Why Ethics Matter in FX Trading:

Best Practices, Market-Based Discipline, and Supervision Support Principles

A speech presented by Mark Snyder, Chair, Foreign Exchange Committee, at the FX Trading and Management Conference, New York City, November 1, 2006

Introduction

I am honored to share with you some thoughts on the ethical implications of the critical, permanent changes under way in the foreign exchange market. And, as I am about to complete my three-year term as Chairman of the Foreign Exchange Committee, I want to tell you about interesting work being done by the Committee, particularly our ground-breaking partnership with industry bodies around the world and our recently published letter, *Autodealing: Market Impact and Best Practice Recommendations.*

As a self-supervising, transnational, unregulated trading community, the foreign exchange market—more than any other financial market—must shoulder the responsibility of ensuring that its practices are state-of-the-art, that market forces are allowed to work unhindered, and that its practitioners adhere to high ethical standards. The FX market's history of supervision without proscriptive regulation has many sources:

- The FX market is by its very nature transnational, so it cannot easily fall under the mandate of single national regulators.
- A supranational regulatory body is very unlikely because sovereign governments and their central banks, I venture to guess, will never cede authority over their currency policies.
- The over-the-counter nature of the market and the absence of central exchange structures make the FX market uniquely dispersed.
- Wholesale FX market participants, by virtue of their size, depth, and global reach, have traditionally been able to "take care of themselves."
- Ethical behavior has been enforced by market forces—network effects make unprofessional practices known among market participants—with resulting subtle and sometimes non-so-subtle sanctions.
- Finally, while the market itself has not been regulated, many participants—in particular, banks and broker-dealers—have been. And their FX activities have been subject to review, with problematic practices subject to criticism and penalty.

This approach has not been the "parking ticket" approach common to the proscriptive regulatory regimes of other asset classes. But nonetheless, the admonishments of banking supervisors and broker-dealer regulators have been persuasively communicated.

This self-regulating structure has resulted in a remarkable success story:

- World trade, foreign direct investment, cross-border securities investment, and FX volumes are at record levels.
- Investors are increasingly employing currency hedging and looking at currencies as a separate asset class.
- Bank-to-bank trade execution is largely electronic, and the rest of the market is migrating in that direction.
- Effective industry bodies, such as the FX Committee and the U.K.'s Foreign Exchange Joint Standing Committee, have successfully established a global understanding of best practices.

The currency market—the world's largest financial market—provides critical 24/6 digital infrastructure to support these trends. In fact, it is not too much of a stretch to say that

the FX market today functions as a "distributed network" for the global economy.

There have been bumps along the road—scandals involving unauthorized trading, fraud, and unprofessional trading practices. But despite the fact that the OTC forex market is essentially supranational and not proscriptively regulated, the ethical character of the currency market is as good as, or better than, that of any other financial market.

Our market has withstood the dynamic changes of modern finance very well. The currency market provides abundant liquidity to other markets and stimulates the emergence of new technologies, risk approaches, products, and services that ensure a smooth market environment for the greatest boom in cross-border finance that the world has ever seen.

Volumes have grown exponentially. Depending on how we measure it, turnover may already be at $2.5 trillion per day. Margins are razor-thin. Liquidity is deep and competition is vigorous. The market is rapidly evolving electronic trading technologies that are generating further efficiency. Most enterprises, from small factories to global asset managers, can obtain the currency they need—when and how they need it and with very low transaction costs.

These are the attributes of a thriving marketplace. To keep it that way, we must do all we can to ensure its healthy, ethical development.

Market Best Practices and the Foreign Exchange Committee

For the past twenty-eight years, the Foreign Exchange Committee—comprised of representatives of major FX market institutions and the Federal Reserve Bank of New York—has met to discuss technical issues and best practices of the currency market. 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 standards and practices that we believe would best serve an efficient and successful market.

The FX Committee and its counterparts around the world are characterized by a diverse collection of views and the vigorous exchange of ideas and opinion. When the Committee achieves consensus on a technical recommendation or urges a "best practice," I can assure you that consensus has been well earned through comprehensive discussion and a candid exchange of perspectives.

Over the years, the Committee has helped our industry evolve through many tumultuous phases in the growth of financial markets—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; and the dramatic expansion of electronic FX trade execution and algorithmic trading.

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

Measuring the Expanding FX Turnover

Since 1989, global foreign exchange turnover has more than quadrupled, to perhaps as much as $2.5 trillion per day.

