New Opportunities and Risks in Foreign Exchange:

The Role of the Foreign Exchange Committee

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Introduction

I am honored to have served as Chairman of the Foreign Exchange Committee for the past year and a half, and I very much appreciate the opportunity to share with you some of our recent work and the ambitious agenda we see before us.

The Foreign Exchange Committee is wholly dedicated to improving the integrity and functioning of the worldwide wholesale over-the-counter foreign exchange market. And as the market rapidly evolves, we are working hard to ensure that all participants—traditional banks, corporations, and asset managers, as well as fast-growing participants such as hedge funds and the burgeoning retail aggregation foreign exchange trading community—know about and understand best practices.

In my comments today, I have three objectives:

- First, I'd like to discuss the remarkable growth of global currency markets and some of the issues that have arisen with the arrival of new participants, the proliferation of electronic distribution channels, and the introduction of innovative products and services.
- Second, I'd like to reflect on the special responsibilities that all of us here shoulder as leading participants in the world's largest capital market.
- Finally, I'd like to briefly describe recent initiatives of the Foreign Exchange Committee and give you a sense of what we see on the road ahead.

The Changing Foreign Exchange Market

The foreign exchange market is undergoing a historic transformation. We are witnessing:

- the rapid expansion of global trade,
- a dramatic increase in the cross-border flows of stocks and bonds,
- the emergence of newly liquid, tradable currencies and heightened activity and interest in non-deliverable currencies,
- the introduction of new electronic trading technologies and methods and the development of new products and services, and
- the arrival of new market participants—including new hedge funds, retail investors, and retail aggregators—many of which trade foreign exchange as an independent asset class.

Together, these new products and players are testing and transforming the very nature of the relationships among various market participants.

Suffice it to say that all these events are taking place rapidly and concurrently, so that the foreign exchange market resembles a kind of vortex with all these trends altering the market—perhaps permanently. This new activity, together with new electronic trading systems that tend to accelerate change, has made the market more complex. It is a very challenging time for the foreign exchange market, and the long-term implications of many of the changes we are observing now are as yet unknown.

While the structural implications of these events are expected to be profound, it is impossible to predict how these shifting pieces will eventually coalesce. In the immediate term, we can see that they have completely changed the character of our trading liquidity.

Foreign exchange volumes are up—way up. According to the Foreign Exchange Committee's second Survey of North American Foreign Exchange Volume, average daily trading in traditional foreign exchange instruments totaled $401 billion in April 2005—a remarkable increase of more than 20 percent from the inaugural October result. I'll talk more about the survey later in my remarks.

Furthermore, new issues have arisen with regard to the nature and transparency of this abundant liquidity. The advent of new products and participants is changing the existing relationships among foreign exchange market participants. In a typical over-the-counter foreign exchange trade, the dealer provides the client with liquidity by taking on a position and increasing its market risk. The dealer also assumes the client's credit risk, both for settlement and for replacement risks, if the client fails before settlement. Those arrangements are well understood by all market participants.

Today, however, the elements of a foreign exchange trade have been unbundled and repackaged, and multiple links have been introduced into the distribution chain. For example, a corporate client might contract for foreign exchange from a local bank that is "white labeling" the liquidity of a major global

bank. That major global foreign exchange dealer may also be providing liquidity to a retail aggregator, who then facilitates foreign exchange trading for thousands of individual investors. Perhaps a foreign exchange dealer provides research trading services and liquidity to a hedge fund or a real-money absolute return fund, and these trades are "given up" to the customer's foreign exchange prime broker. Conversely, the hedge funds could also be making markets in selected instances and currency pairs—in the name of their foreign exchange prime broker—given new access to electronic broking platforms.

Indeed, agents that used to be wholesale competitors might now act as clients, whereas traditional customers may increasingly behave as market makers. The provision of liquidity and the provision of credit are evolving into two distinct services. For those participants providing liquidity, the function has become more challenging because new products have also introduced an element of anonymity to the market. For example, under the prime brokerage framework, it is not always easy for the banks that are the ultimate source of most trading liquidity to identify market conditions precisely.

This dynamism is a hallmark of the foreign exchange market; it should be welcomed. However, market participants should be mindful of the risks and challenges associated with a rapidly evolving marketplace to ensure that their risk management systems keep pace with business developments.

