Mark Snyder
Chairman, Foreign Exchange Committee
Executive Vice President
State Street Global Markets

"Ethics, Best Practices and Self-Regulation: A Crossroads for the Global Foreign Exchange Market"

FX Week Congress - July 13, 2004

Introduction
Good morning. Let me say at the outset how pleased I am to speak at this event, to see so many valued colleagues from whom I've learned so much over the years.

I'm honored to have participated in the work of the FX Committee for the past five years and to have been named its Chairman this past January. And I'm very pleased that the organizers of this event have seen fit to recognize the efforts of our Committee to improve the integrity and functioning of the global foreign exchange market.

I'd like to particularly acknowledge David Puth of JP Morgan, who preceded me in the Committee Chairmanship; Dino Kos and his team at the Federal Reserve Bank of New York who provide invaluable infrastructure, inputs and a home-away from home for our Committee.

Today, I'd like to:

1. Reflect on some of the "bumps in the road" that our industry has endured over the past couple years – large FX driven losses due to a host of weak management practices and trader fraud, as well as criminal prosecutions and the like – and suggest that in any capital market, particularly in an unregulated market such as foreign exchange, personal, corporate and industry-wide ethics…..matter.
2. I'd like to reiterate the critical importance of industry best practices and acquaint or re-acquaint you with the work of our Committee in this context.
3. And finally, I'd like to consider the very special role of foreign exchange as an unregulated financial market. Self-Governed. Supervised. But not regulated. I'll make the case that this unique circumstance is a great virtue of the currency business as compared with other capital markets. And that this circumstance places on us a special burden to conduct our business with the highest possible standards.

Ethics Matter
Ethics matter. I believe they matter for reasons not often spoken of in the financial markets, because people are more than simply rational economic agents that seek to increase their wealth as their only utility function. If people are to find meaning and

significance in their life, which I believe are two of the key yearnings all people have, then ethical standards must be integrated into their daily commercial decisions. However, if others don't share this same belief about the nature of man then ethics also matter if only in the sense of enlightened self interest. In a perfect world, all dealers in the OTC FX market – together with other participants in the wholesale FX market – would embrace best practice guidelines, ethical standards and governance principles so as to foster the highest possible degrees of trust and confidence in currency trading.

In this imaginary world of commercial integrity above reproach, fraud and massive trading losses resulting from disregard for professional ethics would be a thing of the past. Free market competitive forces would rein supreme, unleashing creative energies and driving robust, sustainable volume growth in world currency markets.

It is a market reality that FX plays an integral role in the efficient use of capital and labor allocation. Frankly, through the globalization of finance and trade we help facilitate rising living standards the world over. But it is also a reality that individuals with little regard for the impact of their activities on the welfare of others have been tempted to place short-term personal gain, or sometimes just status it seems, above the best interests of their firms and of the market at large. But I would make the case that this short-sighted thinking is actually at the expense of their long-term economic self interest. Foreshortened trading and sales careers, disgorgement of profits, fines and even prison time – after all – don't add up to sound personal financial or career management.

Trust has an intangible, difficult-to measure, but nevertheless real market value. But in contemplating the role of trust in a market, I think we have to ask ourselves how trust is established and maintained on a day-to-day basis. Can we legislate trust? Can we legally mandate ethical behavior and effectively enforce it through regulation? We can try, but a world of regulatory enforcers and the combined efforts of the world's police agencies have never been able to eliminate even extreme ethical breaches and criminal enterprise.

No amount of regulation will ever be able to do for us what we must do for ourselves. And I'll return to this idea at the conclusion of my remarks.

For now, I'd like to briefly review a pair of the better-known blow-ups and scandals seen in our industry over the past few years and note a common theme. These activities – ranging from incompetent risk management to criminal fraud – can be seen as textbook cases of the ethical dilemma that I have just described – the inevitable tension between the quick-fix, the short-term gain versus the sustainable, profitable long run.

