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The Global Code of Conduct in the Foreign Exchange Market

— For sound development and effective functioning of the Foreign Exchange Market —

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In the foreign exchange market where diverse participants transact across borders, it is crucial to enhance confidence in the market globally for effective functioning of the market. In July 2015, the BIS established the Foreign Exchange Working Group (FXWG) to facilitate the development of a single global code of conduct for the foreign exchange market (the Global Code) and to promote greater adherence to the Global Code. Since its inception, central banks including the Bank of Japan and private-sector professionals from around the world have been working closely together to complete the Global Code by May 2017. The first phase of the Global Code and Principles for Adherence to the Global Code were released in May 2016 by the FXWG. The Global Code is principle-based instead of detailed and rule-based, and therefore takes into account the diversity of market participants, while reinforcing discipline to prevent misconduct. The Bank of Japan believes that market participants should fully understand and adhere to the principles underlined in the Global Code, which will contribute to sound development and effective functioning of the foreign exchange market.

Introduction

The foreign exchange market is a large market where such a wide variety of financial and nonfinancial corporations and individual investors transact on a daily basis. Over-the-counter (OTC) transactions prevail, and the trading venues are also diverse. [1] Regulatory settings covering foreign exchange transactions are different across jurisdictions. Given such diversity of market participants and complexity in market structures across the globe, it is crucial for market participants themselves to proactively develop and adhere to the code of conduct to enhance confidence in the market for sound development and functioning of the foreign exchange market.

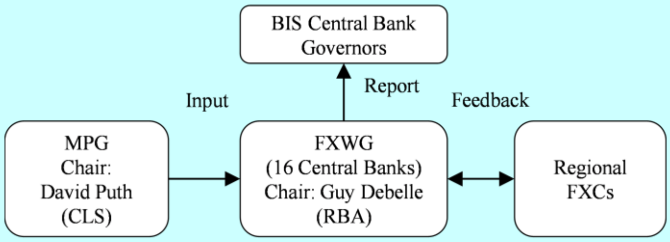
The regional codes of conduct to which foreign exchange market participants should adhere have long existed in the major financial centers. However, misconduct by several banks that received orders from clients in some overseas markets such as London came to light in 2013. This led to an increasing recognition of the importance of enhancing discipline of the foreign exchange market across the globe. The Financial Stability Board (FSB), and the regional Foreign Exchange Committees (FXCs) which comprise private market participants and central banks have been undertaking various initiatives.[2]

As a first step to harmonize the regional codes of conduct in the foreign exchange market, the eight FXCs in the major financial centers[3] gathered in Tokyo (the Bank of Japan headquarters) and adopted the "Global Preamble," which provides a global view on high-level priniciples, sharing their commitment to developing and promoting clear, robust, and implementable best-practice guidance in the foreign exchange market.[4]

Building on this, the Bank for International Settlements (BIS) central bank governors established the Foreign Exchange Working Group (FXWG) to facilitate the development of a single global code of conduct for the foreign exchange market (the Global Code) and to promote greater adherence to the Global Code. The FXWG consists of central banks representing 16 economies,[5] including the Bank of Japan. In the process of developing the Global Code, central banks and private market participants have been closely collaborating: the Market Participants Group (MPG) that consists of more than 30 private-sector professionals from around the world[6] have been providing insights to the FXWG; and the regional FXCs which play an important role in developing and maintaining their reigonal codes of conduct have been actively providing feedback (Chart

1).

[Chart 1] Structure of Global Code Development



The work of the Global Code is carried out with two phases. The first phase of the Global Code and Principles for Adherence to the Global Code were released on May 26, 2016 by the FXWG.[7] The second phase intends to release the complete Global Code and further guidance on the approach to adherence.

In discussions on the development of the Global Code, some had a view that detailed stringent rules to significantly reinforce discipline would be necessary to prevent misconduct; however, others considered it would rather be important to develop a code that fosters a well-functioning market, taking into account the diversity of market participants. Building on these perspectives, the Global Code released in May 2016 is principle-based instead of detailed and rule-based, taking into account the diversity of market participants, while reinforcing discipline to prevent misconduct.

