

Financial Services Authority

The London Code of Conduct:

For principals and broking firms
in the wholesale markets

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THE LONDON CODE OF CONDUCT

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Foreword

This Code has been drawn up in consultation with market practitioners representing principals and brokers. It applies to trading in the wholesale markets as set out in the box on page 7. This Edition of the Code replaces that published by the Bank of England in July 1995 and will expire at 'N2', the date that the Financial Services and Markets Bill comes into effect. A new Code for inter-professional conduct of business will replace the London Code from N2, on which consultation will occur beforehand.

Its main aim is to set out in a clear and concise manner the principles and standards which broking firms and their employees, and 'core principals' in the wholesale markets (ie banks, building societies plus financial institutions supervised under the Financial Services Act 1986) and their employees should observe (see also paragraph 5 of the Code).

Dealers employed in core principals and brokers are expected to understand what their respective roles are and where their respective responsibilities begin and end. However, there are other institutions, companies and local authorities, which also deal as principal in some of the wholesale markets with core principals or through brokers. When conducting business with non-core principals of this type, employees of core principals and brokers should not only conform to the standards set out in the Code, but, in addition, should be ready to provide clarification of their role or responsibilities.

A **complaints** procedure exists under the Code whereby the FSA stands ready to investigate any possible breach of the Code which is brought to its attention. This procedure is described in paragraphs 9-11 of the Code.

Separate **arbitration** arrangements are described in paragraph 120 of the Code. These arrangements are primarily intended for use where the parties involved are supervised by the FSA.

Copies of the Code can be obtained free of charge by writing to the Markets & Exchanges Division, Financial Services Authority, 25 The North Colonnade, Canary Wharf, London E14 5HS. The Code can also be viewed/ downloaded from the Wholesale Markets Supervision pages of the FSA's website (www.fsa.gov.uk).

I Introduction

Aims

- 1 The London financial markets have a long-established reputation for their high degree of professionalism and the maintenance of the highest standards of business conduct. All those operating in these markets share a common interest in their health and in maintaining the established exacting standards.
- 2 The Code is applicable to most wholesale market dealings which are not regulated by the rules of a recognised investment exchange. These typically form part of ‘treasury’ operations and are undertaken in large amounts. A full list of the products covered and the appropriate size criteria are shown in the box on page 7.
- 3 The Financial Services Authority (FSA) wishes to sustain the efficient functioning of the London wholesale markets in which these products are traded and to avoid over-burdensome regulation and believes that this Code is consistent with these objectives.
- 4 The Code has been developed in close consultation with market practitioners and will continue to be kept under regular review. A fuller description of the FSA's regulatory arrangements covering the wholesale markets, of which this Code is an integral part, is set out in the ‘Grey Paper’ (The regulation of the wholesale cash and OTC derivative markets under section 43 of the Financial Services Act 1986) hard copies of which are available from the FSA's Markets & Exchanges Division. Alternatively, the Grey Paper and/ or the London Code can be viewed/ downloaded from the Wholesale Markets Supervision pages of the FSA's website (www.fsa.gov.uk).
- 5 The Code sets out the general standards and controls which the management and individuals at broking firms (including electronic broking firms) and ‘**core principals**’ (banks, building societies plus financial institutions authorised under the FS Act) should adopt when transacting business in the relevant financial products. Furthermore, the Chartered Institute of Public Finance and Accountancy and the Association of Corporate Treasurers commend the Code to their members, which also deal as principal in these markets, as best practice, to which they, too, should adhere.

Distribution

- 6 It is the responsibility of broking firms/core principals to seek to establish whether their UK based clients/counterparties have a copy of the Code. If they do not, they should offer to send them one, direct them to the FSA's website (www.fsa.gov.uk) or advise them to contact the

FSA. Where relevant, local authorities plus other institutions and companies in the UK are encouraged to adopt a similar approach.

- 7 The FSA will seek to make as many overseas based firms as possible aware that their wholesale market deals in the London market should be undertaken in accordance with the London Code. If broking firms or core principals receive any questions from overseas based firms about their wholesale market deals they should, where appropriate, make them aware of the Code's existence and that copies can be obtained from the FSA's website or direct from the FSA. Non-core principals are encouraged to adopt a similar approach.

Compliance and complaints

- 8 **Compliance with the Code is necessary to ensure that the highest standards of integrity and fair dealing continue to be observed throughout these markets.** Breaches by those institutions which they supervise will be viewed most seriously by the FSA and by the Building Societies Commission; any such breaches may be reflected in their assessment of the fitness and propriety of these institutions. In addition, the UK Self-Regulating Organisations (SROs) expect those core principals that they supervise to abide by the Code when dealing in the wholesale markets.
- 9 If any principal (core or non-core) or broking firm believes that an institution supervised by the FSA has breached either the letter or the spirit of the Code in respect of any wholesale market transaction in which it is involved, it is encouraged - whether or not it is itself supervised by the FSA- to seek to settle this matter amicably with the other party. If this is not possible, the institution that is subject to the complaint should make the complainant aware that it can bring the matter to the attention of the Head of the FSA's Markets & Exchanges Division. All such complaints will be investigated by the FSA. As a general rule the FSA will seek evidence from all parties named in the complaint and will wish to discuss this in detail with management of the institution subject to the complaint.
- 10 Where a breach of the Code by a bank or other firm listed by the FSA under Section 43 of the Financial Services Act - a 'listed institution' - is established, and depending on how serious it is, the FSA may privately or publicly reprimand individuals and/or the firms involved. It may also restrict a listed institution's activities or, if the breach is sufficiently serious to cast doubt on the competence of the firm or on its integrity, suspend or remove the offending firm from the list. The FSA will seek to promulgate its decisions as widely as it considers appropriate; in so doing the FSA will wish to consider the possible implications of making its findings known to others.
- 11 Since the Section 43 Compensation Scheme is narrow in its scope, if any breaches of the Code are found to have occurred, the offending institution will be expected to consider making appropriate redress to any damaged party or parties, bearing in mind any legal implications of so doing.

Arbitration

- 12 In order to help resolve differences the FSA is willing, if asked, to arbitrate in disputes between firms it supervises. These arrangements are set out in more detail in paragraph 120.

Products covered by the FSA's wholesale markets arrangements

A: Cash market products:

- 1 Sterling wholesale deposits.
- 2 Foreign currency wholesale deposits.
- 3 Gold and silver bullion wholesale deposits.
- 4 Spot and forward foreign exchange.
- 5 Spot and forward gold and silver bullion.

B: Instruments which are defined as investments in the Financial Services Act but which are outside the scope of the Investment Services Directive:

- 6 Over the counter (OTC) options (including warrants) or futures contracts on gold or silver.

C: Instruments which are defined as investments in the Financial Services Act and are within the scope of the Investment Services Directive:

- 7 All certificates of deposit (CDs) issued by institutions authorised under the Banking Act 1987, European authorised institutions and by UK building societies, with an original maturity of not more than 5 years.
- 8 Bank bills (or bankers' acceptances).*
- 9 Commercial paper.
- 10 Other debentures with an original maturity of not more than five years.

- 11 UK local authority debt (bills, bonds, loan stock or other instruments) with an original maturity of not more than 5 years.
- 12 Other public sector debt with an original maturity of not more than 1 year (eg Treasury bills, but *not* gilt-edged securities).
- 13 Any certificate (or other instrument) representing the securities covered in items 7-12; or rights to, and interests in, these instruments.
- 14 OTC options (including warrants) or futures contracts on any currency (including sterling); on interest rates; or on the instruments listed in items 7-13 above.
- 15 Interest rate and currency swaps, regardless of their original maturity; forward rate agreements, or any other 'contracts for differences' involving arrangements to profit (or avoid loss) by reference to movements in the value of any of the instruments in items 7-13 above; or the value of any currency; or in the interest on loans in any currency.
- 16 Sale and repurchase agreements ('repos'), sale and buybacks and stock borrowing and lending involving debentures, loan stock or other debt instruments, including gilts, of whatever original maturity where the repurchase or repayment will take place within twelve months.

Note 1: Instruments subject to the rules of a Recognised Investment Exchange (as defined in the FS Act) are not covered.

Note 2: Instruments denominated in foreign currencies, as well as sterling are covered.

Note 3: Transactions by listed institutions may come within the FSA's supervisory framework even if one of the other parties to the transaction is operating abroad.

Note 4: The regulation of deposit-taking under the Banking Act 1987 is not affected by these arrangement in any way.