The case of the **National Australia Bank** is a cautionary tale for all of us tempted to maximize returns with practices that stretch the limits of our skills and competence. A regional institution with a steady book of profitable sell side businesses, the NAB appears to have been testing the deep waters of the currency options markets by taking risks for which it was not prepared. Result: 360 million Australian dollars in trading losses, many ruined careers amongst traders, their managers, corporate executives and pending civil and criminal penalties.

Decisions made by individual traders were clearly to blame for the events that transpired. But according to media reports, the supposedly “rogue” trading activities had in fact been noticed over time. A combination of high turnover among trading and supervisory personnel, coupled with temptation to garner higher bonuses as well as perhaps traders attempts to elevate their market status as “big hitters”, appears to have let quantitative risk management erode into undisciplined punting and led senior management to look the other way as the situation drifted toward its inevitable conclusion.

So did internal risk management systems fail? Or did individual firm employees choose to ignore the red warning lights of those systems? At the end of the day it clearly doesn’t matter, because the result is the same: short term greed and hubris careening out of control and collateral damage for employees beyond the desk, the bottom line of the firm and the reputation for the FX industry as a whole.

Operation Wooden Nickel was a very different breed. Fraud is fraud. And no amount of regulation will ever prevent those with criminal intent from breaking the law. But, as with trading blow-ups, this scandal – uncovered by a combined task force of the Federal Bureau of Investigation and the Commodity Futures Trading Corporation and resulting in charges against a total of 47 people, 5 from the wholesale FX bank marketplace – began with a slippery slope that led from less-than-optimal trading practices straight through to criminal conspiracy.

At the heart of the Wooden Nickel incident, which included accusations of fraud against retail investors and against some of the best known and respected firms in our industry, appears to have been a criminal abuse of a long-tolerated but much discouraged practice of allowing “off market deals”, and the awarding of “points” to grease the skids of commerce between banks and voice brokers. The affidavit filed in the case calls it a “Points for Cash Scheme”. While those of us in the currency markets can read the affidavit and see that the fraud involved more than simply the abuse of voice broker points, and the amount of fraudulent gains were small by wholesale financial market standards, the fact remains that allegations against the OTC foreign exchange market in the affidavit are not flattering. I quote: “Based upon information received from various cooperating witnesses in the forex industry, I have learned that, over a period of at least twenty years, there have existed schemes involving rigged forex trades being passed from corrupt bank traders at large financial institutions to co-conspirators in exchange for kickbacks.” Clearly a statement such as this does not do any of us or the industry any good.

The practice of lending “points” to a broker in order to facilitate the broker’s effort to deal at an off-market price in order to hide a trading loss is a vestige of relationship-based trading that is rapidly disappearing as financial institutions impose more comprehensive risk management and, increasingly, electronic trading.

The FX Committee, for its part, has discouraged the practice for nearly twenty years. As stated in the Committee's 1987 annual report, "Whatever an institution's policy may otherwise be, under no circumstance should a trader request or a broker agree to lend points".

Hard to be more definitive than that.

On August 1, 1990 the Fed here in New York issued a formal policy statement on the use of "points", stating that "ineffective policies, procedures and controls over disputed contracts by a financial institution can result in inaccurate records, misleading reports filed with regulatory and tax authorities, misapplication of funds and potential violations of the institution's internal policies and Federal criminal laws, regarding gifts to bank personnel. The US bank regulatory agencies have found that the use of "points" is a practice that can lead to significant abuse and is considered an unsafe and unsound banking practice."

Pretty clear. *It's a bad idea; don't do it.*

I know that there's often a disconnect between the executive offices and the trading floor. And I know that currency dealing is a complex enterprise – it certainly is on my desks. But when armed federal agents are leading your traders away in handcuffs….well, it's a little late to take notice! We all need to insist that all traders are clear on what is expected of them, and to ensure desk managers grasp their oversight duties clearly.

It is disheartening to know that discredited practices are taking place in our industry. And it is, I admit, a little satisfying to see malfeasance punished. But it can't make anyone happy to read something like the following. This, from the 24 November 2003 issue of Securities Week magazine: "The over the counter forex market is lightly regulated and huge and it has become known as a hotbed of fraud."