For the past two years, the FX Committee has been building on the valuable work of the Bank for International Settlements' Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity in an effort to get a clearer picture of the size and shape of our market. Toward this end, we have developed a semi-annual survey of FX trading volumes to provide the market with frequent, accurate information on the size and structure of foreign exchange activity.

According to our fourth Survey of North American Foreign Exchange Volume, for the April 2006 reporting period:

- Average daily volume of over-the-counter FX instruments totaled $507 billion.
- Average daily volume of these instruments increased 31 percent from the April 2005 period, led by a 66 percent rise in forward transactions.
- Average daily volume of these instruments increased 21 percent from the October 2005 reporting period.

We continue to see accelerating growth in FX volume as well as a strong increase in electronic trading as a percentage of the total. Since the initiation of this process, the FX Committee has issued its survey results simultaneously with survey results released by the U.K.'s Foreign Exchange Joint Standing Committee.

This year, for the first time, we are joined in the simultaneous release of survey results by the Singapore Foreign Exchange Market Committee, the Canadian Foreign Exchange Committee, and the Tokyo Foreign Exchange Market Committee.

A critical element of these surveys is that they are well coordinated. All the FX committees are structuring their surveys in very similar ways. It is a question of comparing apples to apples, so that currency market practitioners around the world work from a common understanding.

Suffice it to say, FX markets are booming, and a global constellation of FX committees are increasing their communication and collaboration to establish common sets of data and a common understanding of market developments and trends. Only last week, the Foreign Exchange Committee hosted the first gathering of FX committees, which included:

- the U.K. Foreign Exchange Joint Standing Committee,
- the Singapore Foreign Exchange Market Committee,

- the Canadian Foreign Exchange Committee,
- the Tokyo Foreign Exchange Market Committee,
- the Australian Foreign Exchange Committee,
- the Treasury Markets Association of Hong Kong, and
- the euro area's Foreign Exchange Contact Group.

We discussed such topics as foreign exchange market developments and trends, committee mandates and organizing principles, cross-collaboration on global events, and the coordination of our foreign exchange volume surveys.

Critical Documents from the FX Committee

The Committee and our partner organizations have long sought to play a positive role in the cooperative evolution of risk modeling and management methodologies.

Over the years, the Committee has developed and updated numerous documents. Notably, there are three general documents that everyone in the market should be aware of:

First, *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 business. Through this document, the Committee seeks to promote market efficiencies and transparency and to facilitate informed decision making.

The second document is *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. While FX was once a rather narrowly defined industry comprised principally of banks, today it is a market that includes commercial and investment banks, FX dealers and brokers, multinational corporations, money managers, commodity traders, insurance companies, governments and central banks, pension and hedge funds, prime brokers, and other entities.

In recognition of the growing variety of institutions now involved in foreign exchange, I would draw your attention to the third document, *Foreign Exchange Transaction Processing: Execution-to-Settlement Recommendations for Nondealer Participants*, which shares the experiences of financial institutions regularly engaged in the FX market with nondealer institutions that may engage in FX markets on a more occasional basis. The document highlights twenty-one issues related to risk awareness for nondealers such as asset managers, hedge funds, and corporations.

These documents represent the collected wisdom of hundreds of FX professionals who have guided our industry for a quarter century. 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 currency trade lacks the depth and experience of traditional currency centers like New York and London.

FX Committee Letter on Autodealing

Finally, I would like to draw your attention to a new and very timely FX Committee letter, *Autodealing: Market Impact and Best Practice Recommendations*.

Autodealing—the use of algorithmic trading—has been growing rapidly in currency markets, transforming both the speed and depth of the markets. Bearing this in mind, the FX Committee created a subcommittee charged with examining the current trading environment, analyzing the effect of autodealing, and establishing recommendations for firms employing these fast-evolving techniques.

The autodealing document produced by the subcommittee reviews the effects of autodealing on the FX market, particularly developments and advancements in technology, changes in trading activities and strategies, and descriptions of various market "channels," including "white labeling."

Autodealing has improved the overall operational efficiency of the dealer community by increasing deal flow, deepening liquidity, and stimulating the development of straight-through processing capabilities. At the same time, it has heightened the sensitivities of market participants to the capacity of their respective technological infrastructures and permitted an increase in anonymous trading.

