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Dealer/End-User Relationships -- What They Are and What They Should Be

Remarks by

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Derivatives Developments - Establishing the End-User/Dealer Relationship, Providing Appropriate Disclosure and Satisfying Fiduciary Responsibilities

It is my pleasure to be here with the members of EUDA. I am here today to explain the roots of the Principles and Practices for Wholesale Financial Market Transactions and how the Principles and Practices relates to the subject of your Annual Conference. I assume that the Principles and Practices are part of your program materials. I have submitted two additional items for your book. The first is a paper my colleagues at the Bank and I prepared on over-the-counter derivatives sales practices, comparing the disclosure, suitability, appropriateness, and "best practices" regimes of various supervisors and regulators. The second is the instructions to Federal Reserve examiners entitled "Evaluating the Risk Management and Internal Controls of Securities and Derivatives Contracts Used in Nontrading Activities." As end-users you might find that document of interest. Just as others will find the excellent checklist that EUDA prepared a valuable tool in risk management, you might find the examiners' instructions useful.

The Principles and Practices arose when I asked a number of trade associations in New York City with which I was familiar whether there was a need for a broad, over-arching code of conduct for the wholesale financial markets. I had noted that other countries had such codes. In the United States, trade associations had codes designed for the products encompassed by that particular association. When we started down this path there was no EUDA. That is why EUDA was not invited as a sponsoring trade association. In addition, we did not know whether it would be possible for the six trade associations to agree on a code. The associations assembled and did agree that the effort was worthwhile. A drafting group was assembled. Each organization had to put up one attorney and one real person. The drafting group was jointly headed by Woody Teel of the Foreign Exchange Committee and Bank of America and Gay Evans of ISDA and Bankers Trust. Also, when the drafting group started down the path, we did not know what the scope of the project would be.

I would like to explain the role of the Federal Reserve Bank of New York in this project. Clearly, the idea was mine, but I have lots of ideas, some more worthwhile than others. It was the decision of the trade associations to go ahead. I believe that market participants have an obligation to the markets in which they participate. Market participants must not just take from the market but should also give to the market, to enhance the safety and soundness and liquidity and efficiency of their markets. We believe that we can provide a forum where market participants can perform this work. The New York Reserve Bank sponsors a number of efforts of this sort. The Foreign Exchange Committee is one. That Committee, for example, did ground breaking work which is reflected in the "Settlement Risk in Foreign Exchange Transaction" report issued several weeks ago by the Committee on Payment and Settlement Systems of the G-10 central banks. We do not control these efforts. But we believe that, when groups are working under our roof, they take their effort seriously and to some extent set aside the particular interests of their firms for the broader interest of the market. You might regard me as somewhat naive in saying that. But you, the members of this association, are committed by a similar spirit. And that is a point I would like to return to at the end of my presentation. That is, does EUDA also want to work under our roof on the Principles and Practices.

The Principles and Practices is an introspective document. That is, it gives guidance to market participants on practices that are regarded as best practices or better practices. It is voluntary. It does not change requirements of statutes or regulations. I am quite confident that, as you read through the Principles and Practices, you would agree with 95 percent of the document.

One issue is the application of the Principles and Practices. It states that it is applicable to firms and governments that engage regularly in wholesale transactions in the over-the-counter financial markets. The concept is that, in these markets, all participants are equal participants. The drafting group decided to avoid coming up with a regulatory-type rule based on size.

The Principles and Practices also states that, unless otherwise agreed, the relationship between participants is that of arm's length principal to principal. The Principles and Practices provides that a participant should act honestly and in good faith when marketing, executing, and administering transactions. Caveat emptor is not the rule. Lying and fraudulent conduct is not condoned. However, a participant should satisfy itself that it has the capability, internally or through independent professional advice, to understand or make independent decisions about its transactions. As I have reflected on this, what I see at issue here is human nature. Some would say that an end-user stands no chance against a "dealer". What I think that this boils down to is the tendency of some to be unable to acknowledge that they do not comprehend the transaction being pitched to them by a marketing staff. My initial response to that is that the employer of that individual has some responsibility here. Why would a firm allow that sort of individual to have the authorized responsibility to bind the firm? The second is that there is nothing wrong with saying "I do not understand anything you have said for the last 10 minutes." The answer here is that a participant, be it a corporate, a fund manager, a trust department employee, a bank employee, or an insurance company employee, if it believes that it does not have the requisite expertise, should retain the expertise and that probably will have a cost to it.

