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Observations on the utility of FX global code*

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Organisational values underpin conduct in financial markets but are sometimes too imprecise to guide conduct in practical situations encountered by firms and their employees. The author considers the effectiveness of the FX Global Code and concludes that it is a powerful instrument in the process to guide the conduct of business in the global wholesale FX market. The Code bridges the gap between ethical principles and the practical real-world actions that flow from them. There are strong incentives to adopt industry standards both in terms of operational efficiency and by forestalling formal regulation. Moreover, by incorporating professionalism values, the FX Code should help firms to manage their conduct risk. These outcomes depend on effective implementation of the Code, which is being assisted by official sector support.

1. Introductory comments

The FX Global Code (FX Code), launched in May 2017, is a set of global principles of good practice in the foreign exchange market, developed to promote the integrity and effective functioning of the wholesale foreign exchange market.

The development of the FX Code was framed by a desire by politicians, regulators and the public for greater transparency and assurance of ethical conduct by financial services firms. The industry needed to respond to this situation in a way that exhibited commitment and concern for the health of the FX market and its role in the economy. The FX Code capably serves this objective and was widely welcomed by industry, including the Australia Financial Markets Association (AFMA) at its launch.

Far from being a conceptual document, the Code is a powerful instrument in the process to guide the conduct of business in the global wholesale FX market. The Code steps market participants neatly from the ethical principles that underpin good practice into practical real-world actions that flow from them. The practical application of the Code should measure well against the objectives set for it, provided it is implemented in an effective manner and is maintained in a manner consistent with the contemporary needs of the market.

2. A few preliminaries

2.1. What is a code?

Before discussing the FX Code in detail, it's worth observing that there's a great diversity in the spectrum of industry codes. Some are principles-based and others provide more granular guidance. The optimal construct depends on the purpose of the code in question.

The FX Code has been designed to provide the high-level principles that industry participants should operate in accordance with and also detailed guidance on the nuts and bolts of how those principles should be applied in practice. In this manner, the Code is transparently relevant to managers, dealers, sale people and other individuals who in aggregate form the market. This is not a moot point because, as explained below, it goes to the effectiveness of the Code.

It is relevant to distinguish between institutional codes, which typically deal with how large and financially sophisticated entities interact with each other, and retail codes that are designed for situations in which there is a greater imbalance of power between the provider and its client. The FX Code is intended for the wholesale market and, thus, would often have equal application to both parties in a transaction.

It should be noted too that the conduct outcomes sought for the industry depend on a number of factors that complement a code. Examples include firm's internal policies, staff incentive arrangements and whistle-blower arrangements. Industry codes, like FX Code, will not be effective unless they are supported by a firm's internal policies and staff training, amongst other things. The detail of these complementary factors is beyond the scope of this paper.

3. The connection to professionalism

The values and culture that permeate an industry are a significant determinant of the level of trust that regulators and the broader community will afford it. Professionalism engenders trust, which is an essential ingredient to a profitable wholesale

*The content of this paper reflects author's personal views and experience gained in working on similar financial markets initiatives over the last decade.

banking and financial markets industry. Bank business is underwritten by public confidence that is based in trust.

3.1. Organisational culture, values and industry standards

The related concepts of values and culture are central to the effective operation of financial markets by influencing the behaviour of market participants in a manner that makes them trustworthy. These concepts often get glossed over in speeches about conduct but it needs more than motherhood statements to penetrate the issues we are dealing with and also to explain the role of industry codes.

Weakness in a firm's culture often translates into conduct risk. It follows that management of this risk should be consciously shaped by business leaders and then methodically transmitted within their firms to ensure they deeply influence the conduct of its business.

This involves the board and senior management of the company setting institutional values to shape the basis of decision-making by the employees of a firm where matters require judgement. This is not a simple task for a number of reasons:

Culture is not a set of shared values – different people may think quite differently about common values. It cannot be assumed that individual employees will always use their intrinsic judgement to implement a value in a manner that reflects the intentions of a firm's senior management.

Values tend to be subjective and imprecise and can often conflict.[1] There may be choices and judgements to be made about how best to implement a value. It can be hard to know what specific action might be required to give effect to a specific value.