Positioning of the Global Code

The Global Code is expected to replace the existent regional codes, once the complete Code is released in May 2017.

Objective

The Global Code intends to promote a robust, fair, liquid, open, and appropriately transparent market where diverse market participants, supported by resilient infrastructure, are able to confidently and effectivley transact at competitive prices that reflect available market information and in a manner that conforms to acceptable standards of behavior.

Relationship to Laws and Regulations

The Global Code does not impose legal or regulatory obligations nor does it precede the existent laws, rules, and regulations applicable to market participants in each jurisdiction. The Global Code intends to serve as a supplement to the local laws, rules, and regulations by identifying globally desirable conducts and practices.

Application of the Global Code

The Global Code is applied to all "foreign exchange wholesale market participants (market paritcpants)." The definition of market participants is a person or organization that (i) is active in the foregin exchange market as a regular part of its business and is engaged in the activity of the purchase or sale of one currency against another, or (ii) operates infrastructure through which transactions are executed, or (iii) provides FX benchmark[8] execution services, and (iv) is not considered a retail market participant in the relevant jurisdictions. As a guide provided by the Global Code, financial institutions, asset managers, corporate treasury departments, benchmark execution providers, brokers, electronic trading platforms, firms running high frequency trading strategies[9] and offering algorithmic execution are considered market participants. Also, central banks are considered market participants to whom the Global Code applies except where it would inhibit discharge of their legal duties or policy functions.

Characteristics of the Global Code

Principle-based Code

In the process of developing the Global Code, it has been broadly agreed that the Global Code will become most effective when it is principle-based, taking into account the diversity of market participants. A prescriptive, rule-based code could provide market participants with a disincentive to adhere to standards and principles that are not written as rules. Therefore, a principle-based code intends to provide market participants with an appropriate incentive to consider what the principles address and implement the most effective approach to adhere to the code themselves.[10] The Bank of Japan also supports the principle-based code, and expressed its support at the BIS FXWG-MPG Meeting in Tokyo (BOJ headquarters) in February 2016.[11]

Six Leading Principles

The Global Code is organized around six leading principles: 1) Ethics, 2) Governance, 3) Information Sharing, 4) Execution, 5) Risk Management and Compliance, and 6) Confirmation and Settlement Processes (Chart 2).

Among the six leading principles, the first phase of the Global Code released in May 2016 covers 1) Ethics, 3) Information Sharing, part of 4) Execution, and 6) Confirmation and Settlement.

[Chart 2] Six Leading Principles

1) Ethics

✓ Market Participants are expected to behave in an ethical and professional manner to promote the fairness and integrity of the FX Market.

2) Governance

✓ Market Participants are expected to have robust and clear policies, procedures, and organizational structure in place to promote responsible engagement in the FX Market.

3) Information Sharing

✓ Market Participants are expected to be clear and accurate in their communications and to protect Confidential Information to promote effective communication.

4) Execution

✓ Market Participants are expected to exercise care when negotiating and executing transactions.

5) Risk Management and Compliance

✓ Market Participants are expected to promote and maintain a robust control and compliance environment to effectively identify, measure, monitor, manage, and report on the risks associated with their engagement in the FX Market.

6) Confirmation and Settlement Processes

✓ Market Participants are expected to put in place robust, efficient, transparent, and risk-mitigating post-trade processes to promote the predictable, smooth, and timely settlement of transactions in the FX Market.

Note: Created by the Authors based on the texts of the Global Code of Conduct (See Footnote 7).

Improvement from the Existent Codes

The Global Code not only builds on the existing codes of conduct in the major foreign exchange markets but also reinforces the coverage of some practices in the areas of information sharing and execution, in particular, to enhance the discipline to prevent misconduct. In addition, the Global Code provides "Illustrative Examples" to help clarify concepts drawn from the principles from the practical perspective, so that the Code would become easy to use for market participants themselves.