Think about that: "a hotbed of fraud".

I don't recognize that description as the market in which I work. Another example of concern about ethical practices of our industry came to my attention in May while sitting on a panel at a conference in London along with a number of my distinguished colleagues. A couple of currency overlay managers commented that a few of their pension fund clients were concerned about which banks their managers were dealing with in the wake of all the "FX market scandals", and had they "reviewed the standards of conduct of their FX banks?". If this is how those outside our industry see us, then we have some work to do. Simply declaring Codes of Ethics and the like isn't enough. Frankly, the kind of fraud uncovered in the Wooden Nickel affair might easily have moved under the radar of senior management – even those committed to sound trading practice.

Much of contemporary financial education and practice is dedicated toward wealth maximization as an end in itself. And certainly, making money for one's clients, one's employer and oneself is a defensible, rational practice wholly consistent with fiduciary responsibility. But we need to integrate ethical thinking into the fabric of our workplaces -- if for no other reason that that ethical behavior is in the *long-term* economic interest of each and every one of us.

In a recent paper in the Financial Analysts Journal by John Dobson entitled: *Why Ethics Codes Don't Work*, he persuasively argues that essentially all financial services professionals have been exposed to guidelines on ethics and professional responsibility yet too many individuals have ignored even the basic principals of these guidelines. His answer is "acculturation—that is implicit education into a certain moral value system. Individuals become acculturated by the day-to-day behavior they see around them because they assume such behavior is what is rational and acceptable in the field. In the financial services industry, the implied moral education comes through exposure to the value systems displayed in educational institutions, the industry, and people's firms, particularly by the firm's senior managers. Acculturation comes from observing the actual behavior of other individuals." In other words unless most people see leaders walking the walk as well as talking the talk around them, all the ethical codes in the world will have little effect.

Sustainable and above-board business practice is rational and wholly consistent with wealth maximization. I believe that organizations composed of ethical professionals excel in long-term financial performance and I'll return to this topic at the conclusion of my remarks.

Clearly, unless we get our own house in order others outside our industry may try to do it for us. And ignorance is no excuse. The FX Committee is doing an awful lot to ensure that our colleagues in the FX market are aware of what constitutes best practice, what constitutes unwelcome, impermissible behavior and the kind of high standards to which I think we must aspire.

So let me turn to the "blatant self-promotion" section of my remarks and tell you about the Foreign Exchange Committee.

Market Best Practice and the Foreign Exchange Committee

For the past 25 years, the Foreign Exchange Committee, comprised of representatives of major financial institutions, has met to discuss technical issues and best practices of the FX and international money markets. In partnership with our colleagues in the Federal Reserve Bank of New York, the FX Committee has served as an impartial forum for the exchange of knowledge and information among leading currency practitioners – all with a view to forging a collective vision of the ethics, standards and practices that we believe would best serve an efficient FX market.

Throughout my involvement with the organization I have been consistently impressed by the diversity of views held by Committee members and the vigorous exchange of views held under its auspices. I can assure you that when the Committee decides upon a technical recommendation or urges a “best” practice, that consensus view has been well-earned through vigorous discussion and an honest exchange of different perspectives. I know many of you know my Committee colleagues, and those that have served in prior years, and I doubt you would consider any of them shy!

Over the years, the Committee has helped our industry evolve through many tumultuous phases in the growth of financial markets, including the rocky road to European currency union; the interplay between currency, fixed income and equity markets; market dislocations associated with dramatic currency movements in Europe, Asia and elsewhere; the Russian debt crisis; the collapse of LTCM; the exponential rise in currency and interest-rate derivatives; the proliferation of hedge funds, the dramatic expansion of electronic FX trading, unnamed FX trading and many other issues.

Throughout, our intention has been to ensure a smooth functioning and growing currency market. Because as finance has globalized and capital has moved with steadily increasing volumes and speed, the FX market has become mission-critical infrastructure for every other kind of securities market.