Note 5: The Government made clear in January 1988 that ordinary forward foreign exchange (and bullion) transactions fall outside the FS Act; these nevertheless fall within the scope of the FSA's arrangements. However, as explained by the FSA (the Securities and Investments Board as was) in consultation document 89 issued in August 1995 certain margined products in foreign exchange and bullion do constitute investment business within the meaning of the FS Act.

Note 6: Wholesale transactions between core principals in item 1 are not usually less than £100,000. For items 2 and 4, the usual minimum is £500,000 (or currency equivalent). For bullion (items 3 and 5) the relevant amounts are 2,000 ounces for gold and 50,000 ounces for silver.

Note 7: For items 7-13 and 16, the minimum size of wholesale transactions is £100,000 (or the equivalent in foreign currency). For swaps, options, futures and forward rate agreements (FRAs), or other 'contracts for differences' (items 6, 14 and 15), the minimum underlying value is £500,000 (or the equivalent in foreign currency).

Note 8: Items 7-10 fall within the FS Act under the generic term 'debenture', irrespective of their currency denomination.

Note 9: Since 1 June 1997, the custody of investments has been an authorisable activity regulated by SFA and IMRO. These custody provisions will apply where the custodian both safeguards and administers the assets (or makes arrangements for this). The custody of investments will not generally fall within the exemption under section 43 of the FS Act. Ordinary portfolio custody services will, therefore, not have the benefit of the section 43 exemption. Where exempt transactions, such as repos, are undertaken as an ancillary service by a custodian, the arranging of the transaction is covered by the section 43 regime, but the custody element requires FS Act authorisation. The custody element of hold-in-custody repos also requires authorisation.

*with effect from 1 January 1996, following amendment to the FS Act.

II General Standards

Core principals and broking firms - and their employees - should at all times abide by the spirit as well as the letter of the Code when undertaking, arranging or advising on transactions in the wholesale markets.

Managers of core principals and broking firms must ensure that the obligations imposed on them and their staff by the general law are observed. Management and staff should also be mindful of any relevant rules and codes of practice of other regulatory bodies.

Responsibilities

Of the principal/broker

- 13 All firms (core principals and brokers) should ensure that they and, to the best of their ability, all other parties act in a manner consistent with the Code so as to maintain the highest reputation for the wholesale markets in London. Listed firms are reminded of the Grey Paper requirement to report to the FSA material breaches of the Code by the firm or its employees.
- 14 Core principals which conduct non-investment business (see the box on page 7) with private individuals should have internal procedures which set out whether these individuals will be treated as retail customers or as wholesale market participants under the arrangements set out in this Code. The procedures set out in Part IV of this Code may not be relevant, directly, to such business.
- 15 It is essential that all relevant staff are made familiar with the Code and conduct themselves at all times in a thoroughly professional manner. In particular they must conduct transactions in a way that is consistent with the procedures set out in Part IV of this Code.
- 16 All firms will be held responsible for the actions of their staff. They must:
 - ensure that any individual who commits the firm to a transaction has the necessary authority to do so.
 - ensure that employees are adequately trained in the practices of the markets in which they deal/broke; and are aware of their own, and their firm's, responsibilities. Inexperienced dealers should not rely on a broker, for instance, to fill gaps in their training or experience; to do so is clearly not the broker's responsibility.

- ensure staff are made aware of, and comply with, any other relevant guidance that may from time to time be issued by the FSA.
 - ensure that employees comply with any other regulatory requirements that may be applicable or relevant to a firm's activities in the wholesale markets.
- 17 When establishing a relationship with a **new** counterparty or client, firms must take steps to make them aware of the precise nature of firms' liability for business to be conducted, including any limitations on that liability and the capacity in which they act. **In particular, broking firms should explain to a new client the limited role of brokers (see paragraphs 29 and 30 below).**
- 18 All firms should identify any potential or actual **conflicts of interest** that might arise when undertaking wholesale market transactions and take measures either to eliminate these conflicts or control them such as to ensure the fair treatment of counterparties.
- 19 All firms should **know their counterparty**. For principals this is essential where the nature of the business undertaken requires the assessment of creditworthiness. Before dealing with another principal for the first time in any product covered by this Code, core principals should ensure that appropriate steps (see Part III of this Code) are taken.
- 20 As part of the 'know your counterparty' process firms must take all necessary steps to prevent their transactions in the wholesale markets being used to facilitate **money laundering**. To this end firms should be familiar with the Guidance Notes published by the Joint Money Laundering Steering Group in 1997 (as updated)¹. These make clear the very limited responsibilities name passing brokers have in this area; in particular banks (and others that use brokers) should **not** seek to rely on brokers to undertake anything other than identity and location checks on their behalf.
- 21 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 upon the core principal. All principals should accept responsibility for entering into wholesale market transactions and any subsequent losses they might incur. They should assess for themselves the merits and risks of dealing in these markets. Non-core principals must recognise that it is possible for core principals to take proprietary positions which might be similar or opposite to their own.
- 22 It is good practice for **principals**, subject to their own legal advice, to alert counterparties to any legal or tax uncertainties which they know are relevant to a proposed relationship or transaction, in order that the counterparty may seek its own advice if it so wishes.
- 23 Management of **broking** firms should advise their employees of the need to ensure that their behaviour could not at any time be construed as having misled counterparties about the limited role of brokers (see paragraphs 29 and 30 below); failure to be vigilant in this area will adversely affect the reputation of the broking firm itself.

¹ Available from the Joint Money Laundering Steering Group, Pinners Hall, 105-108 Old Broad Street, London, EC2N 1BX.

Of the employee

- 24 When entering into or arranging individual deals, dealers and brokers must ensure that at all times great care is taken not to misrepresent in any way the nature of any transaction. Dealers and brokers must ensure that:
- the identity of the firm for which they are acting and its role is clear to their counterparties/clients to avoid any risk of confusion. This is particularly important, for instance, where an individual dealer acts for more than one company, or in more than one capacity. If so, he must make absolutely clear, at the outset of any deal, on behalf of which company or in which capacity he is acting.
 - it is clearly understood in which products they are proposing to deal.
 - any claims or acknowledgements about, or reference to, a particular transaction being considered should, as far as the individual dealer or broker is aware, be fair and not misleading.
 - facts believed to be material to completing a specific transaction are disclosed before the deal is done, except where such disclosure would reveal confidential information about the activities of another firm. Unless specifically asked for more information, or clarification, a dealer at a core principal will assume his counterparty has all the necessary information for this decision making process when entering into a wholesale market transaction.
- 25 When a deal is being arranged through a broker, the broker should act in a way which does not unfairly favour one client, amongst those involved, over another, irrespective of what brokerage arrangements exist between them and the broking firm.

Clarity of role

Role of principals

- 26 The role of firms acting as principal is to deal for their own account. **All principals have the responsibility for assessing the creditworthiness of their counterparties or potential counterparties whether dealing direct or through a broking firm. It is for each principal to decide whether or not to seek independent professional advice to assist in this process.**
- 27 **It is also for the principal to decide what credence, if any, is given to any information or comment provided by a broker to a dealer. Where such information or comment might be interpreted as being relevant to a particular counterparty or potential counterparty, this does not alter the fact that the responsibility for assessing the creditworthiness of a counterparty, whether or not it is supervised, rests with the principal alone.**
- 28 Some firms may act as agent for connected or other companies as well as, or instead of, dealing for their own account. If so, such agents should:
- always make absolutely clear to all concerned the capacity in which they are acting (eg if they also act as principal or broker).
 - declare at an early stage of negotiations the party for whom they are acting. It may be considered desirable to set out this relationship formally in writing for future reference.
 - ensure that **all** confirmations make clear when a deal is done on an agency basis.

- when acting as agent for an unregulated principal, make clear at an early stage this qualification to potential counterparties; and include this on confirmations.

Role of brokers

- 29 Typically the role of the specialist wholesale market broking firms in London supervised as such by the FSA is to act as **arrangers** of deals.¹ They:
- bring together counterparties on mutually acceptable terms and pass names to facilitate the conclusion of a transaction.
 - receive payment for this service in the form of brokerage (except where a prior explicit agreement between the management of all parties to a deal provides otherwise).
 - are **not** permitted, even fleetingly, to act as principal in a deal (even on a ‘matched principal’ basis), or to act in any discretionary fund management capacity.²
- 30 It is accepted that, in providing the service specified in the previous paragraph, individual brokers may be called upon to give advice or express opinions, usually in response to requests from individual dealers. While brokers should be mindful of the need not to reveal confidential information about the market activities of individual clients, there is no restriction on brokers passing, or commenting, on general information that is in the public domain. Equally, there is no responsibility upon a broker to volunteer general information of this type. Where information is sought or volunteered individual brokers should exercise particular care. For instance, brokers do not have sufficient information to be qualified to advise principals on the creditworthiness of specific counterparties and to do so is not their role.

