

# COMMITTEE LETTER ON BROKERS' SWITCHES

September 23, 1993

## Re: Name Substitution (i.e. Brokers' Switches)

Dear Sir/Madam:

As part of our continuing efforts to enhance the integrity of the foreign exchange market, the Foreign Exchange Committee is issuing recommended management principles for the purpose of improving the practice of name substitution in the brokered foreign exchange market, known as "brokers' switches." It is the Committee's hope that the adoption of written procedures by dealing institutions consistent with these recommended principles will enable trading room management to distinguish switches from other foreign exchange transactions, thereby bringing switches within management control and permitting more dealing institutions to support the liquidity of the foreign exchange market by occasionally providing the facility of name substitution to other firms with whom they have available credit lines.

### Current Practice

In broker-arranged foreign exchange transactions, the names of the institutions placing bids or offers typically are not revealed until the transaction's size and exchange rate are agreed upon. The anonymity of potential counterparties is a matter of industry convention, as the very identity of the bidding or offering institution is information that could affect the terms of a transaction. From time to time, however, once the terms of such transactions are agreed upon and the identities of the institutions are revealed, one counterparty may be unacceptable to the other due to the limited availability of credit lines.

In such situations, the counterparties generally agree to the substitution of a third counterparty, or "clearing institution," between them. The third institution clears the problem transaction by executing matching and off-setting trades with the original counterparties at the original price. Usually, the clearing institution does not pay the brokerage fee on either of the two trades.

### Problems Associated with Name Substitutions

The Committee's Guidelines for the Management of Foreign Exchange Trading Activity (March 1992) state that name substitution — the interposing of a third coun-

terparty between two original parties, or "switching" — in spot transactions is an acceptable practice provided that (1) both original counterparties receive the name of an acceptable counterparty within a reasonable amount of time, (2) the clearing institution is in full knowledge of the trade, and (3) the clearing institution is operating in accordance with its normal procedures and limits.

In recent Committee discussions, however, members have concluded that, while name substitution may enhance the efficiency of the brokered foreign exchange market, such transactions can entail risks that may undermine the sound operation of the foreign exchange market. Exchange rates continue to move between the time that a counterparty is rejected and the time that an acceptable clearing institution is identified. As a result, switched transactions will usually be executed at rates not currently being quoted in the market and, therefore, must be treated with the same care as any off-market rate transaction. While in some cases the period between counterparty rejection and identification of an acceptable clearing institution may be only a few minutes, in other cases this period may extend to several hours. In addition, because name substitutions as currently arranged are an accommodation between traders and brokers and are not normally reflected as switches in the records of the institutions involved, they are sometimes accomplished without the knowledge or approval of management.

### Recommendations of the Foreign Exchange Committee

The Foreign Exchange Committee has identified the following four principles which, in addition to the Committee's existing recommendations in its Management Guidelines, are recommended to market participants as the basis for the internal management of name substitution by foreign exchange dealing institutions and brokers.

- I. The decision to "switch" or clear a trade should be made only by those individuals at a dealing institution who have been explicitly authorized to do so by senior trading room management and identified as such to brokers.

- II. The broker's confirmations to the clearing institution of the two off-setting trades comprising a switch should clearly identify each trade as being part of a switch.
- III. The clearing institution's confirmations to the two original counterparty institutions should clearly indicate that the trades were part of a switch.
- IV. Compensation to the clearing institution for switching services, if any, should be determined by the dealing institutions involved and must be explicit, clearly recorded in all relevant confirmations, and readily subject to audit controls.

The Committee also recommends that all dealing institutions maintain written procedures to implement these principles. The following guidelines suggest the type of procedures that would satisfy the principles.

1. Authorization: Management at dealing institutions should explicitly notify brokers whether they are willing to provide clearing services. If so, management should also provide the name(s) and phone line(s) of those individuals explicitly authorized to make switching decisions. Specific requests for switching by brokers should be addressed only to those institutions that have indicated their willingness to provide switching services and only to those individuals that have been identified as authorized to make switching decisions. These authorizations should be reviewed and updated periodically by trading room management.

2. Broker record keeping: Broker management should establish procedures to maintain records of all switched transactions and to mark the confirmations to the clearing institution with the legend "switch."

The marking of the confirmation by the broker will provide notice to management at the clearing institution that the two trades were part of switch. This will also provide an independent means of distinguishing switches from other off-market rate transactions and will permit trading room management to verify its own records of those occasions when clearing services were provided.

3. Dealing institution record keeping: Trading room management should establish procedures to ensure that

its institution's confirmations of switched transactions, to each of the original counterparties, also bear the legend "switch." These procedures can rely on either the brokers' confirmations or the dealing institution's own records of switched transactions.

The marking of these confirmations by the clearing institution will provide notice to management at the original counterparty institutions that the trades were part of a switch. This will permit trading room management to verify its own records of the occasions when its institution turned down another institution, or was turned down, in the brokers' market.

4. Compensation of the clearing institution: Dealing institutions are not ordinarily compensated for switching brokered trades. However, if a dealing institution is to receive compensation for switching a brokered transaction, such compensation should be agreed to by all the dealing institutions involved and conveyed by explicit and auditable means. Thus, the clearing institution should establish procedures to ensure that any compensation, from one or both of the original counterparties, is acknowledged on its confirmations of the switched transaction. All dealing institutions should establish procedures to ensure that records are maintained of payment or receipt of such compensation, in order that the compensation itself can be subject to internal and external audit and examination.

Attached is a copy of the Committee's Document of Organization and a list of its 1993 membership. Please feel free to contact myself, members of the Committee, or the Committee's Executive Assistant with any questions or comments regarding this letter.

Very truly yours,

Lewis W. (Woody) Teel  
Chairman