The Committee is a voluntary association—our purposes are recommendatory and we have no enforcement mandate. One of the Committee’s key goals is providing leadership on issues of concern to organizations involved in the wholesale foreign exchange market. It is true that governmental banking supervisors and regulators often look to the Committee’s best practice guidance when reviewing firms involved in trading foreign exchange. Thankfully supervisory enforcement is therefore not part of the Committee’s mandate.

We think we have a full agenda simply collecting and disseminating the collective wisdom of the world’s most important FX practitioners. Toward this end, the FX Committee has produced many helpful policy letters, memoranda, papers and substantial annual reports and documents, most of which are available on our website, which you can find at the site of the New York Fed: **www.newyorkfed.org/fxc.**

Among the documents produced by the Committee – and which are regularly updated as the FX industry evolves, I will highlight three.

The **“Guidelines for Foreign Exchange Trading Activities”** seeks to provide all participants in the wholesale foreign exchange community with a common set of best practices that will assist in the conduct of their businesses. Through this document, the Committee seeks to promote market efficiencies and transparency and to facilitate informed decision making.

The Guidelines cover trading issues such as time-proven best practices for trading staff; safeguards or trading with electronic brokers; procedures for special trading practices, including historical rate rollovers, stop-loss orders and switches; and solutions for trade related problems.

With regard to FX Sales, the Guidelines stress the critical importance of "know your customer" -- awareness of suspicious customer activities; appropriate customer dealings; dealing with unnamed and undisclosed counterparties and money laundering.

The guidelines provide a guide to effective risk management, the types of risk facing every FX trading business and suggestions for limiting risk – including market risk, credit risk, settlement risk, liquidity risk, operations and technical risk and legal risk. Finally, the guidelines stress the importance of ongoing training and support staff.

Another important document is the **"Management of Operational Risk in Foreign Exchange"** – a comprehensive text that details sixty best practices to help manage the revolutionary changes being witnessed in the FX marketplace.

This checklist of best practices seeks to aid industry leaders as they develop internal procedures and guidelines aimed at improving risk management—including direct or indirect loss resulting from inadequate or failed internal procedures, people and systems or from external events. Often, operational risk in the FX context centers on processing, product pricing and valuation – all of which can negatively impact a firm's profitability.

The best practices in the document seek to mitigate some of the operational risks common to FX, in the belief that if individual market participants take advantage of the FX Committee's counsel, we can reduce systemic risk to the market overall. We encourage FX market participants to use this checklist to periodically review the integrity of their own operations.

The best practices are grouped into sections based upon the seven steps of the FX trade process flow: pre-trade preparation, trade capture, confirmation, netting, settlement, nostro reconciliation and accounting/financial control processes.

In recognition of the growing variety of institutions today involved in foreign exchange, I would draw your attention to one additional document, **"Foreign Exchange Transaction Processing – Execution to Settlement",** which contains a series of recommendations for non-dealer participants in the FX market.

This text seeks to share the experience of financial institutions regularly engaged in the FX market with non-dealer institutions that may employ FX markets on a more occasional basis. The document highlights 21 issues related to risk awareness for non-dealers such as asset managers and hedge funds.

Among the specific topics addressed: KYC and counterparty identification; electronic trading; segregation of duties; timely trade entry; trade confirmation and timely resolution of confirmation discrepancies.

This document strongly urges that firms continually evaluate their trading procedures, trade capture systems, accounting policies, operational procedures and risk management tools. It urges the establishment of codes of conduct in conformity with applicable laws and industry conventions as well as the documentation and periodic update of policies and procedures.

These documents represent the collected wisdom of hundreds of FX professionals who have guided our industry for a quarter century. I don't think they contain all the answers, and I certainly don't think that a group of us meeting at the New York Fed have either the right or inclination to suggest that FX practitioners all over the world adopt them word-for-word.

But I think that these guidelines – and others produced by partner Committees in other markets – can serve as a vital blueprint for other industry centers, particularly in emerging economies where cross-border investment and trade are booming and where the currency trade lacks the depth and experience of leading currency centers like New York and London.