1 There are two exceptions to this rule. The first covers the specialist inter-dealer brokers, involved primarily in US Treasury bills, notes and bonds, which act as matched principals. The other exception is when name-passing broking firms are investing their own money; in transactions, brokers must make clear to the relevant counterparties that they are acting as principal.

2 The relationship between an institution offering a discretionary or advisory management service and its clients in any of the financial products described in the box on page 7 falls outside the scope of this Code and, if it constitutes investment business within the terms of the FS Act, should be in accordance with the requirements of the relevant SRO.

III Controls

It is essential that Management have in place, and review regularly, appropriate control procedures which their dealing and other relevant staff must follow.

Know your counterparty

It is necessary for a variety of reasons, including firms' own risk control and the need to meet their legal obligations (eg on money laundering) for firms to undertake basic 'know their counterparty' checks before dealing in any products covered by this Code.

Before agreeing to establish a dealing relationship in any of these wholesale market products, core principals should be mindful of any reputational risks which might arise as a result, and whether these risks might be greater when undertaking such transactions with non-core principals. In the absence of firm evidence to the contrary, non-core principals should be regarded as end-users (ie 'customers') of the wholesale markets.

- 31 In order to minimise the risks which they face it is desirable for core principals to have in place a clearly articulated approval process for their dealers and salespersons to follow before dealing for the first time in any wholesale market product with counterparties. This process, which should be appropriately monitored by management, should apply both when granting an initial dealing line for a product, and subsequently if changing or extending it to other wholesale products. Such a process might include the following considerations, which will need to be tailored to the type of transaction being considered:

With all counterparties

- What information is available to the core principal on the legal capacity of the counterparty to undertake such transactions? Is this information sufficient to make an informed decision on the legal risks it might face if it undertakes such business with the counterparty?

With customers

- Who initiated the request for the product relationship? Might this decision have been influenced by any product **advice** given by the core principal?
- If advice is given was this subject to a written agreement between the parties; if not, should it be? Are both parties clear what reliance the customer is placing upon that advice?

- What, if any, are the legal responsibilities the core principal might owe to the customer to whom advice is given in subsequently undertaking transactions in that product? For instance, management might ask itself if it is being asked to advise on the customer's whole portfolio - which might put it in a different legal position than if it were advising on only part of the portfolio.
- Are there potential conflicts between the firm's interests and those of the potential customer? If there are how should they be managed; and does the customer need to be alerted?
- Have appropriate legal agreements between the core principal and the customer been enacted? Do they make clear the respective responsibilities of both parties for any losses? Do they make clear which party is responsible for decisions to close-out trades undertaken?

32 **Procedures should be in place to ensure that the information available to banks and other core principals, upon which they will base their judgement on whether or not to open/extend a dealing relationship with a particular customer, is carefully assessed on a broad product by product basis.**

33 Once a customer dealing relationship has been established in one, or more, wholesale market product(s) it is **strongly recommended that management at both parties periodically review it**, against the above criteria. It is also in their own interest for core principals to review periodically the totality of their business relationship with each customer against the same criteria.

33a In order to clarify the circumstances under which advice falls under section 43, the following guidelines have been added to paragraph 13 of the 1999 version of the Grey Paper:

- (a) Advice on an investment given by a listed institution is covered by the Grey Paper regime only if it is intended or calculated to lead to a transaction with, or brokered by, that listed institution and if that transaction would fall within Schedule 5 to the FS Act, because of the involvement of that listed institution. Where a listed institution does not hold itself out to be a party to the transaction or, if it is broking, is not within the limits of (d) below, the section 43 exemption will not be open to that listed institution for giving advice on that transaction.
- (b) Listed firms may not give investment advice encompassing transactions that fall outside section 43 unless they are also authorised under the FS Act by membership of an SRO. In such cases, if that listed institution is a member of a SRO, the giving of that advice will instead be governed by the SRO's rules. Thus, for example, if a transaction below the Schedule 5 limits is not ruled out before the investment advice is given, listed firms must not use the section 43 exemption to give that advice.
- (c) Whether the transaction actually resulting falls under SRO authorisation or under the section 43 exemption is not of itself decisive – the crucial element is what the purpose was at the time of the provision of advice.
- (d) There are additional requirements for brokers. The scope of advice and the circumstances in which it is given should not go beyond what is customary in the markets covered by the Grey Paper in the situation in question. The advice should only be given if it is an integral part of the broking services.
- (e) Advice may be given by brokers and principals where the advice falls outside the authorisation requirement derived from paragraph 15 of Schedule 1 to the FS Act. Thus,

for example, giving advice on products not covered by the FS Act (i.e. items 1 to 5 in the table on page 7) does not normally constitute investment advice. General or generic advice on investments is also not generally investment advice. Thus, e.g. advice on the merits of, say, options over futures or investing in one country rather than another is not covered. Neutral information is not investment advice, such as historical data or economic developments. Further guidance on these points is to be found in a number of guidance releases published by the SIB (as the FSA was then called) on the scope of paragraph 15 of Schedule 1 to the FS Act.

Additional arrangements for small investors

The FSA believes that it is in the interest of banks and other listed institutions for management to consider most carefully whether to grant or extend dealing facilities in OTC wholesale market products to 'small investors' (ie individuals or small business investors as defined under SEA rules). It is the FSA's view that such facilities should not be granted automatically.

- 34 The expectation at the time the FS Act was introduced was that individuals (or other small investors) would not normally be dealing in the wholesale OTC markets, which are primarily for core principals and other professionals such as large corporates, that regularly use the markets and which should have professionally trained staff able to undertake such transactions on their behalf.
- 35 It is more likely, therefore, that small investors will ask for **advice** on the particular product being considered (for instance in terms of its risk profile, how this might differ from exchange traded instruments with which they might be more familiar, or how to value its worth over time, etc). It is the FSA's view that where this is so they should **not** automatically be granted a new or extended dealing line for this product. If the product being considered is a derivative and/or leveraged, the FSA believes that it is in the interest of banks and other listed institutions to have in place a written agreement, which makes clear which products are concerned and the extent to which any reliance can be placed by the small investor on any advice given. Listed firms should be in no doubt that the small investor understands fully the risks inherent on the product concerned. The principle of clearly articulated approval procedures and periodic relationship reviews in paragraphs 31 and 33 above are essential for listed firms dealing in exempt products with small investors.
- 36 Where an FS Act exempt product is involved (items 6-16 in the box on page 7) small investors should also be advised that by seeking to conduct such business with a Section 43 listed institution they would not have the protection of the FS Act. The provisions set out in paragraph 21 above would apply.
- 37 The FSA believes it prudent for core principals to maintain, as accurately as they can, records of conversations - both internal or with the investor - material to their relationship. Where these are in written form, records must be kept in line with statutory requirements. Where tapes are the only material record of specific transactions, or discussions leading up to such transactions, management should consider very carefully whether some or all of these should be retained for a similar length of time to written records. Diligent record keeping is particularly important for small investors, since they may not maintain records to the same standards and disputes are more likely to escalate in the absence of a detailed and accurate audit trail of what was done and why.

Dealing mandates

- 38 It is recognised that dealing mandates can be useful in clarifying the nature of the counterparty relationship. A mandate might, for example, clarify whether the relationship is at arms length or advisory, and/or set out confirmation procedures, standard settlement instructions, and other control procedures. It is equally recognised that a mandate may not be appropriate or necessary for all counterparty relationships. It is unlikely, for example, that mandates would be necessary between core principals. The decision to establish a mandate rests firmly with the management of each counterparty.
- 39 It is a matter for the two parties to agree what a mandate should and should not cover. **It is recognised as best practice, however, that mandates should not be used to pass responsibility to another counterparty.** They should not weaken the standard set out in paragraph 16 of the Code, namely that all firms will be held responsible for the actions of their own staff and that it is the responsibility of each firm to ensure that any member of its own staff who commits it to a deal has the necessary authority to do so. A firm should not place any reliance on the ability of a core principal to monitor that authority in the absence of a specific written agreement to accept such responsibility. Such an agreement raises important supervisory considerations and core principals should ensure, before accepting such responsibility, that they have the ability to take on the tasks assigned to them.
- 40 If a mandate is to be adopted, it is important that proper thought is given to the manner in which the mandate is to be structured and administered. There should, for example, be periodic review of the terms of the mandate. As a general rule, the onus is on the counterparty to notify the core principal promptly of any change necessary to an existing mandate.

