Clients&FriendsMemo

Traders and Compliance Professionals Take Note: Phase One of New BIS "Global Code" Establishes "Best Practices" in the Foreign Exchange Markets

Limitations on Use of Confidential Information is Prominent in the New Standards Continuing Recent Enforcement Trend in the Commodities and Derivatives Markets

June 1, 2016

On May 26, 2016, the Foreign Exchange Working Group ("**FXWG**") of the Bank for International Settlements ("**BIS**") published the first phase of a new "Global Code of Conduct for the Foreign Exchange Market" ("**Global Code**").[1] According to Guy Debelle, Assistant Governor (Financial Markets) at the Reserve Bank of Australia and head of the FXWG, the purpose of the Global Code is to set out "global principles of good practice in the foreign exchange market to provide a common set of guidance to the market, including in areas where there is a degree of uncertainty about what sort of practices are acceptable, and what are not." As such, the Global Code will likely be used by global regulators to define "best practices" in the FX markets, and the behavior that would be deemed disruptive, abusive, or manipulative.

I. What is the Global Code and to whom does it apply?

The Global Code *does not* impose legal or regulatory obligations on market participants nor does it substitute for regulation. Rather, the Global Code is a framework supported by specific guidance that may serve to supplement local laws, rules, and regulations. According to the FXWG, the Global Code is intended to become an integral part of the FX market globally, and articulate the "good practices" with which market participants and their counterparties are expected to conduct their business.

To reach a broader audience, the Global Code was drafted to apply to all FX market participants that engage in the FX markets, including financial institutions, asset managers, hedge funds, high-frequency and algorithmic trading firms, and any other entity classified as an "FX market participant" in the relevant jurisdiction.

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[1] The purpose of the FXWG is to establish a single set of global principles for foreign exchange markets. Members of the FXWG are comprised of central banks and market participants from major financial centers in both advanced and emerging market economies.

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Introduced in two phases, this phase of the Global Code covers ethics, information sharing, aspects of trade execution, and trade confirmation and settlement. The second phase, due to be published in May 2017, will cover further aspects of execution including e-trading and platforms, prime brokerage, as well as governance, and risk management and compliance. According to the FXWG, issues addressed in phase one were prioritized because they cover subjects where the market is in more urgent need for clarity.

II. How may the Global Code change standards of acceptable conduct in the FX and other financial markets?

The Global Code provides guidelines that are relevant to a number of different regulatory and compliance subjects, yet three subjects are particularly noteworthy: (1) How market participants should properly handle confidential information; (2) What constitutes appropriate market color and how traders should communicate; and (3) When it is potentially inappropriate for market players to trade around client orders, including pre-hedging.

A. The Global Code articulates standards for handling confidential information.

The Global Code states that, "[m]arket [p]articipants should clearly and effectively identify and appropriately limit access to [c]onfidential [i]nformation,"[2] and that "[m]arket [p]articipants should not disclose [c]onfidential [i]nformation to external parties, except under specific circumstances."[3]

"Confidential information" is defined as any information relating "to the past, present, and future trading activity or positions of the Market Participant itself or of its [c]lients, including related information that is sensitive and is received or produced in the course of such activity." This includes information regarding orders, executed trades, and specific positions held by the firm or its clients. According to the Global Code, traders and other firm personnel "should not disclose [c]onfidential [i]nformation *to any individual under any circumstances* where it appears likely that such individual will misuse the information." In addition, "[c]onfidential [i]nformation obtained from a [c]lient, prospective [c]lient, or other third party *is to be used only for the specific purpose for which it was given*, except as provided above or otherwise agreed with a [c]lient."

FX trading, like all commodities and derivatives activities, was considered somewhat insulated from the prohibitions on insider trading that are well-known in the securities markets. However, landmark legislative changes in the United States that were part of the 2010 Dodd-Frank amendments to the U.S. Commodity Exchange Act ("**CEA**") changed the legal landscape, and the U.S. Commodity Futures Trading Commission ("**CFTC**") interprets this new authority to allow it to pursue certain forms of insider trading in the commodities and derivatives markets.

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[2] Information Sharing, Principle 1.

[3] Information Sharing, Principle 2.

