Ethics, Best Practices, and Self-Regulation:

A Crossroads for the Global Foreign Exchange Market

A speech presented by **Mark Snyder,**
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Introduction

I am honored to have participated in the work of the Foreign Exchange Committee for the past five years and to have been named its Chairman this past January. And I am 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 (FX) market.

I'd like to acknowledge in particular David Puth of JP Morgan Chase, who preceded me as the Committee Chairman, and 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.

In my comments today, I have three objectives:

- First, I'd like to 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 industrywide ethics matter.

- Second, I'd like to reiterate the critical importance of industry best practices and acquaint or reacquaint you with the work of our Committee in this context.
- 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 in accordance 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 lives, 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 over-the-counter 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 reign 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 blowups 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 or short-term gain, on the one hand, and the sustainable, profitable long run on the other.

The case of the National Australia Bank (NAB) 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, 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, and 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. High turnover among trading and supervisory personnel, coupled with the temptation to garner higher bonuses and 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 affair. Fraud is fraud. And no amount of regulation will ever prevent those with criminal intent from breaking the law. But as with trading blowups, 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 forty-seven people (five from the wholesale FX banking 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 most 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 the abuse of voice broker points, and that the amount of fraudulent gains was small by wholesale financial market standards, the fact remains that allegations against the over-the-counter 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 adopt more comprehensive risk management and, increasingly, electronic trading.

The Foreign Exchange 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.”

It’s 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 U.S. 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 that 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 harsh assessment that appeared in the November 24, 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 ethics in 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 questioned whether 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 managers—even those committed to sound trading practice.

Much of contemporary financial education and practice is dedicated to 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 in the fabric of our workplaces—if for no other reason than 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* entitled "Why Ethics Codes Don't Work," John Dobson 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 principles of these guidelines. The reason for the failure of ethics codes, Dobson suggests, 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 ethics codes in the world will have little effect.

Sustainable and above-board business practice is rational and wholly consistent with wealth maximization. Organizations composed of ethical professionals excel in long-term financial performance. 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 Foreign Exchange 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 twenty-six years, the Foreign Exchange Committee, composed 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 Foreign Exchange 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 taking place 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 that many of you know my current 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 (Long-Term Capital Management); 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. This goal is particularly important because as finance has globalized and capital has moved with steadily increasing volume and speed, the FX market has become mission-critical infrastructure for every other kind of securities market.

The Committee is a voluntary association—our purpose is to make recommendations—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 gathering and disseminating the collective wisdom of the world's most important FX practitioners. To this end, the Foreign Exchange 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 at <www.newyorkfed.org/fxc>.

Among the Committee documents that are regularly updated as the FX industry evolves, I will highlight three.

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 them in the conduct of their businesses. Through this document, the Committee seeks to promote market efficiencies and transparency and to facilitate informed decision making.

Guidelines covers trading issues such as time-proven best practices for trading staff; safeguards for 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 document stresses the critical importance of "know your customer" (KYC) duties—for example, the avoidance of transactions with unnamed and undisclosed counterparties and diligence in identifying suspicious customer activities, inappropriate customer dealings, and evidence of money laundering.

Guidelines for Foreign Exchange Trading Activities provides suggestions on the effective management of the risks facing every FX trading business—including market, credit, settlement, liquidity, operations, and legal risk. Finally, the document emphasizes the importance of ongoing staff training.

Another important Committee document is the *Management of Operational Risk in Foreign Exchange*—a comprehensive text that details sixty best practices to help manage the revolutionary changes under way 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, staffing, and systems or from external events. Often, operational risk in the FX context centers on transaction processing, product pricing, and valuation—all of which can hurt a firm's profitability.

The best practices cited in the document are designed to mitigate some of the operational risks common to FX in the belief that if individual market participants take advantage of the Foreign Exchange Committee's counsel, we can reduce systemic risk in 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 involved in foreign exchange today, I would draw your attention to one additional document, *Foreign Exchange Transaction Processing: Execution-to-Settlement Recommendations for Nondealer Participants*.

This text seeks to share the experience of financial institutions regularly engaged in the FX market with nondealer institutions that may participate in the FX market on a more occasional basis. The document highlights twenty-two issues related to risk awareness for nondealers such as asset managers and hedge funds.

Among the specific topics addressed are KYC concerns and counterparty identification, electronic trading, segregation of duties, timely trade entry, trade confirmation, and prompt 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 such as 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 develop our best practices on a global level to our mutual benefit.

Foreign Exchange Committee Agenda

The Foreign Exchange Committee agenda for the coming years is as challenging as it has been at any time in our history. In response to 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 increasingly blurred line between wholesale and retail foreign exchange.

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 KYC responsibility?

In addition to exploring these ethical issues, we are continuing work on some post-9/11 initiatives such as contingency planning and operational continuity issues. We are also continuing our collaboration with the Bank of England's Foreign Exchange 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 Foreign Exchange Committee is working with the Foreign Exchange Joint Standing Committee in the United Kingdom to produce an FX volume survey twice a year, given that the universally used turnover survey from the Bank for International Settlements is updated only triennially.

Our Operations Managers Working Group is reviewing the benefits of electronic affirmations and confirmations. The Committee is working with our colleagues in the Financial Markets Lawyers Group on exotic option definitions and on Asian non-deliverable foreign exchange transactions.

Finally, the Foreign Exchange 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 Marketplace

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

Foreign exchange 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, interest in introducing regulation to the market is 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; stimulated the emergence of new technologies, risk approaches, products, and services; and 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 Foreign Exchange Marketplace Compare Favorably with Those of 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 boom and bust of the 1990s. Equity markets are highly intrusively regulated. And yet they are far from immune from the ethical lapses, mispricing of assets, and fraud that have resulted in disgorgement, fines, and penalties and cost leading financial firms and their customers huge sums of money.

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-known 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 largely doing the right things and delivering a vital service. Of course, it is incumbent on us to keep it that way. And the Foreign Exchange 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 in the DNA of our market culture.

Regulating the Foreign Exchange Market May Well Be Impossible

In truth, the FX market may be unregulatable. 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 supranational 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 on 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. 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 rewarded 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 reemergence 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, the counterparties' word is the essential bond that ties together the entire marketplace. It is in the best interest of us all to ensure that we can promise a high standard of conduct to the other capital markets and global corporations that depend on our services. In this way, the foreign exchange industry—and the firms and individuals that compose it—can 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.