Confidentiality

- 41 Confidentiality is essential for the preservation of a reputable and efficient market place. Principals and brokers share equal responsibility for maintaining confidentiality. Principals or brokers should not, without explicit permission, disclose or discuss, or apply pressure on others to disclose or discuss, any information relating to specific deals which have been transacted, or are in the process of being arranged, except to or with the parties directly involved (and, if necessary, their advisers) or where this is required by law or to comply with the requirements of a supervisory body.
- 42 Where confidential or market sensitive information is routinely shared by a London based firm with other branches/subsidiaries within its group it is for management to review periodically if this is appropriate. Where it is, the FSA believes that London management should be responsible and accountable for how such information is subsequently controlled - in particular they should make clear that such information should **at all times** continue to be treated as being subject to the confidentiality provisions of the Code. It is a responsibility of management to ensure that all relevant personnel are aware of, and observe, this fundamental principle.
- 43 Care should be taken over the use of open loudspeakers in both brokers' offices and principals' dealing rooms to ensure that they do not lead to breaches of confidentiality.
- 44 Situations arise where sales/marketing staff from core principals visit the offices of their customers; during such visits the customer may wish to arrange a transaction via the sales/marketing representative. Subject to proper controls this is perfectly acceptable. However, individual dealers or brokers should not visit each other's dealing rooms except with the express permission of the management of both parties. In particular a principal's dealer

should **not** deal from within the offices of a broker or another principal. Brokers should never conduct business from outside their own offices. The only exception to these general rules might be when it is necessary for two unconnected institutions to share the same facilities as part of their agreed contingency arrangements. In such circumstances management should ensure appropriate arrangements are in place to protect counterparty confidentiality.

- 45 A principal should not place an order with a broker with the intention of ascertaining the name of a counterparty in order to make direct contact to conclude the deal; neither should direct contact be made to increase the amount of a completed trade arranged through a broker.

Location of back office functions

- 46 There is a growing trend towards locating front and back office functions in physically separate locations; indeed a number of the branches of international banks in London have relocated and consolidated their back office functions in their home country. Others have back offices outside London. The FSA's view is that there should be no objection to banks consolidating back-offices in a single location, even if that were overseas - provided that there are individuals in London with whom any deal or settlement queries can be resolved quickly.
- 47 At the same time the banking supervisors have reviewed whether it is still necessary in all cases, on control grounds, to maintain a physical segregation of back and front office staff within banks. They have concluded that whilst in most cases physical segregation is preferable, a lack of such segregation may be acceptable provided that it can be demonstrated that appropriate management controls are in place. For instance lack of segregation may be acceptable where computer logical access controls are in place. **Even so, it is essential that a strict segregation of duties between staff in the front and back office is maintained**, and especially that confirmations are sent direct to back office staff (see also paragraph 98 below).

Taping

- 48 Experience has shown that recourse to tapes proves invaluable to the speedy resolution of differences and disputes. The use of recording equipment in the offices of voice brokers and principals has become common; other means for monitoring 'conversations' are embodied within electronic broking systems now used in the markets. **The FSA expects taping by principals and brokers of all conversations by dealers and brokers** together with back-office telephone lines used by those responsible for confirming deals or passing payment and other instructions. Any listed firm which does not tape all front plus relevant back office conversations should review this management policy periodically and be prepared to persuade the FSA that there are particular reasons for them to continue with such an approach. This review should be repeated annually. Failure to tape will normally count against a firm if it seeks to use the arbitration process described in paragraph 120 to settle a dispute, or is the subject of a complaint.
- 49 When initially installing tape equipment, or taking on new clients or counterparties, firms should take the necessary steps to inform them that conversations will be recorded and to comply with the other relevant provisions of any telecom privacy legislation in force. **Tapes should be kept for at least two months, and preferably longer.** Experience suggests that, with the growing involvement of the private banking divisions within core principals in selling wholesale products to small investors, taping of all conversations by salesmen/account officers in these areas is in the interests of core principals. The longer tapes are retained the greater the chances are that any subsequent disputes over transactions or where advice has been given,

can be resolved satisfactorily. **Tapes which cover any transaction about which there is a dispute should be retained until the problem has been resolved.** Management should ensure that access to taping equipment and tapes, whether in use or in store, is strictly controlled so that they cannot be tampered with.

Deals at non-current rates

There is widespread recognition that, as a general rule, deals at non-market rates should not be undertaken.

- 50 Banks, brokers and other listed firms are strongly discouraged from entering into or arranging deals at materially non-current rates, including rolling-over an existing contract at the original rate. These should only be undertaken, if at all, on rare occasions and then after most careful consideration by both parties and approval, on a deal by deal basis, by their senior management. Senior management must ensure that proper procedures are in place to identify and bring to their attention all such deals **when they are proposed** so that they can be made fully aware of the details before reaching a decision on whether a particular trade should go ahead on this basis. Before reaching such a decision, senior management should seek written confirmation from the counterparty, also at senior management level, of the reasons for the transaction. This is essential not only because of the potential credit risk implications of rolling-over deals at original rates, but also because failure to use current rates could result in the principal unknowingly participating in the concealment of a profit or loss, or in perpetration of a fraud. In order to provide a clear audit trail, there should be an immediate exchange of letters between the senior managements of both parties to any such deals to demonstrate that the above procedures have been followed and these letters should be copied to the parties' compliance departments.
- 51 However, if management accept that the application of non-market rates can be necessary to create deal structures which satisfy the legitimate requirements of counterparties, they should ensure proper controls are in place to prevent such arrangements from concealing fraud, creating unacceptable conflicts of interest, or involving other illegal activity. It is particularly important to ensure that there is no ambiguity in such transactions over the amounts that each counterparty is to pay and receive. It should, for instance, be possible to demonstrate from the documentation available to both parties that the combination of cashflows, coupons, and foreign exchange rates etc, used in such transactions produces a result that is consistent with the current market price for a straightforward transaction of similar maturity. **It is therefore essential that appropriate documentation is in place before any such deals are undertaken and that this is reviewed, by senior management, regularly so that they can satisfy themselves whether it remains appropriate to undertake further transactions on this basis.** Listed firms should also have controls in place that seek to identify any unauthorised use of non-current rates/ off-market deals.
- 52 A specific area where there is sometimes pressure to conduct deals at non-current rates is in the foreign exchange market. In particular pressure can be placed on dealers undertaking a foreign exchange swap to avoid the immediate fixing of the spot price underlying the trade. **This practice is judged by practitioners in the London market to be unethical and is not appropriate practice for UK based institutions. Spot rates should be determined immediately after completion of the foreign exchange swap transaction.**

Dealing with unidentified principals

- 53 There has been a growing trend towards discretionary management companies dealing in wholesale market products on behalf of their clients. For its own commercial reasons a fund manager may not wish to divulge the name of its client(s) when concluding such deals. This practice raises important conduct of business as well as prudential considerations, particularly in terms of Principals' ability to know their counterparties and to assess their credit risk to those particular counterparties and to satisfy documentation requirements. The FSA (formerly the Bank of England) and the SFA have been discussing issues such as these with market practitioners. Further discussion is likely on the subject, both domestically and internationally, eg in Basle, which may result in the issue of updated guidance. In the interim, before any institution transacts business on this basis, its senior management should decide, as a matter of policy, whether they judge it appropriate to do so. In doing so, they should consider all the risks involved. They should fully document the decision that they reach.

After-hours dealing

- 54 Extended trading after normal local hours has become accepted in some markets, most notably foreign exchange. Dealing after-hours into other centres forms an integral part of the operations of many firms both in London and elsewhere. Such dealing can involve additional hazards - whether undertaken direct or via a broker. For example, when dealing continues during the evening from premises other than the principals' dealing rooms, one of the principals involved might subsequently forget, or deny, having done a deal. Management should therefore issue clear guidelines to their staff, both on the kinds of deal which may be undertaken in those circumstances and on the permitted limits of any such dealing. All deals should be confirmed promptly - preferably by telex or similar electronic message direct to the counterparty's offices - and carefully controlled when arranged off-premises. Management should consider installing answerphone facilities in the dealing area which dealers should use to record full details of all off-premises trades. These should be processed promptly on the next working day.

Stop-loss orders

- 55 Principals may receive requests from branches, customers and correspondents to execute transactions - for instance to buy or sell a currency - if prices or rates should reach a specified level. These orders, which include stop-loss and limit orders from counterparties desiring around-the-clock protection for their own positions, may be intended for execution during the day, overnight, or until executed or cancelled. Management should ensure that the terms of such orders are explicitly identified and agreed, and that there is a clear understanding with the counterparty about the obligation it has assumed in accepting such orders. Moreover, management needs to establish clear policies and procedures for its traders who accept and execute stop-loss and limit orders. Management should also ensure that any dealer handling such an instruction has adequate lines of communication with the counterparty so that the dealer can reach authorised personnel in case of an unusual situation or extreme price/rate movement.