Cultivating a corporate culture involves the complex task of developing a shared practical acceptance of values, such that employees act in the manner intended. In practical terms, it necessarily depends on sufficiently specific instructions from the management about how it wants the firm's business to be conducted. This guidance must be incorporated into the firm's codes, policies and procedures, which serve a substantive practical guide for employees on the expectations of management for the way the way they should go about conducting the firm's business.

In the current context, to be of substantive benefit, the FX Code must be of must make sense to the dealer, salesperson and adviser on the desk in a bank, amongst others. Organisational values alone are insufficient to give a clear practical guide to good behaviour in many circumstances. More is needed to guide the actions of firms and their employees and, as outlined below, the FX Code plays a significant role in this regard.

Such practical guidance is also relevant because 'learning by doing' is a useful training technique. In the case of the FX Code, its users work from high-level principles to concrete everyday applications of those principles. This process should better place its users to make good judgements when they face choices on any matters that emerge that not specifically covered by the Code.

3.2. From the firm to the industry

While it is generally accepted that each firm is predominantly responsible for its own culture, it is at a minimum more helpful if industry practice is consistent with that dictated by the firm's culture. This is reflected in Bank England Governor Carney's comment that firms must take greater responsibility for the system by improving the quality, clarity and market-wide understanding of fixed income, currency and commodity (FICC) trading practices.[2]

In this context, it should be said that that industry codes and standards are even more important for markets like FX that are over-the-counter (OTC) markets, as they do not have the level of formal structure of operating and conduct rules as exchange-based markets. In the Australian context, the Australian Securities Exchange (ASX) operational rules and Australian Securities and Investments Commission (ASIC) market integrity rules for cash equities are an example of this formality.

At the industry level, the diversity in business types, scale, origins of firms and their ownership means there may be an even greater diffusion of views about the implementation of values that are universally accepted by industry participants. Since culture is a matter that is sometimes considered by the wider community at the industry level, it is important for the industry to be organised in a manner that enables it to set its collective values and desired culture and then to promote acceptance of this in the actions of its constituent firms.

Industry codes that are well-designed and are placed within a framework that explicitly incorporates professionalism objectives can be of great assistance to individual firms in their efforts to curtail conduct risk in their business activities. As outlined below, effective industry standards build trust in the financial markets, provide greater predictability, support normal risk-taking and promote liquidity that reinforces these outcomes.

4. An effective industry code

Effective industry conduct codes have a number of critical characteristics and these include:

(1) Relevance to, and acceptance by, the covered community and other stakeholders;
(2) Content that is informed, addresses the important issues and is well-targeted;
(3) Effective governance and accountability mechanisms;

The FX Code has been designed and is being implemented in the manner that meets these criteria. Notable components of this process include:

- A programme to promote adoption within the covered community, including industry education and training options;
- Reinforcement by individual firm's internal actions;
- Periodic review.

4.1. Design, governance and authority

Decisions about conduct standards should be made in accordance with the proper process that is based on consensus. This reduces the perceived and actual conflicts of interest that industry participants and regulators would face as the controller of industry standards, particularly in relation to business conduct matters.

Reserve Bank of Australia (RBA) Deputy Governor, Dr Guy Debelle, chaired the Foreign Exchange Working Group that developed the Code under the auspices of the Bank for International Settlements. A Global Foreign Exchange Committee (GFXC) comprised of central bank and private sector delegates was established in May 2017 to promote and maintain the Code. The Australian FX Committee (AFXC) is a member of GFXC.

Regulators have highlighted the importance of the industry's leadership in addressing culture and risk management issues. The legitimacy of FX Code will depend on the level of industry authority that underpins it and the degree of support it receives from industry participants. The outlook for this is positive, with many global banks having already made a public commitment to adopt it.

Industry codes may get ignored if there is any sense that a bank's senior management does not place a priority on them. The authority provided by FX Code central banks commitment will enhance its legitimacy among industry participants and wider stakeholders.

