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The FX Global Code
The Rules are Made to be Followed

The foreign exchange industry ("forex" or "FX"), a seemingly ever-growing massive liquid market accessible to many kinds of market participants, has finally started showing signs of a slowdown. In 2016, the world's largest financial market posted a decline for the first time in 15 years,[i] with trading volumes down amid industry challenges in light of increased regulatory scrutiny. Forex market professionals have cited common sense reasons for the slump, such as difficult trading conditions and the rise in passive management, but the recent regulatory settlements and pleas may also be a factor.

Amid this environment, the Bank for International Settlements ("BIS") established the Foreign Exchange Working Group (FXWG)[ii] in July 2015 to strengthen code of conduct standards and principles in forex markets in the form of a "Global Code." The stated purpose is both ambitious and laudable—"desire to promote integrity and restore confidence in the wholesale foreign exchange market (FX market) in light of the recent cases of misconduct."

This solution to the industry's recent hurdles, in the form of the Code, is unique and untested—a globally adopted industry standard that is both reactive and proactive, and seeks compliance with the law.

Background

The Global Code is intended to articulate good practices and "become an integral part of the FX market globally."[iii] In the initial public update on adherence, the FXWG explained that in order to have the desired effect, the Code must be adopted and embraced by a wide range of Market Participants, including hedge funds, asset managers, financial institutions, high-frequency trading firms, and others. The Code seeks to establish best practices commonly applicable across jurisdictions, and does not impose legal or regulatory obligations or supplant regulatory standards.

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The Code seeks to apply to a diverse set of global forex markets, as the law governing them varies dramatically across borders. Adherence is meant to be flexible but consistent. To achieve that balance, the FXWG initially gave fairly loose guidance as to the adoption of the Code, but urged full transparency of Code execution after the Market Participant's commitment.

The Global Code – Phase I

In May 2016, the first phase of the Code was released, citing six leading principles. According to the FXWG, these principles were prioritized due to market need for clarity, and are broadly set forth in the 30-page BIS document. The principles are as follows: 1) Ethics—the expectation of ethical and professional behavior; 2) governance—requiring robust and clear policies, procedures, and organizational structures; 3) information sharing—anticipating clarity, accuracy, and confidentiality in order to promote effective communication supporting a robust, fair, open, liquid, and appropriately transparent market; 4) execution—requiring the exercise of care when negotiating or executing transactions; 5) risk management and compliance—mandating the promotion and maintenance of a robust control and compliance environment; and 6) confirmation and settlement processes—requiring robust, efficient, transparent, and risk-mitigating post trade processes.

The FXWG's stated principles were broadly applicable, common-sense standards meant to apply to a specifically defined group of "Market Participants." And since the release of the first phase and the continued development and reveal of Phase II last Thursday, market participants have rapidly indicated widespread support and signaled their intent to adopt the Code."[iv]

The Global Code - Phase II

In February, market participants were sent a working draft of Phase II. Although the draft was not disseminated to the wider market, Guy Debelle, Deputy Governor of the Reserve Bank of Australia and the head of the FXWG, promised that the Phase II provisions would "provide a more comprehensive description of the suite of mechanisms to support adherence to the Code."[v]

In speeches in January and March, Debelle set forth three components of adherence—market-based mechanisms; BIS central bank commitment and related expectation of counterparty commitment; and FXWG communication with regulators as to "how they might use the code in monitoring market conduct."[vi] In short, the BIS and FXWG have guaranteed a campaign of collaboration and not-so-subtle peer pressure to ensure that market participants adhere to the Code. Any participants that refuse to adhere, by default, may be subject to regulatory scrutiny in light of the third component.

This past Thursday, the full Code was published, and early feedback is largely positive.[vii] The 78-page document, deemed "[a] set of global principles of good practice in the foreign exchange market," principally expands and elaborates on the Phase I provisions, with a heavy thematic emphasis on transparency. The decision not to ban the controversial "last look" practice is an isolated area of early critique[viii]—instead, the drafters encourage participants to "be transparent regarding its use," — but later drafts could buttress that warning if the Code does not successfully ensure fulsome good behavior, and disclosure alone may effectively end the practice.