Conflicts of interest

Dealing for personal account

- 56 Management should consider carefully whether their employees should be allowed to deal at all for own account in any of the products covered by this Code. Where allowed by management, it is their responsibility to ensure that adequate safeguards are established to prevent abuse. These safeguards should reflect the need to maintain confidentiality with respect to non-public price-sensitive information and to ensure that no action is taken by employees who might adversely affect the interests of the firm's clients or counterparties.

Deals using a connected broker

- 57 Brokers have a legal obligation to disclose the nature and extent of any material conflict between their own interests and their responsibilities to clients. To safeguard the independence of brokers they should give all their clients formal written notification of any principal(s) where a material connection exists (unless a client explicitly waives its rights to this information in writing); and notify any subsequent changes to this list of principals as they occur. For the purposes of this Code, a material connection would include situations where the relationship between the parties could have a bearing on the transaction or its terms, as a result for example of common management responsibilities or material shareholding links, whether direct or indirect. The FSA regards a shareholding of 10% or more in a broker as material; but, depending on the circumstances, a smaller holding may also represent a material connection.
- 58 Any deals arranged by a broker involving a connected principal must be at arm's length (ie at mutually agreed rates that are the same as those prevailing for transactions between unconnected counterparties).

Marketing and incentives

- 59 When listed institutions are operating within the boundaries of the Section 43 arrangements, they will not be subject to advertising or cold-calling rules since these would be inappropriate in such professional markets. Nevertheless listed institutions should take care to ensure that any advertisements for their services within the exempt area are directed so far as possible towards professionals.
- 60 In recent years a number of foreign exchange electronic broking services have begun operating in London. Understandably such firms have considered a range of marketing arrangements, in the form of incentives, to generate liquidity in their systems. After consultation through the Joint Standing Committee it was concluded that the principle that brokers should not make payments to banks for using their services should be strictly maintained. As with conventional voice brokers, the provision of discount arrangements is a legitimate marketing technique, even if these involve cross-product subsidisation between different parts of the same group.

Entertainment, gifts and gambling

- 61 Management or employees must neither offer inducements to conduct business, nor solicit them from the personnel of other institutions. However it is recognised that entertainment and gifts are offered in the normal course of business and do not necessarily constitute inducements. Nevertheless, this is an area where the FSA receives a surprisingly high number of complaints about the potentially excessive nature of entertainment being offered. In

response, practitioners were consulted during 1994 on how best to help facilitate a consistent approach across the London market. This reconfirmed that management should have a clearly articulated policy towards the giving/receipt of entertainment (and gifts), and ensure it is properly observed. It should include procedures for dealing with gifts judged to be excessive but which cannot be declined without causing offence. The policy should be reviewed periodically. In developing and implementing its policy, management should have regard to the potential adverse impact on the reputation of the firm, and the London market generally, of any adverse comment/publicity generated by any entertainment (or gifts) given or received.

62 The following general pointers have been identified which management ought to consider including as part of their policy:

- Firms should have in place arrangements to monitor the type, frequency and cost of entertainment and gifts. Periodic control reports should be made available to management.
- Authorisation and control procedures should be clear and unambiguous in order to ensure proper accountability.
- Policies should contain specific reference to the appropriate treatment for gifts (given and received). This policy should specifically preclude the giving (or receiving) of cash or cash convertible gifts.
- In determining whether the offer of a particular gift or form of entertainment might be construed as excessive, management should bear in mind whether it could be regarded as an improper inducement, either by the employer of the recipient or the supervisory authorities. Any grey areas should be cleared **in advance** with management at the recipient firm(s).
- Firms should not normally offer entertainment if a representative of the host company will not be present at the event.

63 These procedures should be drawn up bearing in mind that the activities of dealers of some of the principals active in the markets may be governed by statute. For instance, offering hospitality or gifts to officers and members of local authorities and other public bodies is subject to the provisions of legislation that carries sanctions under criminal law. One of the most onerous requirements of this legislation is that any offer or receipt of hospitality is, prima facie, deemed to be a criminal offence, unless the contrary is proved.

64 Similar guidelines should also be established on gambling with other market participants. **All these activities carry obvious dangers and, where allowed at all, it is strongly recommended that they are tightly restricted.**

Abused substances (including drugs and alcohol)

65 Management should take all reasonable steps to educate themselves and their staff about possible signs and effects of the use of drugs and other abused substances. The judgement of any member of staff using such substances is likely to be impaired; dependence upon drugs etc makes them more likely to be vulnerable to outside inducement to conduct business not necessarily in the best interests of the firm or the market generally and could seriously diminish their ability to function satisfactorily.

IV Dealing Principles and Procedures: A Statement of Best Practice

Scope

Deals in the London wholesale markets (defined by the products covered in the box on page 7) should be conducted on the basis of this Code of Conduct.

- 66 Whilst this Code is designed for the London markets, its provisions may extend beyond UK shores, for example where a listed UK broker arranges a deal involving an overseas counterparty. Where deals involving overseas counterparties are to be made on a different basis in any respect, for example because of distinct local rules or requirements, this should be clearly identified at the outset to avoid any possible confusion.

Overseas market conventions

The trading of currency assets in London should follow recognised trading conventions that have been established internationally or in specific overseas markets, provided they do not conflict with the principles of this Code.

- 67 Where foreign currency-denominated short-term securities issued overseas are traded in London, there may be important differences in dealing practice compared with the trading of London instruments, partly reflecting the way the instruments are traded in their domestic markets. The London Code is intended to be complementary to any generally accepted local standards and practices for such instruments traded in London. The FSA would expect firms trading these instruments in London to abide by any such local conventions.

Procedures

Preliminary negotiation of terms

Firms should clearly state at the outset, prior to a transaction being executed, any qualifying conditions to which it will be subject.

- 68 Typical examples of qualifications include where a price is quoted subject to the necessary credit approval, finding a counterparty for matching deals or the ability to execute an associated transaction. For instance principals may quote a rate which is 'firm subject to the execution of a hedge transaction'. For good order's sake it is important that firms complete deals as quickly as possible; the onus is on both sides to keep each other informed of progress or possible delays. If a principal's ability to conclude a transaction is constrained by other

factors, for example opening hours in other centres, this should be made known to brokers and potential counterparties at an early stage and before names are exchanged.

- 69 In the Euronote and commercial paper markets, principals should notify investors, at the time of sale, of their willingness or otherwise to repurchase paper. Investors should also be notified, before the sale, of any significant variation from the standard terms or conditions of an issue.

Undertaking derivative transactions with end-users (ie 'customers' of the market)

It is important, before derivative transactions are undertaken with a customer, that dealers are satisfied that appropriate 'know your counterparty' procedures (see section III above) have been implemented for the product under consideration.

- 70 When a core principal is dealing with any customer of the market in leveraged or derivative products it is good practice for its dealers to assist their opposite number by using clear concise terminology. It is however the responsibility of each party involved to seek clarification, before concluding a deal, on any points about which they are not clear. Each party should also consider whether it would be helpful for the core principal to send by electronic means (telex or fax) a pre-deal message setting out the terms upon which the deal will be priced and agreed by both parties. While this may not be judged appropriate for some customers (eg an experienced large corporate), **it is likely to be helpful to send pre-deal messages to small investors (as defined on page 14)**. Such a message may also be particularly useful, for instance, where the product involved is relatively new to the customer; or where the individual dealer acting on behalf of the customer is not the regular contact point for undertaking such trades with that customer. The sending or receipt of such a message is not a substitute for the confirmation procedures described below.
- 71 The existence, or not, of such a message should not however be taken as undermining in any way the principle that each party must accept responsibility for entering into such trades and any losses that they might incur as a result of doing so. There are, of course, circumstances in which this principle might be brought into question; for instance if the dealer at the core principal had deliberately misled the customer by knowingly providing false and/or inaccurate information at the time the deal was being negotiated. It is therefore very important that great care is taken not to mislead or misinform.
- 72 To help minimise the scope for error and misunderstanding the FSA strongly recommends that management require their dealers to use standard pre-deal check lists of the key terms that they need to agree when entering into leveraged and/or derivative transactions.

Firmness of quotation

All firms, whether acting as principal, agent or broker, have a duty to make absolutely clear whether the prices they are quoting are firm or merely indicative. Prices quoted by brokers should be taken to be firm in marketable amounts unless otherwise qualified.