(A) Information Sharing

The Global Code provides a clear, practical definition for "Confidential Information" which market participants should protect and "Market Colour (information on the general state of the market)" which market participants should disseminate, and also provides clear guidance to appropriate communication with clients for specific types of information.[12] In the past, misconduct where banks shared "Confidential Information" such as clients' order book to profit themselves occurred in some overseas markets. To prevent such misconduct, the Global Code intends to reinforce discipline for the protection of "Confidential Information."

(B) Execution

Regarding order handling and execution, the Global Code clarifies the difference in capacities and expected roles between "Principal," by which the foreign exchange market has traditionally operated, and "Agent," which has recently evolved with development of electronic trading (Chart 3).

[Chart 3] Two Models of Execution

	Principal	Agent
Relationship with Clients	Principals and clients act at arm's length and the client maintains the right to seek other prices. Therefore, the client may reject the quoted price.	Clients bestow upon Agents upfront the authority to execute on behalf of them. Therefore, clients are obligated to accept their Agents' execution.
Providing Liquidity to Clients	Principals provide liquidity to their clients by taking long or short positions in the market (Principals engage in market-making).	Agents source liquidity to the extent required to satisfy their client's order (Agents do not engage in market-making).
Bearing Market Risk	Principals bear market risk to the extent that they source liquidity, and until clients agree to execute the transaction. Therefore, principals may "pre-hedge" to manage the market risk with purpose of benefiting the client.	Since agents execute orders on behalf of their clients, market risk is fully borne by clients. Therefore, agents may not "pre-hedge."

Note: Created by the Authors based on the texts of the Global Code of Conduct (See Footnote 7).

For instance, acting as "Principal," banks provide liquidity to the clients, taking on market risk; therefore, banks are often granted some discretion for the execution timing and hedging for market risk. Because of the capacities, a conflict of interests between banks and clients could arise, which indeed led to some misconduct in the past in some overseas markets.[13] However, "Principal" plays such an important role to provide liquidity to the foreign exchange market. Therefore, for sound development and effective functioning of the foreign exchange market, it is most desirable to ensure transparency and integrity for both "Principal" and "Agent" models and to foster a market where clients can choose either model appropriate to their needs. Building on such a concept, the Global Code emphasizes the importance of clear disclosure of the capacities and roles in which market participants act to the clients and the appropriate handling of conflicts of interests.[14]

(C) Illustrative Examples

The Global Code expects market participants to understand the principles and adhere to them in their day-to-day business at the practical level. Also, given the diversity of market participants and business models, it has been considered important to clearly address what market participants *can* do under the code to promote their understanding and to prevent over-cautious behavior which could be detrimental to fostering well-functioning markets.

Therefore, not only does the Global Code provide succinct, clear descriptions, but also gives "Illustrative Examples" to explain appropriate and inappropriate practices to supplement the important aspects of some principles such as Market Colour and order handling (Chart 4).[15]

[Chart 4] Illustrative Examples

Communication regarding "Market Colour"

[NG] "We've just seen large USD/KRW demand from XYZ (where 'XYZ' is a code name for a specific Client)."

→ It is inappropriate to communicate information related to a specific client.

[OK] "We saw large USD/KRW demand from real money names this morning."

→ The term "real money names" appropriately anonymizes the client.

Communication regarding "Confidential Information"

[NG] "Our view on USD/JPY has shifted in line with our new central bank rate forecasts and I'm publishing a new bullish trade recommendation later today."

→ It is inappropriate to communicate information contained in unpublished research.

[OK] "I'm calling to check that you've received our bullish USD/JPY trade recommendation published an hour ago in line with our new central bank rate forecasts."

→ It is appropriate to communicate information contained in research only after it is published.

Note: Created by the Authors based on the texts of the Global Code of Conduct (See Footnote 7.)

The Tokyo Foreign Exchange Market Committee (Tokyo FXC) developed "Tokyo Blue Book" in April 2015, providing guidance with succinct, clear statements and practical examples that clarify appropriate and inappropriate practices to promote understanding of the Tokyo code of conduct among market participants.[16] The initiative by the Tokyo FXC has been highly recognized globally, and the idea of providing practical examples was taken up in the Global Code.

