The Buy Side and the Global Code: Patience Required

Much has been made of the low buy side sign up to the FX Global Code, but as Colin Lambert finds out, it is likely only to be a matter of time.

Talk to senior members of the Global FX Committee and one can discern a sense of exasperation when they are asked (probably for the tenth time that day) about the lack of buy side adoption of the FX Global Code. The exasperation stems from what is the thorn in the side of the GFXC that is low adoption rates.

The latest release from the GFXC indicates that 22 asset management firms have made a Statement of Commitment (SoC) to the Code publicly available, this number includes five banks that have signed a statement on behalf of their asset management unit as well as their FX business. The good news from this is that the number is growing, it was just 14 at the end of May, and also that corporate treasuries are signing up quicker now since the European Association of Corporate Treasurers (EACT) launched its own Global Code register.

Jean-Marc Servat, chair of EACT, says the association launched the register to help drive take up and interest in its principles. "Just a few months ago there were just two corporate treasuries with Statements of Commitment posted on a register," he explains. "Companies were coming to us and saying they didn't feel they had anywhere to register because they felt the existing registers mainly had other types of market participants. They also pointed out that they had no other interaction with those managing registers. That is why we have started our register."

In an interview with *Profit & Loss* after the most recent GFXC meeting, its chairman, Simon Potter, expressed the view that buy side adoption of the Code has "probably been better than we expected". He did, however, also acknowledge that more work needed to be done and that was amply demonstrated by the establishment of a buy side liaison committee to look at the issue.

Michael O'Brien from US asset manager Eaton Vance is a member of the sub-group and his personal view is that it is largely a question of managing expectations. "Something I have noticed over the last decade which has seen a lot of changes in the market structure in all asset classes, not just FX, is that everyone wants to see a big bang," he observes. "But we never have one, there are very few, if any examples of that happening. It is the same with the Code, I think people saw the great take up on the sell side and expected the same from the buy side and they are wondering why it hasn't happened yet.

"The buy side, as it is generically known, is a very diverse group compared to the sell side," he adds. "So it will inevitably take longer because there is a much more diverse range of participants with different needs and interactions with the FX market and therefore changing things becomes much more complex. If you had the sell side in one room together and the buy side in a different room it would have to be much larger room and I think sometimes that gets overlooked."

O'Brien remains confident in the longer term – "The adoption rate will go up over time, but it will take time" – although he accepts that what is needed is an education effort and an outreach effort, hence the new group established by the GFXC.

The outreach and education effort will be closely watched from many quarters, not least the buy side itself. One senior member of an asset management firm tells *Profit & Loss* that the firm is "reluctant" to sign up to the Code because it doesn't feel the disclosures guidelines go far enough. "Too many disclosures are generic and ambiguous," the manager argues. "For example, I can be rejected on last look – a practice I fundamentally disagree with by the way – but not know the real reason. It is also hard to understand exactly how the bank is using my order information and while we can ask direct questions, they can hide behind their disclosures which broadly say 'we can do a variety of things with your information'."

The manager adds that if disclosures

Joseph Hoffman

Ian Battye

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are tightened up, then the firm "will probably consider" signing a Statement of Commitment.

If there is good news for the GFXC in that it is that the firm concerned has actually heard of the Global Code, for many apparently still have not. O' Brien acknowledges that some firms need to be made aware of the existence of the Code and believes that will be a significant part of the buy side liaison committee's work. "We need to show firms that aren't aware of the Code what has been done and demonstrate the benefits of adoption," he says. "There has been a great outreach effort by the GFXC but it has to continue and spread further. It is not just about getting the buy side to sign up, it is more about ensuring they appreciate the benefits of doing so."

Russell Investments was one of the early adopters of the Code from the buy side, and Ian Battye, CIO- currency at the firm, says that after becoming aware of the Code just after the launch of the full version in May 2017, Russell Investments committed to ensuring both its asset management and agency businesses adhered.