- 73 A principal quoting a firm price (or rate) either through a broker or directly to a potential counterparty is committed to deal at that price (or rate) in a marketable amount provided the counterparty name is acceptable. In order to minimise the scope for confusion where there is no clear market convention, dealers quoting a firm price (rate) should indicate the length of time for which their quote is firm.
- 74 It is generally accepted that when dealing in fast moving markets (like spot forex or currency options) a principal has to assume that a price given to a broker is good only for a short

length of time - typically a matter of seconds. However, this practice would be open to misunderstandings about how quickly a price is deemed to lapse if it were adopted when dealing in generally less hectic markets, for example the forward foreign exchange or deposit markets, or when market conditions are relatively quiet. Since dealers have prime responsibility for prices put to a broker, the onus in such circumstances is on dealers to satisfy themselves that their prices have been taken off, unless a time limit is placed by the principal on its interest at the outset (eg 'firm for one minute only'). Otherwise, the principal should feel bound to deal with an acceptable name at the quoted rate in a marketable amount.

- 75 For their part brokers should make every effort to assist dealers by checking from time to time with them whether their interest at particular prices (rates) is still current. They should also do so when a specific name and amount have been quoted.
- 76 What constitutes a marketable amount varies from market to market but will generally be familiar to practitioners. A broker, if quoting on the basis of small amounts or particular names, should qualify the quotation accordingly. Where principals are proposing to deal in unfamiliar markets through a broker, it is recommended that they first ask brokers what amounts are sufficient to validate normal market quotations. If their interest is in a smaller amount, this should be specified by the principal when initially requesting a price from or offering a price to the broker.
- 77 In the swap market, considerable use is made of 'indicative interest' quotations. When arranging a swap an unconditional firm rate will only be given where a principal deals directly with a client, or when such a principal has received the name of a client from a broker. A principal who quotes a rate or spread as 'firm subject to credit' is bound to deal at the quoted rate or spread if the name is consistent with a category of counterparty previously identified for this purpose (see also paragraph 82 below). The only exception is where the particular name cannot be accepted, for example if the principal has reached its credit limit for that name, in which case the principal will correctly reject the transaction. It is not an acceptable practice for a principal to revise a rate which was 'firm subject to credit' once the name of the counterparty has been disclosed. Brokers and principals should work together to establish a range of institutions for whom the principal's rate is firm subject to credit.

Concluding a deal

Principals should regard themselves as bound to a deal once the price and any other key commercial terms have been agreed. Oral agreements are considered binding. However, holding brokers unreasonably to a price is viewed as unprofessional and should be discouraged by management.

- 78 Where quoted prices are qualified as being indicative or subject to negotiation of commercial terms, principals should normally treat themselves as bound to a deal at the point where the terms have been agreed without qualification. Oral agreements are considered binding; the subsequent confirmation is evidence of the deal but should not override terms agreed orally. The practice of making a transaction subject to documentation is **not** good practice (see also paragraphs 107-109). In order to minimise the likelihood of disputes arising once documentation is prepared, firms should make every effort to agree all material points quickly during the oral negotiation of terms, and should include these on the confirmation. Any remaining details should be agreed as soon as possible thereafter.
- 79 Where brokers are involved, it is their responsibility to ensure that the principal providing the price (rate) is made aware immediately it has been dealt upon. As a general rule a deal should only be regarded as having been 'done' where the broker's contact is positively acknowledged

by the dealer. A broker should never assume that a deal is done without some form of oral acknowledgement from the dealer. Where a broker puts a specific proposition to a dealer for a price (eg specifying an amount and a name for which a quote is required), the dealer can reasonably expect to be told almost immediately by the broker whether the price has been hit or not.

Passing of names by brokers

Brokers should not divulge the names of principals prematurely, and certainly not until satisfied that both sides display a serious intention to transact. Principals and brokers should at all times treat the details of transactions as absolutely confidential to the parties involved (see paragraph 41 above).

- 80 To save time and minimise frustration, principals should wherever practicable give brokers prior indication of counterparties with whom, for whatever reason, they would be unwilling to do business (referring as necessary to particular markets or instruments). At the same time brokers should take full account of the best interests and any precise instructions of the client.
- 81 To save subsequent awkwardness, principals (including agents) have a particular obligation to give guidance to brokers on any particular features (maturities etc) or types of counterparty (such as non-financial institutions) which might cause difficulties. In some instruments, principals may also wish to give brokers guidance on the extent of their price differentiation across broad categories of counterparties. Where a broker is acting for an unlisted (or unsupervised) name he should disclose this fact as soon as possible; the degree of disclosure required in such a case will usually be greater. For instance, credit considerations may require that such names be disclosed to a listed principal first (as in the swap market), in order that the listed principal may quote a rate at which it is committed to deal. Equally, disclosure of difficult names may be necessary since this may influence the documentation.
- 82 In all their wholesale market business, brokers should aim to achieve a mutual and immediate exchange of names. However this will not always be possible. There will be times when one principal's name proves unacceptable to another and the broker will quite properly decline to divulge by whom it was refused. This may sometimes result in the principal whose name has been rejected feeling that the broker may in fact have quoted a price (rate) which it could not in fact substantiate. In such cases, the FSA will be prepared to establish with the reluctant principal that it did have business to do at the quoted price and the reasons why the name was turned down, so that the aggrieved party can be assured the original quote was valid without, of course, revealing the reluctant party's name.
- 83 In the sterling and currency deposit markets, it is accepted that principals dealing through a broker have the right to turn down a name wishing to take deposits; this could therefore require predisclosure of the name before closing the deal. Once a lender has asked the key question 'who pays', it is considered committed to do business at the price quoted with that name, or an alternative acceptable name if offered immediately. The name of a lender shall be disclosed only after the borrower's name has been accepted by the lender. Conversely, where a borrower is taking secured money there may be occasions when it will wish to decline to take funds, through a broker, when the lender's name is passed.
- 84 In the case of instruments like CDs, where the seller may not be the same entity as the issuer, the broker shall first disclose the issuer's name to the potential buyer. Once a buyer has asked 'whose paper is it', the buyer is considered committed to deal at the price quoted. Once the buyer asks 'who sells' it is considered committed to deal with the particular seller in question (or an alternative acceptable name, so long as this name is immediately shown to the buyer by

the broker). The name of the buyer shall be disclosed only after the seller's name has been accepted by the buyer. The seller has the right to refuse the particular buyer, so long as it is prepared at that time to sell the same amount at the same price to an alternative acceptable name immediately shown to it by the broker.

- 85 In the CD markets a price quoted is generally accepted as good for any name 'on the run'.

Use of intermediaries

Brokers must not interpose an intermediary in any deal which could take place without its introduction.

- 86 An intermediary should only be introduced by a broker where it is strictly necessary for the completion of a deal, most obviously where a name switch is required because one counterparty is full of another's name but is prepared to deal with a third party. Any fees involved in transactions involving intermediaries must be explicitly identified by the broker and shown on the relevant confirmation(s).
- 87 Where a broker needs to switch a name this should be undertaken as promptly as possible, bearing in mind that this may take longer at certain times of the day; or if the name is a particularly difficult one; or if the deal is larger than normal. In no circumstances should a deal be left overnight without acceptable names having been passed.

Confirmation procedures

Prompt passing, recording and careful checking of confirmations is vital to minimise the possibility of errors and misunderstanding whether dealing direct or through brokers. Details should be passed as soon as practicable after deals have been done and checked upon receipt. The passing of details in batches is not recommended. For markets where standard terms are applicable eg under standard documentation, it is recommended that confirmations conform to the formats specified for the market or instrument concerned.

(a) Oral deal checks

An increasing number of practitioners find it helpful to undertake oral deal checks at least once especially when using a broker.

- 88 Particularly when dealing in faster moving markets like foreign exchange, but also when dealing in other instruments which have very short settlement periods, many principals now request regular oral deal checks - whether dealing through brokers or direct - prior to the exchange and checking of a written or electronically dispatched confirmation. Their use can be an important means of helping to reduce the number and size of differences particularly when dealing through brokers or for deals involving non-London counterparties. It is for each firm to agree with its broker(s) whether or not it wishes to be provided with this service and, if so, how many such checks a day it requires. When arbitrating in disputes, the FSA will take into account the extent to which principals have sought to safeguard their interests by undertaking oral checks.
- 89 If a single check is thought to be sufficient, the FSA sees merit in this being undertaken towards the end of the trading day as a useful complement, particularly where late deals are concerned, to the process of sending out and checking confirmations.