Take these documents – extract their essence, adapt them to your local circumstances and needs – and by all means feel free to engage in our collective conversation so that we can evolve our best practices on a global level to our mutual benefit.

FX Committee Agenda

The FX Committee agenda for the coming years is as challenging as it has been at any time in our history. Given the Wooden Nickel events, today we have issued an updated letter advising against the practice of "points". This document can be found on our website as well as the associated updates to the **Guidelines for Foreign Exchange Trading Activities**. We are also looking at the blurring line between wholesale and retail FX.

In this connection we are looking more closely at prime brokerage and at the use of white labeling of electronic FX. For example, in a dealing chain that involves a primary FX bank, secondary banks and/or prime brokers, currency overlay managers and end users, who exactly has "Know Your Customer" responsibility?

In addition to these ethical issues we are also continuing work on some post-9/11 initiatives such as contingency planning and operational continuity issues. And we are continuing our collaboration with the Bank of England's FX Joint Standing Committee and with sister FX Committees in Singapore, Canada, Europe and Japan with regard to unnamed trading activity as it relates to fund managers.

The FX Committee is working with the Joint Standing Committee in the UK to produce an FX Volume survey twice a year, given that the universally-used turnover survey from the Bank of International Settlements (BIS) is updated only triennially.

Our Operations Subcommittee is reviewing the benefits of electronic affirmations and confirmations. The Committee is working with our colleagues in the Financial markets Lawyers Group (FMLG) on exotic option definitions and on Asian NDFs.

Finally, the FX Committee is undertaking a comprehensive communications and outreach program. We are determined to take our message of best practice, ethics and good governance as far as we can throughout the global currency market. To be frank, we've been better at developing our intellectual assets than in communicating them. So we are committed to making the industry aware of these standards so that no one can deviate from them while claiming that they did not know of their existence.

Self-Regulation and a Healthy FX Marketplace

The foreign exchange marketplace today is playing a more critical role in global capital markets and world trade – and at the same time undergoing perhaps its most dynamic, rapid evolution – than at any time in the history of currency. Notwithstanding trading errors and lapses of professional ethics, I would make the case that this diverse, non-centralized self-regulating marketplace has evolved and flourished as well as any capital market on earth.

FX is at the heart of a globalized world in which cross border trade and investing are critical to fostering high rates of economic growth, sustainable investment returns and the efficient – worldwide – allocation of capital and labor. This is a huge responsibility and, for the most part, I think we have lived up to the challenges that we have faced.

Because the FX marketplace is one of the least-regulated on earth, the topic of introducing regulation to the market is a perennial. But there are very good reasons why this idea has never moved beyond the talking stage.

If it ain't broke, don't fix it.

The FX market has withstood the dynamic changes of modern markets well. Currency practitioners, together with Central Banks, have provided abounding liquidity to other capital markets and to world trade; have stimulated the emergence of new technologies, risk approaches, products and services and have ensured a smooth market environment for the greatest boom in cross-border finance that the world has ever seen.

Volumes have grown exponentially. Margins are razor-thin. Competition is vigorous. Every enterprise on earth -- from tiny factories to global asset managers can obtain the currency they need when and how they need it at transparent prices. These are the attributes of a thriving marketplace.

The probity, efficiency and ethics of the FX marketplace compare favorably with other financial markets.

Yes, we have endured occasional difficulties. But we have never seen anything like the systematic erosion of standards and practices that we've been reading about in world equity markets in the wake of the 1990s boom-and-bust. Equity markets are highly, intrusively regulated. And yet they are far from immune from ethical lapses, mis-pricing of assets, and fraud that have resulted in disgorgement, fines and penalties that have cost leading financial firms and their customers *billions.*

The mutual fund marketplace here in the United States – arguably the most heavily regulated major market in the entire financial services industry – likewise appears to have allowed the widespread embrace of insider information, illegal trading, indefensible sales practices and the systematic abuse of small investors in the interest of personal gain on the part of traders, fund managers and even the executive leadership of some of the best-know brands in the fund management industry.