Credit Risk

For example, one important implication arising from the prime brokerage product is the redefinition of credit relationships and the reallocation of credit risk. While the client is able to trade with a variety of counterparties or executing dealers, the counterparty or executing dealer "gives up" that trade to the prime broker. When the prime broker accepts the credit risk for both the client and the counterparty bank, there is clearly a greater concentration of credit risk, as well as heightened pressure to manage that credit risk appropriately. The task of managing that risk becomes even more challenging in the tri-party framework. Like a standard counterparty relationship, foreign exchange prime broker arrangements require active credit-limit monitoring against the limits set forth in the governing legal agreements. However, the foreign exchange prime broker model involves an additional layer of complexity because of the presence of three parties to each transaction—the client, the executing dealer, and the prime broker. In this context, real-time usage updates of applicable lines and limits are critical.

Operational Risk

The complexity of the prime brokerage model also has implications for operational risk because the model involves not only more parties but also more processes. As anyone here from the operational side of the business can attest, there are some days when tracking down confirmations and effecting settlements between two parties pose a great challenge—so you can imagine what is involved when a third party is introduced to the process.

Moreover, while a traditional foreign exchange transaction proceeds directly from execution to confirmation and settlement, prime brokerage introduces to the foreign exchange process the additional steps of notification and trade acceptance or rejection. Following a trade execution between a client and an executing dealer, both parties must provide the trade details to the prime broker for acceptance or rejection. At that point, separate confirmations must be exchanged between both the prime broker and the executing dealer and the prime broker and the client as legal evidence of the terms of the transaction. Because each stage of the process is generally dependent on the successful conclusion of the preceding step, timeliness and accuracy in each leg of trade processing are key to orderly market functioning and the minimization of market risk for the client and the executing dealer.

Legal Risk

These innovations introduce new aspects of legal risk because they make it more challenging for well-meaning market participants to be sure that they understand who has know-your-customer requirements in the distribution chain of transactions. Products and services such as white labeling and retail aggregation separate the wholesale foreign exchange dealer from the end user, perhaps by multiple intermediaries. This situation may complicate the execution of responsibilities that accompany foreign exchange trading—from typical know-your-customer and anti-money-laundering obligations to compliance with statutory and supervisory guidance invoked for particular client or market segments. Banks need to know their retail aggregator clients. And aggregators need to know their retail customers and serve them with integrity. The same can be said for the white-label framework.

We encourage market participants to review their legal and contractual relationships with clients, intermediaries, vendors, and anyone else that might be considered a counterparty. Market participants should ensure that the existence of intermediaries does not obscure the responsibility for compliance with anti-money-laundering, counterterrorism, bank secrecy, and privacy regulations by the party or parties that bear the legal responsibility.

Standardized documentation can play a key role in the reduction of legal risk in foreign exchange. The Foreign Exchange Committee believes in the collaborative development of industry norms and standard practices. Entities can and should compete aggressively. But at the same time, all market participants should speak a common language—so that the technical, operational, and legal terminology is understood by all concerned. Standardized agreements make life much simpler for everyone and contribute to the legal certainty of contracts for all market participants. And it is vitally important that new market players understand and internalize industry standards.

Reputational Risk

Market, credit, operational, and legal risks have been the traditional focus of the Foreign Exchange Committee. And while new products introduce new elements to risk management, these types of risk are familiar territory that we have successfully navigated in the past. Consequently, I am confident that the Committee, with the market's full participation, will develop norms of behavior and commonly agreed-upon standards that will mitigate many risks associated with the new products and services. However, there is a substantial and growing risk that may emerge from the current environment of rapid market evolution that we haven't previously addressed directly.

Reputational risk is the impact, both current and prospective, on earnings and capital produced by negative public opinion regarding an institution's products or activities. Negative publicity can affect the institution's ability to establish new relationships or services or to maintain existing relationships. This risk may expose the institution to litigation, financial loss, or a decline in its customer base.

Because the foreign exchange market is in a rapid state of change with new participants, practices, and technologies, there exists the possibility of a misstep that could have an enormous impact. One area of particular concern is the entry of new retail investors into the foreign exchange market. These individual investors, trading through aggregators that have different legal personalities, domiciles, and regulatory status, may pose some problems. In many cases, these individual traders can use greater leverage than they normally could with, for example, equity margin trading. In addition, there have been media reports and lawsuits alleging that unscrupulous retail foreign exchange aggregators have defrauded their clients.

The Foreign Exchange Committee's role is not to police these or any market participants; however, we do think that we have a role when it comes to the overall reputation of our market. The foreign exchange banks exist to serve market participants—of whatever stripe. However, the fact that some banks have no direct contact with retail investors, rather only with aggregators, has raised questions. What we want to avoid is an unfortunate situation in which unsound trading practices by individuals or aggregators or both create a negative "black mark" on the reputation of an otherwise prudent institution and, by extension, on the reputation of all of us who are significant participants in the foreign exchange market.