90 As a matter of common sense, the broker should always obtain acknowledgement from a dealer on completion of the check that all the deals have been agreed or, if not, that any identified discrepancies are resolved as a matter of urgency. Lack of response should not be construed as acknowledgement.

(b) Written/electronic confirmations

In all markets, the confirmation provides a necessary final safeguard against dealing errors. Confirmations should be dispatched and checked carefully and promptly, even when oral deal checks have been undertaken. The issue and checking of confirmations is a back-office responsibility which should be carried out independently from those who initiate deals.

91 A confirmation of each deal must be sent out without delay. This is particularly essential if dealing for same day settlement. As a general rule the FSA believes all participants in the wholesale markets should have, or be aiming to have, in place the capability to dispatch confirmations so that they are received and can be checked within a few hours of when the deal was struck. Where the products involved are more complex, and so require more details to be included on the confirmation, this may not be possible; nevertheless it is in the interest of all concerned that such deals are confirmed as quickly as is practicable. The FSA recommends that principals should enquire about any confirmations that have not been received within the expected timescale.

92 It is not uncommon in the derivatives markets, and perfectly acceptable if the two principals involved agree, for only **one** party (rather than both) to the deal to send out a confirmation. But where this is so, it is imperative not only that the recipient checks it promptly, but that it also in good time responds to the issuer of the confirmation agreeing/querying the terms. For good order's sake it would also be imperative that the issuer of the confirmation has in place procedures for chasing a response if one is not forthcoming within a few hours of the confirmation being sent.

93 All confirmations should include the trade date, the name of the other counterparty and all other details of the deal, including where appropriate the commission charged by the broker. Some principals include their own terms and conditions of trading on their written confirmations. To avoid misunderstandings, any subsequent changes should be brought specifically to the attention of their counterparties.

94 In many markets, it is accepted practice for principals to confirm directly all the details of transactions arranged through a broker; the broker should nevertheless also send a confirmation to each counterparty.

95 All principals are reminded that the prompt sending and checking of confirmations is also regarded as best practice in deals not arranged through a broker, including those with corporates and other customers.

96 Wherever practicable the FSA wishes to discourage the practice in some markets of sending two confirmations (eg an initial one by telex, fax or other acceptable electronic means) followed by a written confirmation, which if posted could easily not arrive until after the settlement date and could cause confusion and uncertainty. For this reason, the FSA believes that wherever practicable a single

confirmation should be sent promptly by each party, if possible by one of the generally accepted electronic means now available (notably the ACS system, SWIFT, TRAX, fax or telex). Where this is not practicable, for instance in more complex derivative transactions, firms should indicate (eg on the preliminary confirmation) that a more detailed written version is to follow. The FSA does not believe that it is good practice to rely solely on an oral check.

- 97 It is vital that principals check confirmations carefully and immediately upon receipt so that discrepancies can be quickly revealed and corrected. Firms that check within a few hours of receipt would be complying with best practice.
- 98 As a general rule, confirmations should not be issued by or sent to and checked by dealers. This is a back-office function. Where dealers do get involved in these procedures they should be closely controlled. The most common instance where it may sometimes be thought helpful to mark a copy of the confirmation for the attention of the person who has arranged the deal, in addition to the back office, is in markets requiring detailed negotiation of terms (notably those involving contracts for differences). Certain automated dealing systems produce confirmations automatically. Provided these are received in the back office no additional confirmation need be sent.
- 99 Particular attention needs to be paid by all parties when confirming deals in which at least one of the counterparties is based outside London, and to any consequential differences in confirmation procedure.

Payment/settlement instructions

Instructions should be passed as quickly as possible to facilitate prompt settlement. The FSA strongly recommends the use of standard settlement instructions; their use can make a significant contribution to reducing both the incidence and size of differences arising from the mistaken settlement of funds.

- 100 The use of standard settlement instructions (SSIs) continues to increase in London. International acceptance of the benefits of many SSIs is an important next step. In order to facilitate still greater usage of SSIs the BBA now maintains a directory of London based institutions that use them. The FSA wishes to encourage firms that it supervises, that do not already do so, to draw up plans to move towards using SSIs as soon as possible. A major advantage of using SSIs is that they remove the need to confirm payment details by phone. Market participants may also wish to refer to the BBA's guidance on the 'Format for exchange of SSIs' issued on 28 May 1999.
- 101 The guidelines set out in Schedule 2, which have been drawn up in consultation with practitioners, set out a framework which it is hoped principals will aim to adopt when using SSIs for wholesale market transactions. The guidance notes emphasise that SSIs should only be established or amended via confirmed letter, authenticated SWIFT message or SWIFT SSI/ FX Directory Service and **not** by SWIFT broadcast. While many firms comply with this guidance, difficulties have been encountered where some insist on using SWIFT broadcasts. Both SWIFT and the FSA are agreed that broadcast messages remain unsuitable for the purpose of changing SSIs, are non-binding on recipients and should not be used by listed firms for this purpose. However, if a listed firm receives notice from a counterparty of the amendment of a SSI by a SWIFT broadcast, it should be free to act upon such notice if it wishes. It should seek authentication of the message by way of sending confirmation of the arrangement, making

clear when and for what deals the new instructions will be implemented. Until that process is complete the original instructions will be deemed still to be operative.

- 102 It has been the practice in the domestic sterling market that brokers pass payment instructions. In view of the increasing use of SSIs, the domestic sterling market should be moving away from requiring this service from brokers. Brokers should therefore only be expected to pass payment instructions in very unusual circumstances or in certain deposit markets where the counterparty is a non-core principal (such as a local authority).
- 103 Similarly, brokers do not pass payment instructions in the foreign exchange and currency deposits market where the counterparties are both in the UK. However, where mutually agreed between the broker and the principal, payment instructions will be passed for deals using non-UK counterparties. All such instructions should be passed with minimum delay. It has been stated in the Code for some years that, with the growth of SSIs, brokers would eventually cease routinely to pass payment instructions. The FSA's view is that the inter-professional conduct of business code that will replace the London Code from N2 should explicitly limit the brokers' role in passing payment instructions to "exceptional circumstances". Discussions will continue between the FSA and practitioners to consider whether such a change can be implemented before N2.
- 104 Where SSIs are not being used, principals should ensure that any alterations to original payment instructions, including the paying agent where this has been specifically requested, should be immediately notified direct to the counterparty. This notification should be supported by written, telex, or similar confirmation of the new instructions.
- 105 While it is important that payment instructions are passed quickly, it is equally important that principals have in place appropriate procedures for controlling the timing of their instructions to correspondent banks to release funds when settling wholesale market transactions. A survey by G-10 central banks in the mid-1990s suggested that there was, at that time, a wide gap between the best and worst controls practised in the markets; failure to maintain effective controls over payment flows can significantly increase the risks that institutions face when dealing in the OTC wholesale markets.

Fraud

- 106 There is a need for great vigilance by all staff against attempted fraud. This is particularly so where calls are received on an ordinary telephone line (usually in principal to principal transactions). As a precautionary measure, it is strongly recommended that the details of all telephone deals which do not include pre-agreed standard settlement instructions should be confirmed by telex or similar means without delay by the recipient, seeking an answer-back to ensure the deal is genuine.

Terms and documentation

It is now common for wholesale market deals to be subject to some form of legal documentation binding the two parties to certain standard conditions and undertakings. The FSA endorses the use, wherever possible, of such documentation (which typically will take the form either of signed Master Agreements exchanged between the two parties or can take the form of standard Terms). Core principals should have procedures in place to enable documentation to be completed and exchanged as soon as possible.

- 107 It is in the interest of all principals to make every effort to progress the finalisation of documentation as quickly as possible. In some markets, such as repo, or in other

circumstances such as those described in paragraphs 31 and 51, documentation should be in place before any deals are undertaken. More generally, however, the FSA believes the aim should be for documentation to be in place within three months of the first deal being struck. Failure to agree documentation within this timescale should cause management to review the additional risks that this might imply for any future deals with the counterparty concerned. Factors which may influence management's' views include whether they can take comfort on their legal position from the mutual confirmation of terms with a particular counterparty; or where the delay is in putting in place multiple master agreements for products that are, in the interim, subject to previously agreed documentation.