Adherence to the Global Code[17]

Principles for Adherence

The Global Code becomes valuable only when it is adhered to by a wide range of market participants. Given the diversity of market participants and business models, there can be no "one-size fits all" approach. However, the globally-interconnected feature of the foreign exchange market calls for a level of global consistency in adherence practices.

It is in this regard that the Code outlines, as Principles for Adherence, that the specifics of market participants' adherence (how market participants embed the Code in their culture and day-to-day practices, and demonstrate their adherence to it) should be proportionate and appropriate to the type of participant and the context of the local financial markets in which they operate, while it is important for all market participants to be open and transparent about how they adhere to the Code.[18]

Global Commitment to Code Adherence

Upon the launch of the Global Code in May 2017, central banks, private market participants, and regional FXCs, which have worked together on the development of the Code, envisage global promotion of adherence through the three channels as shown below.

(1) FXC members

The eight FXCs in the major financial centers have issued a joint statement confirming that they intend to endorse and support widespread adherence to the Global Code once it is launched in May 2017.[19]

The FXWG has also suggested that FXCs consider whether adherence to the Global Code should become a pre-requisite for achieving and maintaining membership going forward, as a stronger approach to adherence.

(2) Users of market infrastructure

In the foreign exchange market, there are electronic trading platforms and settlement systems where a large numbers of market participants participate. Accordingly, the FXWG is considering whether it is feasible to promote and facilitate adherence through engagement with key market infrastructure providers.

(3) Central Banks and their FX trading counterparties

The BIS central bank governors have issued a joint press release expressing their intent to adhere to the code where they act as market participants themselves, except where this would inhibit the discharge of their policy functions.[20]

Further, as adherence by market participants is considered beneficial for the central banks in their effective foreign exchange transactions, the central banks are expecting to take into account market participants' adherence to the code when selecting their regular foreign exchange counterparties.

Next Steps and Issues to be Addressed

Finalizing the Global Code

Looking ahead, the FXWG will continue its ongoing work to finalize the Global Code by May 2017, by formulating the remaining leading principles: 2) Governance, remaining areas of 4) Execution such as electronic trading, brokerage, and options, and 5) Risk Management and Compliance will be completed. Furthermore, the text of the first phase of the Global Code will be finalized based on public feedback.

Central banks (FXWG) and market participants (MPG) will continue to work closely over the coming year. For instance, there are new issues in the area of electronic trading that need to be addressed based on recent changes in market structure,[21] and insights provided by private market participants through the MPG and the FXCs will continue to be indispensable.

Global Adherence to the Global Code

As for the first phase of the Global Code released in May 2016, market participants are expected to familiarize themselves with the content and take it into account in the context of their foreign exchange activities. To support market participants' expeditious adoption of the Global Code following the release of the final Code in May 2017, the FXWG will deepen practical examinations on the aforementioned three adherence channels over the coming year, and publish further guidance on the approach to adherence alongside the final Code.

The Global Code does not impose legal or regulatory obligations, and thus, it is expected that market participants voluntarily adhere to it. In addition, given such diversity of market participants as well as the regulatory settings across a range of jurisdictions, it is not practical to set forth a global adherence scheme that would be enforceable by laws or regulations. However, to ensure effectiveness of the Code, it is imperative to establish a framework that enhances private market participants' incentives to adhere to the Code through a channel such as FXCs that is discussed now.

Efforts by the Tokyo FXC

The Tokyo FXC, which comprises the Bank of Japan and private financial institutions, intends to promote sound market practices in the Tokyo foreign exchange market. In the process of developing and implementing the regional code of conduct in the Tokyo market including the aforementioned "Tokyo Blue Book," the Tokyo FXC has engaged with a wide range of market participants including non-member financial institutions (sell-side) and clients such as non-financial firms and institutional investors (buy-side) to seek their understanding.