Market participants are expected to sign a *Statement of Commitment* to demonstrate their commitment to adopting the FX Code. In Australia, the RBA has stated that it will not deal FX with any participant who has not signed a Statement of Commitment. In addition, the market regulator, ASIC, as has specifically cited its relevance to market participants.[3]

Official recognition of the FX Code in this manner significantly enhances its standing in the eyes of market participants and, at a minimum, requires each to assess their business practices in the context of the guidance provided. Moreover, the public declaration of a firm's commitment to the FX Code improves industry recognition of the standard, enhance client awareness and create an incentive for firms to comply. It should be noted too that regulators may refer to industry conduct standards, and firm's position in relation to them, in market surveillance and enforcement actions.

4.2. Public registers of commitments

A practical step in the transition from development to implementation of the FX Code is the creation of a register to record the commitment of individual financial institutions to adhere to the Code and also make this information public. The Register will help market participants by providing a forum to publicly declare their commitment to the FX Code and also assist stakeholders to identify the market participants that have done so.

The GFXC expects public and private sector entities in individual jurisdictions or regions to create their own register. It will consider establishing a Global Index, linking registers in different jurisdictions that are aligned with the above recommendations, to support a comprehensive view across all registers. Coordination of the various public registers that emerge is desirable to avoid creating complications for their users.

AFMA in conjunction with ACI Australia will launch the Australian Public Register for Statements of Commitment to the FX Code at the beginning of 2018.

4.3. Training and accreditation

Academic research suggests that the mere existence of a standard or code is not sufficient for it to be effective.[4] A code needs to be intelligently designed and used capably to be effective. Industry codes should be supported by a structured programme, which includes industry education and training options, to promote adoption within the covered community. This will help to overcome the problem identified by the UK Fair and Effective Market Review of FICC markets that standards of acceptable market practice were usually poorly understood, often ignored and always lacked teeth

A range of training options is being developed by providers (including AFMA) to assist financial institutions who are adopting the FX Code to train their staff on its content and application. The details of a programme to address these aspects are outside the scope of this paper.

4.4. Maintaining a contemporary code

The FX market and associated business practices will continue to evolve in response to new technology, regulation and other developments. The FX Code must evolve accordingly, if they are to meet the changing needs of market participants. Therefore, there must be a defined process through which the performance of the Code is reviewed.

One of the challenges going forward will be to maintain the cohesion, commitment and priority evident in the process to develop the Code in the work to maintain it in a fully effective form, so the GFXC has an important role. The regular review and assessment of the effectiveness by the national FX committees and the GFXC should provide a means to gauge the adoption of a code by market participants. This should identify circumstances where greater promotion and industry education about a standard might be required.

4.5. Going global

Wholesale FX business is conducted on a global basis and often on global markets but regulation applies on a national basis and diverges between jurisdictions. In addition, global firms generally seek to promote a consistent operating culture throughout their organisation and implement associated internal policies and protocols on a global basis.

Industry standards cannot overcome the problem of inconsistencies between regulators but they do provide the capacity to better align industry practices across the developed financial centres and operate more consistently with global practices. The FX Code illustrates both the potential of a global industry approach to conduct issues. However, given the structure, traditions and practices in other FICC markets, there is a great practical challenge to be overcome in attempting to develop standards and codes that could similarly have global application in the detail of their implementation.

5. The benefits from effective industry standards

There are multiple practical benefits from effective industry codes like the FX Code.

Perhaps the most important benefit is the capacity for industry standards to fill a void left by regulation. Laws and regulation delineate what is wrong but often do not indicate what is right. Conduct risk management is about good business practice rather than just compliance with rules. Effective industry codes have great applicability to everyday conduct within financial markets. The FX Code provides many examples of practices that should be adopted and that should be avoided.

There is a prevalent view that tackling misconduct in financial services will require a combination of 'hard law', 'soft law' and better culture.[5] Hard law means public rules and regulations, and is the official sector's responsibility. Soft law and culture belong to the private sector – included in these categories are best practices, ethical codes and incentives.

'Hard law' is not a substitute for 'soft law'. AFMA's experience over the years is that legislation and associated regulations are less flexible and dynamic than 'soft law' and consequently often have unintended consequences. Moreover, unintended outcomes in 'hard law' can take years to be rectified, even when the government and regulators agree that a fix is required.

Industry standards that are developed within the right framework should not have unintended consequences (being determined by market participants), should be more dynamic in adjusting to any issues that do arise and better curtail any creative interpretation, given the competitive nature of markets.