The CFTC relied on this authority in December 2015 when it settled a case against Arya Motazedi, a trader that allegedly misappropriated trading and position information from his employer, then traded off of that information for personal gain.[4] Furthermore, recent statements by senior enforcement officials indicate that the CFTC intends to continue to pursue insider trading cases using the misappropriation theory.[5] During an interview by a major trade publication, one of the Deputy Directors of Enforcement at the CFTC provided two specific examples of the types of insider trading cases that the CFTC may prosecute:

- One example of insider trading under the CEA might be where an employee of a bank, who sits on the futures and swaps desk, discloses the bank's positions to a hedge fund trader who then trades on that information. In this example, the Division of Enforcement finds that it is not necessary that the hedge fund trade against the bank. The article notes that the CFTC could charge *both* the employee of the bank, as well as the hedge fund trader, under the misappropriation theory of insider trading.
- A second example follows the allegations arising out of the 2012 J.P. Morgan "London Whale" trade, where the bank's chief investment officer alleged that some of its traders had leaked positions to hedge funds whom it suspected of trading against it. If those allegations were true, and the positions were leaked in exchange for a personal benefit, the article claims that the CFTC could have gone after both the tippers and the tippees.

The detailed discussion of confidential information in the Global Code, and how it can and cannot be used, suggests that the concept of insider trading in the commodities and derivatives markets will continue to develop as a potential focus for future enforcement actions.

B. The Global Code proposed new limits on how "market color" should be defined and used.

The Global Code provides that, "[m]arket [p]articipants should communicate [m]arket [c]olor appropriately and without compromising [c]onfidential [i]Information." While acknowledging that the timely dissemination of market color can contribute to an efficient, open, and transparent market "through the exchange of information on the general state of the market, views, and anonymized and aggregated flow information," it cautions that "communications *should be restricted* to information that is effectively aggregated and anonymized."

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[4] The CFTC's settlement is available here.

[5] The CFTC explained that it is a violation of the misappropriation theory for "a person [to] engage[] in deceptive or manipulative conduct in connection with any swap, or contract of sale of any commodity in interstate commerce, or contract for future delivery on or subject to the rules of any registered entity, *for example by trading on the basis of material nonpublic information in breach of a pre-existing duty (established by another law or rule, or agreement, understanding, or some other source), or by trading on the basis of material nonpublic information that was obtained through fraud or deception*, may be in violation of final Rule 180.1." 41 Fed. Reg. 41,398, 41,403 (emphasis added).

Certain forms of "market color" are specifically discouraged under the Global Code, including communications that:

- include specific client names, other mechanisms for communicating a client's identity or trading patterns externally (*e.g.*, code names which implicitly link activity to a specific market participant);
- reference specific client groups, locations, and strategies that allow market participants to derive underlying confidential information;
- disclose information about individual trading positions; and
- reference exact rates, volumes, or locations that relate to a single client.

To help illustrate how the guidance regarding market color should be applied in practice, the Global Code included an annex of illustrative examples such as:

- **Statement from a broker to a bank market-maker:** "European banks are currently bidding for 1-month at-the-money USD/JPY volatility in size." (Information not properly aggregated or anonymized).
- **Statement from an asset manager to bank market-maker:** "Bank ABC just called me with an axe to buy EUR/SEK. Are you seeing buying as well?" (Sharing of confidential information).
- **Bank market-maker to another bank market-maker:** "I'm being asked to quote a two way price in USD 150m in USD/MXN. What does your bank's pricing matrix show in terms of spread?" (Sharing of confidential information).

Although the Global Code is not legally binding and these concepts will need to be interpreted in each relevant jurisdiction, it provides a new persuasive authority that regulators may look to when trying to apply legal concepts. Compliance departments that oversee all commodities and derivatives trading desks should review the thought-provoking examples provided in the Global Code to determine how they may apply to their businesses.

C. The Global Code emphasized that trading around client orders must be done "fairly and with transparency."

The Global Code states that, "[m]arket [p]articipants should handle [c]lient orders fairly and with transparency."[6] As part of such fairness and transparency, market participants "should only pre-hedge client orders when acting as a principal."[7]

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[6] Execution, Principle 2.

[7] Execution, Principle 3.

According to the Global Code, certain trading activity may suggest abusive or disruptive behavior, including trading in a manner designed to move the market to a known stop loss level (*i.e.*, client order), or pre-hedging a client trade in order to disadvantage the customer.

Some of these concepts parallel the Global Code guidance on confidential information, however others echo the now familiar refrain of "spoofing" and disruptive trading practices. Nonetheless, the common answer to each of the potential concerns raised in the Global Code is to implement strong and clear policies and procedures that define a firm's detailed code of conduct, and then to implement those procedures through effective training, appropriate surveillance, and genuine remedial actions whenever violations occur.