As the Global Code applies to all "foreign exchange wholesale market participants," it becomes even more vital for the Tokyo FXC to reach out to broader market participants to enhance the effectiveness of the Code. The Tokyo FXC has in April 2016 launched the "Buy-side Sub-Committee," with the aim of strengthening communication with broader market participants on issues concerning the foreign exchange market including the code.

Concluding Remarks

The Global Code of Conduct aims to promote a robust, fair, liquid, open, and transparent foreign exchange market. Achieving this goal is crucial to the sound development and effective functioning of the foreign exchange market.

A well-functioning foreign exchange market is highly important from a central bank's perspective. Financial markets carry crucial information regarding market participants' views on economic and financial conditions, and also play a vital role for policy transmission. Financial markets must be functioning effectively to play such important roles.

For the foreign exchange market to function effectively, it is important for a diverse set of market participants with diverse business models that are properly aligned with the code to be able to confidently transact in the market. Such a market will support market liquidity, which, in turn, enhances the functioning of the foreign exchange market.[22]

Such point of view by the Bank of Japan has been broadly shared in the process of development of the Global Code. It is reflected in the first phase of the Global Code released in May 2016, which adopted a principle-based approach rather than a prescriptive, rule-based approach to address the diversity of market participants, while strengthening discipline in the areas such as information sharing and execution. Therefore, the Bank of Japan believes that market participants should fully understand and adhere to the principles underlined in the Global Code, which will contribute to the sound development and effective functioning of the foreign exchange market.

Finally, it would be desirable that innovations led by the private sector continue to evolve under the appropriate code of conduct, thereby improving market functioning. Therefore, to support further innovations and sound market functioning, the public sector such as central banks and the private sector should closely collaborate and endeavor to align the private sector's incentives appropriately in promoting adherence to the Global Code. From this standpoint, the Bank of Japan will continue to work closely with other central banks and private market participants to fully support and be committed to the work of the Global Code.

[1] According to the "Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity" conducted by the BIS, electronic trading accounted for around 60% of total turnover in the global foreign exchange market in 2013, up from around 40% in 2010. Forms of electronic trading platforms have become diverse, ranging from brokers to single- and multi-dealer platforms. For details on the (different) forms of electronic trading and changes in the structure of the foreign exchange market brought about by the expansion of electronic trading, see Maiko Koga and Atsushi Takeuchi, "Gaikokukawaseshijou ni okeru kousokuka/jidouka: shijoukouzou no henka to arata na ronten," Bank of Japan Review Series, No. 2013-J-1, January 2013, and Yusuke Ou, Yoshihiro Takada, and Yasushi Sugayama, "Saikin no gaikokukawaseshijou no kouzouhenka," Bank of Japan Review Series, 2014-J-5, July 2014.

[2] For details on the work to strengthen the code of conduct with the aim of enhancing confidence in the foreign exchange market, see Lisa Uemae, Lisa Ohkawa, and Hirotaka Inoue, "Gaikokukawaseshijou no shinraiseikoujou ni muketa inishiachibu – Code of Conduct (koudoukihan) no seibi ya kokusaitekichouwa no torikumi," Bank of Japan Review, 2015-J-9, June 2015.

[3] The eight FXCs in the major financial centers (Australia, Canada, Europe<ECB>, Hong Kong, London, New York, Singapore, Tokyo) form a community in light of the international nature of foreign exchange transactions.

[4] See the following page for The Global Preamble.
(http://www.fxcomtky.com/announce/pdf_file/global_preamble.pdf)

[5] The FXWG is composed of central banks in eight economies, who have discussed international cooperation global code of conduct (Reserve Bank of Australia, Bank of Canada, Bank of Japan, European Central Bank, Hong Kong Monetary Authority, Monetary Authority of Singapore, Bank of England, Federal Reserve Bank of New York), as well as Central Bank of Brazil, Bank of France, Reserve Bank of India, Bank of Korea, Bank of Mexico, Sveriges Riksbank, Swiss National Bank, and State Administration of Foreign Exchange (China).