Again, the Foreign Exchange Committee cannot regulate behavior or instruct market participants. But if a market participant violates a norm, we do not want ignorance to be an excuse. The Committee is reaching out to new market participants to make them aware of the work we have done with traditional dealers and nondealer participants, so that they understand the "rules of the road" and can efficiently take part in this great market with full awareness of the best practices and, indeed, an understanding of the obligations of participation. We want everyone to know about the standards and practices we have worked hard to establish, with the hope that the participants that abide by these guidelines will help create a smooth and scandal-free market.

To this end, the Foreign Exchange Committee is currently preparing the final draft of a market letter on the retail trade. In this document, we will reiterate our calls for good legal documentation and stress the importance of understanding know-your-customer obligations and contractual relationships. We will emphasize that foreign exchange dealers run a reputational risk if they are linked to a chain of transactions that result in an illegality or other unfortunate consequence.

In the letter, we will encourage market participants to review their legal and contractual relationships with clients, intermediaries, vendors, and other entities that might be considered counterparties. And we will reiterate that the existence of multiple intermediaries does not lessen the responsibility of market participants to comply with existing anti-money-laundering, counter-terrorism, bank secrecy, and privacy regulations.

Appendices to the letter will present detailed descriptions of the services provided by aggregators acting as portals for both retail investors that trade foreign exchange on a margin basis and banks or e-commerce platforms that allow their customers to trade at prices quoted by a third-party bank through white labeling.

The Committee's intention is to remind all participants of the potentially catastrophic impact of reputational risk and to reaffirm its belief that business in our market should be conducted prudently, legally, and ethically.

Unique Demands of a Cross-Border, Nonregulated Market

The foreign exchange market is unique. Because 100 percent of its transactions have cross-border implications and because it is the only over-the-counter trading arena that, by definition, transcends the boundaries of any national jurisdiction, it is the ultimate global market.

Clearly, regulators play their role in the licensing and supervision of individual market participants. And the world's central bankers will never relinquish their important role when it comes to their national currencies. However, any governmental or inter-governmental agency would have a difficult time imposing prescriptive rules and rigid controls on the market because the uniquely supranational foreign exchange market is literally everywhere, operating twenty-four hours a day. It is the ultimate virtual market—the central nervous system of global finance, without which every other capital market would seize up and cease functioning.

I might also mention that I cannot foresee a day when a nation's central bank would cede its sovereign authority over the currency component of its monetary policy to any worldwide currency regulatory body.

This situation places the unique burdens of probity and ethics upon all market participants. In practical terms, in order for our market to function smoothly, all the participants must share responsibility. This is why the Foreign Exchange Committee and its counterparts around the world have adopted an ambitious agenda of initiatives.

The Role of the Foreign Exchange Committee: The Road Ahead

The Foreign Exchange Committee exists to

- provide a forum for discussing best practices and technical issues in the foreign exchange market,
- foster improvements in risk management in the foreign exchange market by presenting timely recommendations and guidelines, and
- enhance the legal certainty of foreign exchange contracts through the development of standard documentation.

We have achieved much over the years, but we cannot afford to rest. The changes we have seen in the market in recent years have altered the environment for familiar agreements and practices. And this development has, in turn, changed the effectiveness of the agreements. Thus, the Foreign Exchange Committee works to update long-standing documents and best practices to keep abreast of events.

At the same time, changes in the marketplace and notable events have driven the establishment of increased know-your-customer duties, disaster recovery requirements, and, sometimes, regulatory or supervisory oversight. In accordance with these changes, the Committee is developing new documents and guidelines.

The Committee tries always to be proactive—anticipating trends and preparing for them, not just reacting to events as they occur. Often, a major part of what we do consists of simply asking questions:

- Is the infrastructure and framework of the foreign exchange market up to the challenges presented by rapid change?
- Is our legal framework sufficiently robust?
- Are market participants sufficiently aware of the changes taking place around them?
- Are foreign exchange market professionals and their staffs aware of the challenges they face and the standards that our market expects them to maintain?

I'd like to take this opportunity to mention three major documents that have served us well as the core of the Committee's knowledge base.

- *Guidelines for Foreign Exchange Trading Activities* is a long-standing master document, published for the first time in 1979 and regularly updated—most recently in July 2004. Noting that market activities that were considered appropriate even a few years ago need to be reconsidered in the electronic age, the document identifies essential best business practices for the foreign exchange marketplace.