If a participant does not wish to make independent decisions regarding a transaction and wants to rely on its counterparty's communications as recommendations or investment advice, that participant should, prior to entering into the transaction involving such reliance: (i) put its counterparty on notice in writing that it is relying on the counterparty, (ii) obtain the counterparty's agreement in writing to do business on that basis, and (iii) provide the counterparty with accurate information regarding its financial objectives and the size, nature, and condition of its business sufficient to provide for suitable recommendations or advice.

The point here is that relationships in the wholesale financial markets should not be left to "facts and circumstances" determined by a court after the fact. I certainly agree that it is desirable for the parties to enter into agreements that set out the nature of their relationship. But can such an agreement cover all situations?

I am sure that you are aware, some firms are dealing with this issue through representations in documentation. One such version provides that the counterparties represent on the date into which they enter into a transaction, unless they otherwise agree in writing, that each is acting for its own account and has made its own independent decisions to enter into that transaction and as to whether the transaction is appropriate or proper for it based on its own judgment or advice from its advisors. They also represent that each is not relying on any communication, written or oral,

of the other as investment advice or as recommendations. Each also represents that it is capable of assessing the merits of and understanding the terms, conditions, and risks of that transaction and that it is capable of assuming and does assume the risks of the transaction. Finally, they each represent that the other is not acting as a fiduciary of or adviser in respect of the transaction.

It is interesting to note that the newly revised London Code of Conduct follows an approach similar to that of the Principles and Practices. The Code is addressed to dealers and brokers. However, it also deals with "non-core principals". The London Code sets out the general standards and controls which the management and individuals at "core principals" -- that is, banks, building societies plus financial institutions authorized under the Financial Services Act -- should adopt. The London Code goes on to note that the Chartered Institute of Public Finance and Accountancy and the Association of Corporate Treasurers commend the Code to their members, which also deal as principals in these markets, as best practice, to which they, too, should adhere. The London Code states:

"As a general rule core principals will assume that their counterparties have the capability to make independent decisions and to act accordingly; it is for each counterparty to decide if it needs to seek independent advice. If a non-core principal wishes to retain a core principal as its financial adviser it is strongly encouraged to do so in writing, setting forth the exact nature and extent of the reliance it will place on the core principal..."
There is something to be said for the two main centers of finance have a similar approach.
A participant, nonetheless, needs to be concerned about whether its counterparty understands the transaction. This can be referred to as appropriateness. The Principles and Practices states that a participant, particularly one that is holding itself out as a dealer in a particular wholesale financial instrument, should maintain policies and procedures that identify and address circumstances that can lead to uncertainties, misunderstandings, or disputes with the potential for relationship, reputational, or litigation risk. A participant may wish to evaluate, based on information in its possession, its counterparty's capability, internally or through independent professional advice, to understand or make independent decisions about the terms and conditions of its transactions. The Principles and Practices address the situation where a participant concludes that its counterparty either (i) does not have the capability to understand and make independent decisions regarding a proposed transaction or (ii) has the capability but (a) the amount of risk to the counterparty is clearly disproportionate in relation to its size, nature, and condition of its business or (b) the counterparty appears to assume incorrectly that it may rely on the participant for advice. Some steps to take in such a situation are suggested -- (i) provide or obtain additional information to or from the counterparty, (ii) involve additional qualified personnel internally at the participant, (iii) involve additional qualified personnel at the counterparty, (iv) entering into a written agreement specifying the nature of the relationship, or (v) not entering into that transaction with that counterparty.

You and I know how aggressive a marketeer can be. But we also know the power of a single market participant in our highly competitive financial markets. No major participant is required to enter into transactions with a given firm. And that is, indeed, the basis of the Principles and Practices -- participants are equal or have the ability to become equal by the acquisition of the requisite financial advice.

I would like to close by noting the Institute of International Bankers, which represents foreign banks operating in the United States, has recently recommended the Principles and Practices to its members. I would like to see EUDA to do likewise and join the group. I am sure that the group's first effort will need to be polished. No first effort is likely to be perfect. In addition, to extent that market practices change and improve those should also be reflected in the Principles and Practices. I think that EUDA participation on the implementation Committee and on any new drafting group could be very productive.