[6] The MPG is composed of a wide range of market participants, including sell-side (financial institutions), buy-side (institutional investors, fund managers and corporates), market infrastructure providers, and industry groups. Its members are: Barclays, JPMorgan, The Hongkong and Shanghai Banking Corporation Limited, Bank of Tokyo-Mitsubishi UFJ, Mizuho Bank, Société Générale, Citi, BNPParibas, DBS Group Holding Ltd, Deutsche Bank, UBS, Standard Chartered Bank, RBC, SEB, State Bank of India, Banco Ve por Más, Banco Itau BBA, Westpac, China CITIC Bank, China Foreign Exchange Trade System, PGGM, XTX Markets, Rolls-Royce, Industrial Bank of Korea, Seoul Money Brokerage Services, Airbus Group, Millennium Global, Virtu Financial, Colonial First State Investments, BlackRock, CLS, EBS, Thomson Reuters, and ACI (as of June, 2016).

[7] See the following page for the document of the Global Code of Conduct.
(http://www.bis.org/mktc/fxwg_phase1.htm)

[8] "Fixing rates," which are calculated using price and trade data within a predetermined time window, are widely used by institutional investors and corporates as a benchmark in the foreign exchange market. One example is the "London Fixing" which is released by WM/Reuters at 4 p.m., London time.

[9] HFT (High Frequency Trading) refers to hedge funds that make use of algorithmic trading techniques to conduct high speed, automated transactions at a high frequency to accumulate profit. For details, see footnote 1 of Maiko Koga and Atsushi Takeuchi (2013).

[10] See G. Debelle (2015), "The Global Code of Conduct for the Foreign Exchange Market," Speech at FX Week Europe conference.

[11] See H. Nakaso (2016), "Developing a Global Code of Conduct for the Foreign Exchange Market Opening Remarks at the BIS FXWG-MPG Meeting in Tokyo."

[12] See Principles 1 to 4of the "Information Sharing" section of the Global Code ("FX Global Code: May 2016 Update").

[13] For example, a dealer who received a stop-loss order from a client (S/L orders; an order type that automatically executes buy <sell> limit orders when market prices rise <fall> to a predetermined level with the aim of limiting client losses from adverse price movements. Market movements are likely to gain further momentum once market prices rise <fall> to levels where there are buy-<sell>-S/L orders) could buy (sell) below (over) the level of the buy (sell) S/L order beforehand when the market price is approaching to the level of the S/L order with an intention to provide the client with a price as close as possible to the level of the S/L order, limiting the client's loss (pre-hedging). However, a dealer's pre-hedging activity could generate a conflict of interest, by increasing (decreasing) the market price, possibly hitting the level of the client's S/L order. In cases of misconduct in some overseas markets, banks intentionally hit their clients' S/L orders for their own profit with clear intention to make losses on the clients.

[14] See Principles 1 to 3, and 5 of the "Execution" section of the Global Code ("FX Global Code: May 2016 Update").

[15] See "Annex 1: Illustrative Examples" of the Global Code ("FX Global Code: May 2016 Update").

[16] See the following page for the text of the Tokyo Blue Book.
(http://www.fxcomtky.com/coc/pdf_file/code_of_conduct_e2015.pdf)

[17] See Principles for Adherence to the Global Code ("FX Global Code Public Update on Adherence May 2016").

[18] See Principles for Adherence to the Global Code ("FX Global Code Public Update on Adherence May 2016").

[19] See the following page for the joint statement by the eight FXCs in the major financial centers.
(http://www.fxcomtky.com/coc/pdf_file/joint_statement_may2016.pdf)

[20] See the following page for the joint press release by BIS governors.
(http://www.bis.org/press/p160526a.htm)

[21] For instance, the practice of "Last Look," which allows dealers to reject clients' orders received via electronic trading venues, has existed in the foreign exchange market as a means for dealers to protect themselves from the risk caused by

instantaneous price movements in the electronic trading. Going forward, further consideration would be expected on ways to ensure transparency to clients when dealers conduct this practice.

[22] See footnote 11 of H. Nakaso (2016).

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