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If you have any questions about the new FX Global Code or anything discussed herein, please contact Gregory Mocek at gregory.mocek@cwt.com, Anthony Mansfield at anthony.mansfield@cwt.com, Jonathan Flynn at jonathan.flynn@cwt.com, or Jorge Pesok at jorge.pesok@cwt.com.

Appendix A

List of Principles in the Global Code

Ethics – Leading Principle: Market participants are expected to behave in an ethical and professional manner to promote the fairness and integrity of the FX Market.

Ethics – Principle 1: Market participants should strive for the highest ethical standards.

Ethics – Principle 2: Market participants should strive for the highest professional standards.

Ethics – Principle 3: Market participants should identify and address conflicts of interest.

Governance – Leading Principle: Market participants are expected to have robust and clear policies, procedures, and organizational structure in place to promote responsible engagement in the FX market.

[This section is in development as content to be published May 2017 as part of phase 2 of this work. This section is expected to include content related to the policies and procedures to support the principles within the Global Code and other material relevant to governance.]

Information Sharing – Leading Principle: Market participants are expected to be clear and accurate in their communications and to protect confidential information to promote effective communication that supports a robust, fair, open, liquid and appropriately transparent FX market.

Information Sharing – Principle 1: Market participants should clearly and effectively identify and appropriately limit access to confidential information.

Information Sharing – Principle 2: Market participants should not disclose confidential information to external parties, except under specific circumstances.

Information Sharing – Principle 3: Market participants should communicate in a manner that is clear, accurate, professional, and not misleading.

Information Sharing – Principle 4: Market participants should communicate market color appropriately and without compromising confidential information.

Information Sharing – Principle 5: Market participants should provide personnel with clear guidance on approved modes and channels of communication.

Execution – Leading Principle: Market participants are expected to exercise care when negotiating and executing transactions in order to promote a robust, fair, open, liquid, and appropriately transparent FX market.

Execution – Principle 1: Market participants should be clear about the capacities in which they act.

Execution – Principle 2: Market participants should handle client orders fairly and with transparency

Execution – Principle 3: A market participant should only pre-hedge client orders when acting as a principal, and should do so fairly and with transparency.

Execution – Principle 4: Market participants should not request transactions with the purpose of disrupting the market.

Execution – Principle 5: The mark-up applied to client transactions by market participants acting as principal should be fair and reasonable.

Execution – Principle 6: Clients should be aware of the risks associated with the transactions they request and undertake, and should regularly evaluate the execution they receive.

Risk Management and Compliance – Leading Principle: 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.

[This section is in development as content to be published May 2017 as part of phase 2 of this work.]

Confirmation and Settlement – Leading Principle: 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.

Confirmation and Settlement – Principle 1: Market participants should establish consistency between their operating practices, their documentation, and their policies for managing credit and legal risk.

Confirmation and Settlement – Principle 2: Market participants should institute a robust framework for monitoring and managing capacity in both normal and peak conditions.

Confirmation and Settlement – Principle 3: Market participants are encouraged to implement straight-through automatic transmission of trade data from their front office systems to their operations systems.

Confirmation and Settlement – Principle 4: Market participants should conduct any novations, amendments, and/or cancellations of transactions in a carefully controlled manner.

Confirmation and Settlement – Principle 5: Market participants should confirm trades as soon as practicable, and in a secure and efficient manner.

Confirmation and Settlement – Principle 6: Market participants should review, affirm, and allocate block transactions as soon as practicable.

Confirmation and Settlement – Principle 7: Market participants should identify and resolve confirmation and settlement discrepancies as soon as practicable.

Confirmation and Settlement – Principle 8: Market participants should be aware of the particular confirmation and processing features specific to life cycle events of each FX product.

Confirmation and Settlement – Principle 9: Market participants should measure and monitor their settlement risk and seek to mitigate that risk when possible.

Confirmation and Settlement – Principle 10: Market participants should utilize standing settlement instructions.

Confirmation and Settlement – Principle 11: Market participants should request direct payments.

Confirmation and Settlement – Principle 12: Market participants should have adequate systems in place to allow them to project, monitor, and manage their intra-day and end-of-day funding requirements to reduce potential complications during the settlement process.

Confirmation and Settlement – Principle 13: Market participants should perform timely account reconciliation processes.

Confirmation and Settlement – Principle 14: Market participants should identify settlement discrepancies and submit compensation claims in a timely manner.