"I worked with our risk and compliance teams through a robust process first to understand the Code and pick out which principles were relevant to us, not all are of course, we are not a market maker for example," he explains. "We looked at those that were relevant to an asset manager and agency execution provider. We have strong views on making sure the role of principal and agency are clearly defined.

"The process wasn't overly difficult, we found our operation was aligned with the Code's principles but we wanted to be thorough to ensure we could sign up to the Code," he continues. "Generally speaking, our philosophy aligns nicely with the Code's principles although one or two did give us pause for thought."

Battye cites Principles 33 on business continuity, and 34 on technology risk, as the two, but stresses neither was difficult to comply with. "They did prompt some introspection and due diligence around our processes, however, and I suspect we were not alone in that. Many asset managers looking to sign up would have worked through the same process.

"Ultimately there were no really significant changes and we found we did meet the principles' demands and we are aligned with the Code," Battye adds.

Benefits

A significant proportion of the outreach effort by the GFXC will involve educating buy side firms in the benefits of adopting the Code. For O'Brien, there are several reasons for firms to sign up. "Adopting the Global Code will enable buy side firms to maintain the pressure on their banks and service providers to keep pace with best practice standards," he suggests. "Banks respond to client demand and if that demand is for best practice standards, then it is helpful if the client adheres to them as well so they understand what is expected of them.

"It also helps the banks have confidence that their clients understand the standards they are working to, there are incentives for all in doing this," he adds.

O'Brien also believes there are business benefits. "Internally, the asset manager can demonstrate that they are adhering to best practice, asset managers and hedge funds have customers too, so it can help them demonstrate good governance," he says. "It is beneficial generally for your business to show that you adhere to best practice guidelines, it can be a competitive edge. If I see one of my rivals with that edge, then I want to have it as well, so there will be an element of competitive pressure. When these firms are approaching investors, they will not want to face tricky questions to which they don't have a good answer, so they'll want to get in front of the issue.

"Going forward, we expect to see pension funds and those hybrid funds that outsource part of their funds management and keep the rest in house to ask the questions about how the outsourcing firm conducts their business – whether they adhere to the Code," O'Brien adds. "This will not just be a check the box exercise, a lot of these firms have sophisticated clients who will know about the Code and ask pertinent questions. I think firms will want to have the information and best practices in place before they put something in front of their clients."

While he stresses it is important that all the Code's principles appropriately reflect its stated objectives of fairness and transparency, Battye, picks out two that can have a direct and positive impact on

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investors. "Principle One on ethical behaviour, and Three on managing business and conflict of interests," he states. "The absence of ethical standards played a role in the problems the industry encountered a few years back and the Code addresses these directly, which is important. This is a real and tangible benefit to investors.

"The Code can also help restore confidence – there may have been an erosion of confidence that has also been addressed and that serves everyone's interests in the industry," he adds.

That said, Battye is less sure if there will be a tangible impact in the form of increased hedging by asset managers brought about by this restoration of confidence. "I am not sure the Code will lead to an uptick in hedging activities, probably it will be business as usual for managers," he says. "Is there a benefit in an asset management firm pulling back from their usual activities because they had lost confidence in the mechanism? Maybe, but, nonetheless restoring this confidence does remove one impediment to them being active in the market place."

Joseph Hoffman, CEO of Mesirow Financial Currency Management, believes that signing an SoC signals the firm's intent to be a good market citizen. "It was important to commit to the Code to demonstrate our commitment to these principles and the best interests of our clients," he says. "By adhering to the Code, our clients can be assured that Mesirow continues to strive for fairness and transparency in the FX marketplace. Our adoption of the Code sets the expectations of how Mesirow will interact in the global FX space."

Servat, meanwhile, believes there are broader business benefits for corporate treasuries in adoption. "It is important we recognise that greater transparency benefits everyone, including corporates," he says. "Previously it was hard for many corporates to be able to challenge the price they received for FX deals. With the Code, they can have confidence there will be better behaviour and less instances of alleged manipulation and they can ask legitimate questions about how the price was arrived at.