My intention here isn't to disparage the values of other capital markets. But when I read about the supposedly chronic absence of ethical practices in the currency arena I can't help but reflect that the FX marketplace is arguably the most transparent, efficient, appropriately priced and liquid financial market on earth.

I think that we're doing the right things and delivering a vital service. Of course it is incumbent on us to keep it that way. And the FX Committee, together with Central Banks and others in our industry, is working continually to maintain high standards, communicate them to new entrants in our industry and incorporate them into the DNA of our market culture.

Regulating the FX market may well be impossible.

In truth, the FX market may be un-regulatable. It is governed well and it is ably supervised. But the currency market is, by definition, a transnational market. One-hundred percent of our volume moves across borders. The only conceivable regulatory approach would involve a supra-national agency governed by a board of world central banks attempting to impose standards and practices that would be appropriate for every economy on earth.

Were we to achieve a globally imposed set of standards and practices, the inevitable result would be a regulatory regime based upon the lowest-common denominator of market practice. I submit that it would decidedly not be in the interest of the global economy for the deepest, most liquid market on earth to actually reduce the quality of its working infrastructure.

Imposing a regulatory compliance regime over the market would unavoidably lead to an increased cost of doing business, which would in turn expand trading spreads and increase profit margin requirements with negative consequences for every other capital market and for the global economy as a whole.

Self-governance places responsibility for the integrity of our market squarely on our shoulders. In the context of the Basel II accords, this is doubly important. Because if ethical lapses and bad practice raise the risk premium of our market, our parent institutions will have no choice but to increase our capital-adequacy allocations, with unpredictable consequences.

FX might suddenly change from a relatively low-overhead, “lean and mean” industry with minimal capital requirements into an expensive and less efficient market that would drive firms out of the trade, thereby reducing liquidity, efficiency and trading diversity. The smothering of this market with intrusive, burdensome regulatory requirements might have a corrosive effect on every other financial market, raising the cost of global trade across the board.

In other words, if we don’t keep our house in order we may witness the permanent alteration of the entire economic predicate of our industry.

The Trust Premium

Let me conclude by reiterating the notion that trustworthy business practices, defensible and transparent dealings and the like have a real value in the marketplace.

As Fed Chairman Alan Greenspan has often noted, it is incumbent on corporate officers and senior managers to shoulder responsibility for operating their companies in the best long-term interest of their shareholders through business practices that will be respected and awarded in the marketplace.

Speaking before the 2003 Conference on Bank Structure and Competition, Chairman Greenspan stated: “It is hard to overstate the importance of reputation in a market economy. To be sure a market economy requires a structure of formal rules….but rules cannot substitute for character.” Chairman Greenspan described corporate reputations as having “an exceptionally important market value that in principle is capitalized on a balance sheet as goodwill.” Chairman Greenspan went on to say “We should not be surprised then to see a re-emergence of the market value placed on trust and personal reputation in business practice. After the revelations of corporate malfeasance, the market punished the stock prices of those corporations whose behaviors had cast doubt on the reliability of their reputations. Recent allegations on Wall Street of breaches of trust or even legality, if true, could begin to undermine the very basis on which the world’s greatest financial markets thrive. Guilty parties should be expeditiously punished. Some practices and rules have outlived their usefulness and require updating. But in so doing we need to be careful not to undermine the paradigm that has so effectively governed voluntary trade. Rewriting rules that have served us well is fraught with the possibility for collateral damage. I hope and anticipate that trust and integrity again will be amply rewarded in the marketplace as they were in earlier generations.”

I believe that these ideas are doubly important in an unregulated Over-the-Counter financial market such as our own. For the Foreign Exchange market, counterparties’ word is the essential bond that ties together the entire marketplace. It is in all of our best interest to ensure that ethical conduct becomes an irreproachable standard that we can promise to the other capital markets and global corporations that depend on our services. As individuals, firms and as an industry it makes sense to earn the trust premium that Chairman Greenspan implies.

Foreign Exchange markets are the central nervous system of the global economy. It is up to us to ensure that these markets function in a trustworthy and sustainable manner for the benefit of people all over the world.

Thanks very much for your attention.