The full Code remains centered around the original six "leading principles," but offers specific provisions tied to an expanded set of fifty-five principles categorized within the six. It also sets forth detailed illustrative examples; provides a framework for risk management, compliance, and review; and includes a form "Statement of Compliance," meant to be signed by industry institutions.[ix]

In his speech at the release of the full Code, Debelle described the Code's motivation as a "lack of trust" in the industry, and ambitiously promised that the Code would help "restore confidence and promote the effective functioning of the wholesale FX market." Debelle also emphasized that the Code was a reflection of collective judgment and comment by the industry. Finally, and notably, he also set forth a period of time for expected adherence of "no more than twelve months" for the "vast majority of market participants."[x]

Changing Implications

In nearly every public discussion of the Code, FXWG and BIS are quick to caution that the Code does not attempt to promulgate or supplement law. But in the practical sense, the Code will necessitate change on the part of Market Participants and scrutiny by regulators. Firms will need to take immediate action to address the six leading principles set forth in Phase I, and the fifty-five principles outlined in Phase II, and they will need to document that action for the larger market and face examination under the auspices of "transparency." Firms will also need to consider clearly delineated roles and specific senior management responsibility for the execution of Code mandates, and likely redo or supplement policies and procedures to make it clear that such rules are in line with the Code.

In Phase I of the Code, FXWG suggested the use of technology to reduce operational risk. As the use of FinTech increases in the market, firms may want to reevaluate their processing and trade confirmations and make sure they are using appropriate technology, both to expedite and streamline their processes and minimize risk. This, along with other best practices, could contribute to the mandated "robust framework" in place for confirmation and trade settlements.

Other principles embodied in the Code require specific action on the part of market participants, such as identification of disclosures that counterparties, customers, or other firms should receive regarding the protection of information, confidentiality, and identification of how a firm intends to handle orders. As disclosure continues to be an area of focus for regulators, this requirement is one more way for market participants to ensure a clear-cut mechanism to avoid compliance issues. And firms will need to scrutinize their existing risk management protocol to be sure it is in line with the new Code requirements released in May, particularly independent and effective oversight and trade and risk limit monitoring.

Only time will tell if the Code will be widely embraced, result in adherence to the guidelines, and ultimately succeed in reaffirming trust for the largest and most liquid market in the world. But in the interim, firms should be prepared, as otherwise the chance to misstep will inevitably come.

[i] Farah Khalique, BIS stats: the steady decline of foreign exchange, *Euromoney*, September 6, 2016, *available at* http://www.euromoney.com/Article/3583394/BIS-stats-the-steady-decline-of-foreign-exchange.html.

[ii] The FXWG consists of central banks representing 16 economies.

[iii] *See* FXCM Global Code, Public Update on Adherence, May 2016, *available at* http://www.bis.org/mktc/fxwg/am_may16.pdf.

[iv] For example, on March 20, ACI The Financial Markets Association, a member of the MPG and the largest trade association for the global FX market, mandated that its members commit to the code. *See* ACI FMA Welcomes the BIS Global FX Code, March 20, 2017, *available at* https://acifma.com/news/aci-fma-welcomes-bis-global-fx-cod ("we will strongly urge all ACI FMA members and wholesale market participants to learn the code, attest to their compliance, and demonstrate their adherence to the new Code.")

[v] Guy Debelle: Regulatory overview: The FX Global Code - defining the next steps towards a standard industry Code of Conduct, March 22, 2017, *available at* http://www.bis.org/review/r170322e.pdf.

[vi] Guy Debelle: The FX Global Code of Conduct - final phase, March 28, 2017, *available at* http://www.bis.org/review/r170329e.htm.

[vii] Upon publication on May 25, 2017, multiple major players in the FX market (e.g. Foreign Exchange Professionals Association, CLS, ParFX) made public statements lauding the code's provisions, indicating their support, or officially endorsing the Code.

[viii] The "last look" practice, which enables market makers to pull out of a trade at the last minute if the market moves against them, has been restricted by certain major currency trading platforms like BATS and Thompson Reuters since May 2015, as it subjects forex dealers to buy-side complaints about unfair pricing.

[ix] The Statement of Compliance, available in Annex 3 of the Code, is accompanied by an Explanatory Note outlining how the Statement should be used and its benefits and attempting to anticipate and answer other questions by market participants, such as "How should Market Participants take account of their corporate structure?"

[x] Guy Debelle: Opening Remarks at the Launch of the FX Global Code, May 25, 2017, *available at* http://www.rba.gov.au/speeches/2017/sp-dg-2017-05-25.html.