"Smaller corporates can also benefit from the Code," he continues. "It may not be as important to them in terms of their actual trading, but there are several sections in the Code that deal with risk management, compliance and governance that apply to these companies and can help them build a more robust governance structure around their Treasury unit.

"The Code is all about high level principles, proportionality means that it has different values for different businesses, but the main factor is corporates can feel more confident in their counterparties' conduct – the failures that led to the fines and manipulation claims were nothing to do with the corporate world obviously, but that world will benefit from the advent of the Code," Servat adds.

Peer Pressure

For all the positives that can be named about the FX Global Code, the fact remains that momentum, in some form at least, has to be maintained when it comes to broader adoption. So is peer pressure one tactic that can be used? It is notable that for all the talk of FX Committee members having to commit to the Code to maintain membership (and indeed to have central banks deal with them) it is still difficult to find a buy side member of the New York Foreign Exchange Committee (FXC) with an SoC published on a register.

One member of that committee tells *Profit & Loss* that it is a matter of time, but also that it is becoming a little awkward. "Direct questions are not being asked, I think everyone knows we want to do it, but getting the internal mechanism to work quickly is proving tough. We will get there though," the FXC member says.

Much was made in the early days of the Code about firms not dealing with counterparties who had not adhered, but to date this does not seem to be playing out – although again, it could just be a matter of patience, as Hoffman explains. "We have conveyed the importance of the Code to our counterparties and have continued the dialogue," he says. "At this time, Mesirow would not discontinue a counterparty relationship because they have not signed up to the Code because it takes time for these institutions to implement the appropriate controls and processes to fully commit.

"Many of the banks have been consumed by regulatory reform (ie, Dodd-Frank, EMIR, MiFID II, etc) over the past several years and have committed enormous resources and attention to achieving compliance," he continues. "Perhaps now that much of that effort has been completed, more banks will focus on the steps necessary to comply with the Code.

"As a fiduciary, it's Mesirow Financial Currency Management's responsibility to manage our bank counterparty roster prudently and transact with the counterparties that we believe are providing competitive pricing and acting in our clients' best interest," Hoffman stresses.

Peer pressure will work best with transparency of course, as Servat points out, "If a bank provider has not signed a SoC and registered it, we would very much expect corporates to question them very closely about why. There may be good reasons, but they should insist on an answer."

It could also be said that with transparency comes awareness and it is here that some feel the GFXC could have done a slightly better job around the registers when they were first launched. The GFXC website now hosts a central register of registers, which is acting as a quasi global register, but participants still need to go to one of the 12 regional or business segment orientated registers to actually post their SoC.

"In terms of buy side firms signing up, I think it is about awareness of the Code and what it is trying to achieve," says Battye. "The sell side has that awareness but it is by no means universal and it is hard to discern the general level of awareness of the Code.

"A challenge is there is no formal central register of signatories and it is not obligatory to publish a Statement of Commitment to the Code," he continues. "We have found it easier to directly ask our service providers if they have signed up to the Code and if not, whether they plan to, and if not, why? We are very satisfied by the feedback from our counterparties and the coverage amongst that group.

"Personally I think the FXC would be well served to create or direct people to one central register for all participants to go and review who has signed, and I'm not sure why they didn't take that additional step because I think it would be helpful," Battye adds. "Maybe they are allowing the market forces to drive the project and create user adoption, that would be slower but ultimately create more depth of adoption if firms don't have to work to a deadline imposed on them. Maybe at some stage the FXC asks some direct questions of firms that have not signed up."

Until that happens it is up to individual firms to ask the questions, and that can be time consuming if the firm in question has a broad service base. "We are probably interacting with 50 or more counterparties in the FX market every week," explains the principal of an Asia-based hedge fund. "I don't know how long it would take to find the right person in each institution to ask, but we don't have the resources. We went through the registers a few months back and that was tough enough, we don't want to waste valuable time checking for signatures on a piece of paper."

Will it Work?