It is in this context that industry standards are relevant and valuable, providing clear, well-articulated guidance that deals with the specific situations and choices encountered by dealers, advisers and others in the financial markets.

The UK FICC Markets Standards Board Chair, Mark Yallop, has observed that standards have a strong natural bias to efficiency.[6] In contrast, financial regulators are generally concerned with policing the system to protect consumers and ensure market integrity and have a distant regard for efficiency. Industry standards more naturally promote efficiency as they are driven by market participants who have a deeper knowledge of what does and does not work.

The alternative is an increasing volume of prescriptive regulation that, in addition to the direct cost burden imposed on industry participants, will among other things pressure OTC markets to operate more within the standardised constraints of exchange markets.

Principles-based laws and regulation reduce the risks of 'hard law' but also require guidance on their application to specific circumstances. Regulators can unfold the detail of the intended application of the law to some degree but may not have the resources or the expertise and knowledge required to efficiently address the nuances that market participants must grapple with on a daily basis. Industry standards are the preferred means to provide such practical guidance. In this context, it is significant that the central banks who led development of the FX Code in conjunction with industry representatives are also participants in the FX market.

A collective industry approach makes minimum standards of behaviour a non-competitive issue – firms and their employees that intend to adopt a high standard of conduct may be challenged, or frustrated in extreme circumstances, by the consequence for their business of going it alone. The approach to being taken in implementing the FX Code, including a requirement by some central banks for their counterparts to commit to the Code, deals with this risk.

Reinforcing the objective for codes to have a neutral competitive impact, the existence of an industry standard should have a deterrent effect, as market participants would be aware that it could be a gauge against which a firm's conduct, or that of its employees, may be judged. A code would also provide a basis to resist any requests from other parties to do business with them, or on their behalf, in a manner that might involve a questionable practice from an ethical perspective.

In summary, market participants have clear and strong business incentives to support effective industry codes. The requisite framework includes not just the documentation of standards that provide operational clarity but also a framework that will sustain the relevance and adoption of the standards by industry participants.

6. Concluding comments

Organisational values underpin conduct in financial markets but are sometimes too imprecise to guide conduct in some situations encountered by firms and their employees. Industry codes and standards are a tool to help close this gap in guidance and reinforce a positive culture. The guidance provided through the FX Code applies to the everyday conduct of business in the FX market and will support the integrity and effectiveness of the market. The FX Code sets collective industry values for the market and reduces areas of potential uncertainty about market practice through many useful practical examples.

The FX market is subject to less formal regulatory and operational rules than a typical exchange-based market and, thus, benefits more from a collective process through which participants set out good practice. The FX Code is consistent with regulatory requirements, can take account of changing business models and practices and is being supported by a programme to promote its adoption by market participants.

There are strong economic incentives to have a broad range of industry standards both in terms of operational efficiency and by forestalling formal regulation. Moreover, by incorporating professionalism values, the FX Code should help individual firms to manage their conduct risk.

In summary, the FX Code is a significant, positive development. Nonetheless, the industry still has work to do in making the Code fully operational, as commitments have to be made by many firms, public registers of commitments have to be established, training and accreditation tools have to be developed and the process to maintain the Code has to be managed. In a broader context, the form of the FX Code and the approach taken by the authorities and market participants to its implementation provide insights that may usefully be applied in the development of other industry codes, especially for wholesale financial markets. ■

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[1] For example, see Chapter 7, Rules and their Enforcement, Howard Becker, 1963. One person's practical interpretation of a concept like freedom that is central to the organisation of society may differ greatly than another's.

[2] Building real markets for the good of the people, M Carney, Governor of the Bank of England, 10 June 2015.

[3] ASIC Report 525, 'Promoting better behaviour: Spot FX', May 2017.

[4] 'Towards effective codes: testing the relationship with unethical behaviour', Muel Kaptein, Journal of Business Ethics, Sept 2010.

[5] See 'From ethical drift to "ethical lift": Reversing the tide of misconduct in global financial markets', October 2016, M Shafik, Bank of England.

[6] M Yallop, Regulation, Ethics and Standards in Wholesale Financial Markets, ICMA ERCC Conference, Sept. 2016.