Electronic FX dealing began in the bank-to-bank market in the early 1990s, when dealing systems enabled the automatic matching of trading interests of large market-making banks. These early innovations eventually gave rise to autodealing strategies in which large banks with substantial capital and well-developed proprietary trading technologies began to deliver electronic pricing and trading directly to their clients.

This technology led to the growth of "white labeling," the sale of trading systems by a large global bank or technology vendor to smaller banks. Through this arrangement, large banks benefit by gaining access to additional client transaction volume and client banks benefit by gaining access to liquidity and more efficient trading platforms while outsourcing market risk to larger banks.

"White labeling" was followed by the introduction of multidealer electronic marketplaces in which secondary-market participants could access liquidity from multiple competing bank sources. Prime brokerage services have driven substantial growth in these platforms by granting secondary institutions access to credit from multiple counterparties. Moreover, quite key to the emergence of FX autodealing, prime brokerage services have also enabled some nontraditional market participants to enter the traditional market.

Some of these clients use autodealing to trade anonymously in the interdealer market. In such cases, the identities of the executing dealer and prime broker are revealed to each other, while the client remains anonymous. Moreover, given the separation between a bank's prime broker unit and trading desk, the client's identity can remain anonymous to the trading desk of the prime brokerage bank.

The FX Committee letter calls on institutions using autodealing to deploy adequate risk management and technology, including working with electronic brokers to understand pricing and dealing protocols and ensuring that their risk management systems are stress-tested and that latencies are measured and monitored.

The letter notes that while autodealing and prime brokerage may decrease transparency and allow for anonymous trading in certain situations, it should not be considered a negative market development. Rather, it is an innovation for which banks and prime broker-dealers should prepare themselves.

The letter calls on banks that offer "white labeling" or prime brokerage to review internal policies rigorously to ensure that the banks do not incur any reputational risks or face confidentiality issues as a result of a client engaging in autodealing anonymously through the bank's extension of credit.

Finally, the Committee letter notes that technology now allows clients to access dealers' liquidity through a variety of channels—brokers, ECNs, technology vendors, bank GUIs, and APIs. Dealers using these channels should carefully manage risks associated with system and network latency—whether within their own systems, at a broker or ECN, within the network used to link to their clients, or within the client's trading infrastructure. Banks should be able to measure and monitor relative latencies in their provision of pricing to clients across various channels and to manage related risks.

Autodealing clearly demands focused attention to a variety of risk issues. But the significant and growing role of autodealing is only the latest market innovation in a natural progression ongoing for many years. Given the supervised yet unregulated nature of the FX market, participants should be aware of all the challenges and opportunities implied by autodealing. Liquidity providers should use technology to offer infrastructure and risk management tools; prime brokers should be aware that clients are transacting in their name and be prepared to investigate any complaint by an executing dealer that their customer may have engaged in unprofessional or unethical trading practices.

The New FX Market

The foreign exchange market is undergoing an historic transformation that brings both opportunities and risks. We are witnessing:

- The introduction of new electronic trading technologies and methods and the development of unbundled products and services.
- The arrival of new market participants—from the rapid increase in new hedge funds to retail investors and retail aggregators—many of whom trade FX as an independent asset class.

Together, these new products and players are testing and transforming the very nature of the relationships between market participants. While the long-term 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.

We are currently facing difficult new issues with regard to the nature and transparency of our increasingly abundant trading liquidity. In addition, the advent of new products and participants is changing fundamental relationships among FX trading partners.

Today, the elements of an FX trade have been unbundled and repackaged, and multiple links have been introduced into the distribution chain. For example, a corporate client might contract for FX from a local bank that is "white labeling" the liquidity of a major global bank. That major global FX dealer may also be providing liquidity to a retail aggregator, which then facilitates FX trading for thousands of individual investors. Perhaps an FX dealer provides trade execution/liquidity to a hedge fund, only to "give up" the trade to the customer's FX prime broker. Conversely, those hedge funds could also be making markets in selected instances and currency pairs, in the name of their FX prime broker, given the new access to electronic broking platforms.

At a broader level, we see that market participants that were formerly wholesale competitors might now act as clients while traditional customers increasingly behave as market makers. The provision of liquidity and credit is evolving into two distinct services. For those participants providing liquidity, that function has become more challenging as new products have also introduced an element of anonymity into the market.

This dynamism is a hallmark of the FX market and should be welcomed. The "new FX market" is enabling a more efficient allocation of risk capital among market participants and allowing the law of comparative advantage to rule the day among competing service providers. These benefits are enabling more corporations, fund managers, and individual investors to access low-cost currency transactions as never before with less administrative burden.

