'principal' is described as taking on one or more risks in executing a client order. In doing so, a principal may have discretion in the execution of a trade and, if so, that discretion should be communicated clearly and exercised fairly and in such a way that is not designed or intended to disadvantage the client. These concepts are echoed in the various principles that follow, which highlight more specific recommendations based upon the roles market participants take on and the types of transactions in which they engage. Labels aside, the fundamental recommendations regarding roles recognize the importance of clear communication of roles, the importance of fairness and the strong expectation that discretion not be used in a manner designed to disadvantage a client.

Clarity of terminology was again important during the development of Principle 11 on pre-hedging. The Code is very specific in how it describes pre-hedging. It is defined as "the management of the risk associated with one or more *anticipated* client orders, designed to benefit the client in connection with such orders and any resulting transactions." The principle then lays out circumstances in which such pre-hedging may or may not be appropriate.

The principles on information sharing cover topics where there had seemed to be a lack of clarity within the market. The principles emphasize the importance of appropriately identifying and managing confidential information. They describe *what* may constitute confidential information and *when* such information should or should not be shared and with *whom*. They also provide guidance as to how market participants might communicate market color appropriately and, critically, without compromising confidential information.

It is important to recognize that the FX market is not entirely about trading and execution—risk management, compliance, and confirmation and settlement are central to FX transactions, and they comprise the final two sections of the Code.

Within the section on risk management and compliance, principles focus on recognizing and understanding the risks faced and employing tools to mitigate those risks where possible. In this context, the Code highlights that it is important for each institution to evaluate these risks based on the role it plays in the market. Two areas we focused significant time on during the development of the Code were prime brokerage and electronic trading platforms. The Code notes that market participants who provide credit intermediation and/or market access to other market participants should (a) take that activity into account in their risk assessment and (b) engage in dialogue with the participants they are providing access to about responsible behavior in the market.

Finally, the last section includes various confirmation and settlement principles that reduce operational risk related to FX transactions where possible. These principles encourage smooth, efficient, and timely settlement of FX trades and highlight various steps to help support that aim.

Adoption of the Code

The FXWG central banks had a clear mandate from the BIS governors to not just develop the Code, but to also develop means to promote its adherence and ultimate effectiveness. Central banks and the industry can take steps to support the Code's widespread adoption in the market across all types of market participants—from FX dealers, regional banks, asset managers, and corporations, to hedge funds, high frequency trading firms and others, such as FX trading platforms and algorithmic service providers. As I noted earlier, while the Code is not a set of rules, nor is it regulation, support for the Code and its principles is central to achieving its goals. With that in mind, I would like to turn now to the Statement of Commitment that was developed alongside the Code, talk about steps the New York Fed itself is taking, and then touch upon some of the industry measures underway to support adoption.

The Statement of Commitment was developed and appended to the Code to provide a standard tool by which an institution may—on a voluntary basis—demonstrate its commitment to the principles of the Code. The Statement of Commitment provides that an institution is an FX market participant and has reviewed the Code. By using it, an institution acknowledges the principles as reflecting good practice and exhibits a commitment to conducting that institution's activities in a manner consistent with the Code. The Statement, like the Code itself, acknowledges that market participants vary by size, complexity and nature of activities, and that diversity should be reflected in the steps they may need to take for adoption and adherence.

Central banks, similar to FX market participants, are committed to the Code's adoption as well. Following its publication, BIS central bank governors expressed their support for the Code by noting that central banks "are strongly committed to supporting and promoting adherence to the Code. They confirm that they intend to adhere to the principles of the Code, and will expect the same of their regular FX counterparties, except where this would inhibit the discharge of their policy functions. Additionally, members of central bank sponsored foreign exchange committees will be expected to adhere to the Code."

Consistent with this support, and in light of our interest in the integrity and effective function of the

FX market, the New York Fed will be focusing on adherence to these best practices. We are currently assessing our own FX market activities relative to the Code and evaluating what steps, if any, we must take to be able to make our own Statement of Commitment. In addition, we have revisited our own counterparty policy in light of the Code. The Federal Reserve Bank of New York policy on counterparties for market operations had already noted that counterparties were expected to operate in accordance with best practices promulgated by the New York Fed-sponsored Treasury Market Practices Group and the Foreign Exchange Committee. However, that policy was recently revised to emphasize adherence to the Code in light of its publication. Finally, adherence to the Code is also being integrated into the membership framework for our sponsored Foreign Exchange Committee. These steps illustrate our desire to transact and engage with entities that are behaving with integrity.

Central banks have an important role to play in supporting best practices, such as the Global Code. It is, however, ultimately incumbent upon the industry to support and promote adoption of the Code across the marketplace. I'd like to highlight a variety of initiatives underway to support this adoption.

First, outreach and education regarding the Code is critical and has been underway via events like this and ongoing engagement with industry associations. Central bank colleagues and industry market participants here and abroad have been active in reaching out locally to raise awareness of the Code. New and updated education tools are already in development to help further promote the Code. As awareness permeates the market, these efforts will support better understanding and adoption of the Code.

Second, industry market participants have expressed a desire for a mechanism, such as a public register, to make public their Statements of Commitment. Discussions with industry suggest that multiple public registers may likely be established over time. I look forward to seeing how this work evolves.