  The guidelines address best practices for trading staff, including recommendations on electronic trading; sound sales practices, including know-your-customer obligations and the risks of trading with unnamed or undisclosed counterparties; the development of an

ethical environment; legal and compliance issues and documentation; risk management and mitigation; and operational best practices.

- *Management of Operational Risk in Foreign Exchange*, first published in 1996 by the Committee's Operations Managers Working Group and updated in 2003, serves as a resource for firms as they evaluate and update their risk management procedures. Comprising sixty best practices, the document covers pre-trade and trade; confirmation, netting, and settlement; accounting/finance control; and the unique features of foreign exchange options and non-deliverable forwards. The document recommends close coordination between sales and trading personnel and operational staff to best respond to changes in the business environment.

- Finally, I'd like to draw your attention to our *Recommendations for Nondealer Participants*. Earlier in my remarks, I noted that the Committee is updating its market practice recommendations to take account of newer entrants to the foreign exchange marketplace. In recent years, the market has indeed grown more diverse, with commercial and investment banks being joined increasingly by very active corporations, investment managers, hedge funds, retail aggregators, and high-net-worth individuals, as well as central banks whose foreign reserves have risen dramatically.

  This document, first drafted in 1998 and updated in 2004, recognizes that nondealer participants in the foreign exchange market may have unique needs with regard to internal guidelines and procedures for risk management. Accordingly, the document delivers to these new entrants the collected wisdom of foreign exchange veterans, summarized in twenty-two best practice recommendations specifically tailored to the special requirements of nondealers.

Foreign Exchange Volume Survey

Before I leave you today, I'd like to briefly update you on an exciting new initiative of the Foreign Exchange Committee—our semi-annual Survey of North American Foreign Exchange Volume. The Committee developed this survey in the belief that market participants could use more frequent volume data to support business decisions, resource allocation, and risk management in the rapidly evolving foreign exchange market. We coordinated our work with the Bank of England's Joint Standing Committee on Foreign Exchange, which is conducting a similar survey for its market.

Working together with staff at the Federal Reserve Bank of New York to develop the best methods of data collection and aggregation, the Committee was determined to create a survey that would provide an accurate picture of market activity in North America. In line with this goal, the survey covers thirty-one participating institutions and captures an estimated 90 percent of market activity.

We produced our first survey in October of last year and our second survey in April of this year. Although it is impossible to discern long-term market trends from only two surveys, we did observe an increase in volume of more

than 20 percent—a finding that highlights the growing importance of currency as an asset class. We also noted that nonbank financial firms, essentially fund managers, were responsible for fully 30 percent of foreign exchange volume in April—up from 25 percent in October.

As in all of our work, the Committee encourages the market to comment on and participate in the refinement of the survey. We see the survey, together with the survey conducted by our colleagues in the United Kingdom, as a means of clarifying the depth of liquidity in different currency pairs and products—and as part of a larger effort to render the market more transparent and efficient and to facilitate risk management.

The coordination of the New York and London Committees on these surveys bodes well for greater coordination in the worldwide foreign exchange market as a whole. Our standing subcommittees maintain regular contact with similar bodies in Canada, Europe, Hong Kong, Japan, and Singapore. I believe that as our market widens to embrace more currencies, new technologies, and different kinds of market participants—in multiple jurisdictions around the world—we will be seen as a model for global capital market coordination.

Conclusion

I appreciate the invitation from *Profit & Loss* magazine, the Financial Markets Association–USA, and the Financial Markets Association of Canada to come here today to tell you about the work of the Foreign Exchange Committee. We see great opportunities ahead as our market grows, and I believe that a real spirit of collaboration—and even of mission—is driving our work. I would encourage any institution or individual committed to foreign exchange to make use of our guidelines and to avail themselves of our expertise.

Like other capital markets, the foreign exchange market holds many investment and trading risks and opportunities. Our objective is to minimize the kind of operational, transactional, reputational, and legal risks that arise through differences in understanding. Accordingly, we support collaborative efforts to smooth out market standards and practices so that all participants can concentrate on competing vigorously and fairly.

I know that I speak for all my colleagues on the Committee when I urge everyone involved in this most critical of capital markets to embrace the best practices and norms that we have developed for the common good. The foreign exchange market does have a unique responsibility for self-governance. And I hope that all of you share the Committee's belief in collaboration and sound market practice for our mutual benefit.