However, market participants should be mindful of the risks and challenges associated with a rapidly evolving marketplace and ensure that their management systems for controlling credit, operational, and legal risks keep pace with business developments.

There is one other risk category that bears close monitoring in this new market. Overarching this complex thicket of market, credit, legal, and operational risks is a risk consideration that is difficult to quantify, but perhaps most significant in its implication: reputational risk. Reputational risk is the current and prospective impact on earnings and capital arising from negative public opinion regarding an institution's products or activities. This affects the institution's ability to establish new relationships or services or to continue servicing existing relationships. Reputational risk may expose the institution to litigation, financial loss, or a decline in its customer base.

Chairing the FX Committee

As I am wrapping up my three-year term as Chairman of the FX Committee, I hope you will permit me a moment of personal reflection on what has been one of the most rewarding experiences of my career.

In a free market in which private sector agents have a big say over an industry, there is often a temptation to regulate from without. I think we all agree that this is practically and politically infeasible in the case of the transnational FX market. But by working closely with the FX Committee, the Federal Reserve Bank of New York has been rather clever—letting our industry determine its own way while at the same time making clear its own views or areas of concern.

The FX Committee meets eight times a year to work out consensus views on some stubbornly difficult challenges. By grappling with solutions to these issues, the FX market effectively takes ownership of their resolution. After all, if we determine a course of action and undertake it, there is no one else to blame after the fact. And when the New York Fed wants to make its own views known to the Committee, well, there is something about meeting in the Bank's boardroom—next to a crackling fire with portraits of past Fed chairmen and New York Fed presidents staring down at you—that makes you want to do the right thing.

The issues that I have been privileged to help the Committee formulate are among the most challenging that we face today:

- We championed the trend away from unnamed trading, drawing the distinction between appropriately confidential trading and unwise anonymous trading. In practice, this means allowing compliance, legal, and credit personnel to receive all the information they need to assess counterparty risk while leaving the client's identity unknown to the front office—which is, after all, but one other market participant.
- Other issues on which I think we made real progress include clarifying industry views on the division between wholesale and retail FX trading, the constructive benefits of prime brokerage, and the technical and legal implications of autodealing—about which I spoke earlier.

While these operational and technical discussions have been compelling, the most significant lasting benefit of working with an organization such as the FX Committee, for someone like me, was the opportunity to develop a cooperative relationship with many leading industry figures from around the world. The FX Committee gives one a feeling of shared purpose and makes one want to achieve something substantial—beyond narrow self-interest.

Regularly meeting with peers and competitors from around the world—outside the ambit of day-to-day market activities—gives us the opportunity to consider issues that are of concern or that may arise in the future, and then assist all market participants by shaping a best practice or standard that does not favor competing commercial interests.

In this regard, I would like to make particular mention of some individuals who have made a big impact on me. These colleagues are not only some of the most intelligent, hard-working, and personable leaders with whom I have had the opportunity to work, but each has a terrific sense of humor:

- Paul Kimball of Morgan Stanley, who encouraged me to join the Committee and chaired the Committee when I joined in 1999.
- Lloyd Blankfein of Goldman Sachs, who was a Committee member for thirteen years and is of course the most well-known former Committee member now that he is CEO and Chairman of Goldman.
- David Puth of J.P. Morgan, who preceded me in the Committee Chairmanship and has provided me with invaluable advice.
- And Dino Kos and his team at the Federal Reserve Bank of New York, who provide critical infrastructure, guidance, and a home away from home for the FX Committee. Dino's quiet wisdom and perspective have been at the core of the Committee's achievements over the many years of his membership.

I wish I could take the time to name and thank all the many past and present members who have made serving on the Committee meaningful and a lot of fun, but I will find another occasion for that.

Ethics and Best Practices

I will wrap up by reiterating a concept that I find myself returning to in many of my industry talks. Ethics matter—not only in the sense of enlightened self-interest, but also because we are of course much more than simply rational, profit-maximizing economic agents. At their truest and best, market participants want to be part of something beyond themselves that has virtue and integrity.

The foreign exchange market plays an integral role in the efficient use of capital and labor allocation and in the transparent analysis of national economies and the currencies that represent them. And while the transnational FX market is probably impossible to regulate, self-supervision has worked—our market delivers a vital 24/6 service critical to every other financial market.

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 ethical manner for the benefit of people all over the world.