It will be important to understand how the Code is being adopted across the industry. To this end, the GFXC is also developing a survey to help assess how the Code is being applied following its publication. This survey can provide a baseline that we can measure against over time, and can help to assess how the Code is filtering into the market, going forward.

GFXC, evolution of the Code and last look

Over the past two years, the industry has been very heavily engaged in Global Code efforts through the MPG and the regional foreign exchange committees (FXCs). The past two years have shown that the work of central banks and industry in partnership, at a global level, is productive in developing and supporting best practices. As such, while both the FXWG and MPG have fulfilled their mandate to develop the Code, this spirit of central bank-industry partnership will be maintained, as will the Code itself, in the future by the newly formalized GFXC.

The GFXC reflects a significant expansion of cross-border and public-private sector efforts. It is a forum that brings together central banks and market participants via the FXCs—currently representing sixteen regions—to encourage collaboration and communication on FX-related issues, to exchange views on trends and developments in the FX market, and to promote and maintain the FX Global Code. In addition, the work to develop the Code has led to the development of central bank-sponsored FXCs in *new* regions, some of which have already launched and others that are forthcoming. FXCs, including the one sponsored by the New York Fed, will play important roles both within their own region and in their global engagement via the GFXC.

One of the key objectives of the GFXC is to keep abreast of the evolution of the market, and work to ensure that the Code's principles remain relevant. One area of evolution is electronic trading. Before concluding, I want to spend some time discussing the GFXC's request for feedback on particular aspects related to the use of last look in electronic FX trading.

As you might suspect, Principle 17 on last look likely consumed the most time and energy of any of the principles in the Code. In many areas within the last look principle there was broad consensus as to what constitutes good practice. What was clear from this process was that market participants seemed to define last look in different ways and apply it in different ways as well. Last look is described in the Code as a practice in which a market participant receives a trade request and has the opportunity to accept or reject that trade request against its quoted price. The Code notes that if utilized, last look should be used as a risk mechanism to verify validity and/or price. The principle focuses on the importance of transparency and fairness. Market participants should be clear about whether and, if so, how last look might apply to their client trade requests to allow clients to make an informed choice regarding their execution.

In one particular area—that of trading during the last look "window"—there was a definite diversity of views. On the one hand, some market participants argued that such trading activity would always be detrimental to the client as it could move the market in a direction that is not to the client's advantage. On the other hand, some market participants felt that such trading activity could increase their ability and willingness to conduct client trades presented by clients without necessarily placing the clients at a disadvantage. Some expressed the view that they prefer only to use dealers that don't trade during the last look window, while others preferred having different options.

Given this range of input, the principle highlights that last look should not be used for the purposes of information gathering without an intention to accept the trade request. Further, it notes the risk associated with trading activity during the last look window. The principle provides that "trading activity that utilizes the information from a Client's trade request, included any related hedging activity, is likely inconsistent with good market practice because it may signal to other Market Participants the Client's trading intent, skewing market prices against the Client, which (1) is not likely to benefit the Client, and (2) in the event that the Market Participant rejects the Client's request to trade, constitutes use of Confidential Information in a manner not specified by the Client."

In light of the breadth of opinions expressed during the development of this principle, the GFXC has decided to reach out to the broader market for further input on this narrow topic of trading during the last look window. The GFXC poses two questions. First, it asks whether respondents agree with the characterization of trading activity during the last look window and whether there are examples where such activity can benefit the client within the context of how last look is described in the Code. Second, it asks whether respondents believe the language related to trading during the last look window should be modified.

Many of you are very knowledgeable about these topics and we hope you will take the opportunity to share your insights on these questions. The GFXC is not only seeking views at the tails, but also those more in the middle of the spectrum as well. Importantly, all perspectives are welcome.

Conclusion

The request for feedback is an opportunity to engage at an industry level in supporting the resilience of this critical and fundamental market—one that represents far more than the sum of its parts and players. As I said in 2015,[3] "the transactions that take place [in the FX market] are the lifeblood of a global economy that comprises many different national currencies." At that time, I called upon the industry to take action and I am impressed by what I have seen through the work in developing the Code and in the spirit in which it has been received so far. But that work isn't over—it never is.

Best practices do not work without the ongoing commitment of those in the industry, those making the choices each day. No Code, and in fact no law or regulation, can force all participants in a market as broad and diverse as FX to maintain a marketplace that values openness, resilience, high ethical standards, and competition. But, that fact is no reason to forego striving for such a marketplace. Developing the Code has been one way of working toward that goal. I hope that you all continue your focus on these issues and do your part to support a resilient global, wholesale FX market. I encourage you to adopt the Code as a benchmark for your firm's activities in the wholesale FX market and use the Statement of Commitment to demonstrate that adoption to your fellow participants. As we state in the foreword of the Code, the goal is an FX market that is a "robust, fair, liquid, open and appropriately transparent market in which a diverse set of Market Participants, supported by resilient infrastructure, are able to confidently and effectively transact at competitive process that reflect available market information and in a manner that conforms to acceptable standards of behaviour."

Many thanks for your time and continued active engagement.

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[1] The FX Global Code is available at www.globalfxc.org/index.htm.

[2] For more information about the FXWG see: www.bis.org/about/factmktc/fxwg.htm.

[3] 2015 FX Week USA speech available at: www.newyorkfed.org/newsevents/speeches/2015/pot150714.