When the full version of the FX Global Code was launched, Guy Debelle, then chair of the group that created the Code, told *Profit & Loss* in response to a question about the metrics of success for the document, "I hope the Code, by providing clear guidance, and assuming firms train their staff properly, will reduce the number of transgressions. That said, I think the real test will be if any transgression is detected and self-declared. That would be a really good outcome because it means the control systems have picked it up either at the firm or at a counterparty. If a counterparty also feels sufficiently confident to alert a participant and ask questions of certain practices – for example, 'we're not sure this is in accord with the Code', then that too would be a good outcome."

It is, of course, impossible to know whether the number of transgressions has been reduced – especially at this early stage – however there is optimism that the Code is having an impact. As Potter notes, "The GFXC made a great deal of progress in its first year. It is a great achievement to have over 300 Statements of Commitment signed and we look forward to adding to this number."

For the buy side, reducing the number of transgressions and making processes much more transparent is what it is all about and there are one or two firms that seem to be on the sidelines awaiting events. "Before we commit to the work needed to ensure we can adopt the Code we want to make sure it is effective," says an Asia-based asset manager. "The buy side didn't cause the problems in the first place that led to the Code so I am not sure why we need to sign up, but I accept peer pressure may get us to that point."

For others though, it's about the right order of business, and that means getting the sell side – where, as the Asia-based asset manager correctly observes, most of the transgressions were seen – to adopt first. Russell Investments' Battye also believes it was important that the sell side drove the project forward and were the early adopters. "I would have expected it to be driven by the sell side, I think had this been buy side driven, there would have been some cynicism over the sell side's intent," he says. "There is a genuineness about the development of the Code amongst the sell side firms involved that is good to see and that will, I believe, help provide at some stage, greater depth of adoption."

Jean-Marc Servat

Michael O'Brien

O'Brien believes that dialogue is the key to broadening adoption, "We have to listen to those people reluctant or slow to sign up to the Code and understand their reasons," he says. "Our education and outreach effort is only just starting out, but a big part of that will be identifying the issues that may be holding up broader adoption."

A strength of the Code has often been seen as its provision of a generally accepted set of standards to which all participants can adhere, and this is something highlighted by Hoffman. "We believe the Code is helpful in outlining the appropriate principles and practices that will lead to a robust, fair, liquid and appropriately transparent market," he says. "However, to prevent the issues we've seen in the FX markets in recent years, it's important for firms to look at their business model as well as the culture of the firm. If the business is aligned with the interests of the underlying clients and there is a culture which promotes integrity and honesty, we believe many of the past issues can be avoided."

As things stand, the work of the GFXC is about opening eyes, ears and minds to the Code's benefits for the buy side. Going forward, the ultimate success could be about opening mouths. Questions need to be asked of those firms that are not adopting, but just as important, they need to be asked of those who have signed up. "Until a few years ago, some activity by banks was seen as acceptable and the lack of transparency was not a top concern," observes Servat. "Now it is seen as not OK to be less than transparent. It used to be corporates said nothing if they were suspicious of how a transaction was handled, now, thanks to the Code and internal governance changes, they ask questions."

Progress then, may be slower amongst the buy side than it was on the sell side, but it could all just be a question of time. There is often an impatience in the financial markets industry when it comes to implementing inevitable change, but this is offset by the time it can take major institutions to undertake even the most basic of changes to their processes.

Looking at the Code through the prism of one full year of existence, it can be judged a success purely on how well it has been embedded amongst firms that, it is widely acknowledged, had a cultural problem around the turn of this decade. Success from here is about ensuring all market participants understand the value of the Code's principles and why it is important for them to adhere as well, and principal amongst those needing to be converted is the buy side.

It is true that the buy side had little to do with the misconduct from which the Code was born, but it could be argued that buy side attitudes, especially to benchmark fixes (in their old form), were part of the problem. By putting all sides of the industry on one level in terms of expected behaviours, the Code can create that nirvana for markets, a truly fair, transparent and balanced trading environment that meets the vastly different needs of different participants.

To achieve that, the Code has to increase buy side adoption rates. A success today? Yes. A success in one year's time? That will very much depend on how many buy side firms add their signatures to a Statement of Commitment.