- 108 Some documentation in common usage provides for various options and/or modifications to be agreed by mutual consent. These must be clearly stated before dealing. Firms should make clear at an early stage, when trading any of the above mentioned products, if they are not intending to use standard terms documentation. Where changes are proposed these should also be made clear. For other wholesale instruments, where standard terms may not yet exist (eg exotic options), particular care and attention should be paid to the negotiation of terms and documentation.
- 109 Some outstanding transactions might still be subject to old documentation (eg the 1987 ISDA) that results in one-way payment provisions. The use of such provisions is not recommended. Banking supervisors world-wide have indicated that such transactions will not be eligible for netting for capital adequacy purposes and the FSA supports moves to amend such clauses where they are still in existence. Non-core principals are encouraged to co-operate with core principals in this objective.
- 109a Where documentation indicates that redemption pricing is to be determined by reference to a dealer poll, it is good market practice for that polling to be based on a representative amount (representative of a normal single transaction in the relevant market at the relevant time) unless explicitly stated to the contrary in the documentation.

Stock lending and repos

Where sale and repurchase (or stock borrowing and lending) transactions are entered into, proper documentation and prior agreement of key terms and conditions are essential.

- 110 The FSA expects core principals to abide by the relevant codes drawn up by market practitioners. When undertaking stock lending transactions the Stock Lending and Repo Committee's Codes of Conduct should apply, including, but not limited to, the Gilt Repo Code of Best Practice, which was updated and reissued in August 1998. Copies can be obtained from: The Secretary, Stock Lending and Repo Committee, c/o Bank of England, Threadneedle Street, London, EC2R 8AH, or alternatively from the BoE's web-site (www.bankofengland.co.uk).
- 111 The Gilt Repo Code will apply not only to gilt repo, but also to other transactions involving gilts which have a similar effect and intent, including secured lending (of money and gilts), eg under the gilt-edged stock lending agreement; lending of gilts against collateral; buy/ sellbacks (whether or not under a Master Agreement). Where not covered by an alternative more specific repo code of conduct issued by the Stock Lending and Repo Committee, the FSA also expects that the standards set down in the Gilt Repo Code should be applied when undertaking other, non-gilt, repo activity covered by the London Code.

Assignments or transfers

Assignments should not generally be undertaken without the consent of the parties concerned.

- 112 Assignments have become increasingly common in the derivatives market. Principals who enter into any wholesale market transaction with the intention of shortly afterwards assigning or transferring the deal to a third party should make clear their intention to do so when initially negotiating the deal. It is recommended that the confirmation sent by the principal should specify any intent to assign and give details of the procedure that will be used. The subsequent documentation should also make provision for assignment.
- 113 When a principal is intending to execute such a transfer it must obtain the consent of the transferee before releasing its name. If the principal proposes to use a broker to arrange the transfer, consent from the transferee for this to happen must also be obtained. The transferee has an obligation to give the principal intending to transfer sufficient information to enable the transaction to be conducted in accordance with the principles of best practice set out elsewhere in the Code. Where the transaction is conducted through a broker, this information should likewise be made available to him. In particular, the information from the transferee should include details of the type of credit the transferee is prepared to accept, and whether he is seeking any sort of reimbursement for the administrative costs that might be incurred. Principals and brokers arranging a transfer or assignment should also agree the basis of pricing the transfer at an early stage of the negotiations. When arranging assignments, it is important for participants to observe the general principle set out elsewhere in the Code that there should be mutual disclosure of names. Finally it should be noted that proper, clear documentation is as important for transfers as for the origination of deals.

Settlement of differences

If all the procedures outlined above are adhered to, the incidence and size of differences should be reduced; and those mistakes which do occur should be identified and corrected promptly. Failure to observe these principles could leave those responsible bearing the cost, without limit on size or duration, of any differences which arise. Except in the foreign exchange market, all differences must be settled in cash or, by mutual management agreement, by offset against brokerage due. In the absence of agreement otherwise, cash remains the default means of settlement.

- 114 In all the wholesale markets (including foreign exchange) if a broker misses a price he is required by the FSA to offer to close the deal at the next best price if held to the deal. The broker must then settle the difference arising by cheque. However, providing management on both sides agree, the difference may be offset against brokerage due or, subject to paras 118-119, if it is a foreign exchange transaction, by points. **In the absence of mutual agreement to settle a difference by brokerage offset or points, principals should accept cash settlement. Principals should always be prepared to accept cash settlement, since to do otherwise would put the broker in breach of the Code. It is unprofessional for a dealer to refuse to accept a difference cheque and insist the deal is honoured;** individual brokers facing this situation should advise their senior management who, if necessary, should raise the matter with management of the client. The FSA is keen to be advised of any persistent offenders.
- 115 Where brokers are used to arrange derivative products like barrier options, they should not be held liable for disputes between principals that arise where there is a disagreement over whether a certain spot level has or has not been reached in sufficient quantity to trigger the

option. Nor should brokers be cited as independent referees in such transactions unless they have explicitly agreed to do so before the deal is struck.

- 116 As noted above, the prompt dispatch and checking of confirmations is of paramount importance. Non-standard settlement instructions should be particularly carefully checked, and any discrepancies identified promptly upon receipt, and notified direct to the counterparty, or to the broker (in circumstances described earlier).
- 117 Where difference payments arise because of errors in the payment of funds, principals are reminded that it is the view of the FSA and the Joint Standing Committees that they should not benefit from undue enrichment by retaining the funds. Technological developments have resulted in faster and more efficient mechanisms for the delivery and checking of confirmations. This means that when brokers pass payment instructions that cannot be crosschecked against direct confirmation details, their liability in the event of an error should be limited to 24 hours from when the deal was struck. This limit on the broker's liability is not intended to absolve brokers of responsibility for their own errors; rather it recognises that once payments do go astray the broker is limited in what action it can directly take to rectify the situation.
- 118 In the foreign exchange and currency deposit markets arrangements have been drawn up to facilitate the payment of differences via the Secretary of the Foreign Exchange Joint Standing Committee.¹ In the foreign exchange market only, and only with the explicit consent of principals, brokers may make use of 'points' to settle differences. Even then their use will only be permitted if arrangements for management control, recording and reporting of points consistent with the requirements laid down by the FSA in Schedule 4 have been established.
- 119 Listed broking firms must agree their own procedures with the FSA's Markets & Exchanges Division before using 'points'. The informal use of 'points' between individual dealers and brokers is not acceptable. Using 'points' in lieu of cash to settle differences is not permitted in any market other than foreign exchange. As a matter of prudent housekeeping, all differences should normally be settled within 30 days from the date the original deal was undertaken.

Arbitration procedure

- 120 The FSA is prepared to arbitrate in disputes between firms it supervises about the application of the Code, or current market practice, to specific transactions in wholesale market products. As a condition for doing so, the FSA will expect the parties to have exhausted their own efforts to resolve the matter directly. All parties must then first agree to the FSA taking such a role and to accept its decision in full and final settlement of the dispute. In doing so, the FSA may draw on the advice and expertise of members of the Joint Standing Committees or other market practitioners as it feels appropriate. Requests for arbitration should be addressed to the FSA's Markets & Exchanges Division. The FSA will not normally arbitrate in any dispute that is subject to, or is likely to be subject to, legal proceedings. Paragraphs 48 and 49 of the Code, on taping, and paragraphs 88-90, on oral deal checks, are especially relevant to firms considering recourse to these arrangements.

¹ All requests for settlement via these arrangements should be marked for the attention of the Secretary, Foreign Exchange Joint Standing Committee, Bank of England Dealing Room (HO-G), Bank of England, Threadneedle Street, London EC2R 8AH. They should be accompanied by a written report of the circumstances resulting in the difference.

Commission/brokerage

Brokers' charges are freely negotiable. Principals should pay brokerage bills promptly.

- 121 Where the services of a broker are used it is traditional practice for an appropriate brokerage package to be agreed by the directors or senior management on each side. Any variation on a particular transaction from those previously agreed brokerage arrangements should be expressly approved by both parties and clearly recorded on the subsequent documentation; this should be the exception rather than the rule. Under no circumstances should a broker pay cash to a principal as an incentive to use its service (see also paragraphs 59 - 60).
- 122 Although brokers normally quote dealing prices excluding commission/brokerage charges, it is perfectly acceptable, and not uncommon, in some derivative markets for the parties to agree that the broker quotes rates gross of commission and separately identifies the brokerage charge. Equally there may be circumstances when the broker (or principal) and client may agree on an acceptable net rate; if so it is important that the broker (or principal) subsequently informs the client how that rate is divided between payments to counterparties and upfront commission. In such cases it is essential that all parties are quite clear that this division will be determined no later than the time at which the deal is struck and that a record is kept.
- 123 The FSA is aware that some principals fail to pay due brokerage bills promptly. This is not good practice and can significantly disadvantage brokers since overdue payments are treated by the FSA, for regulatory purposes, as a deduction from their capital base.

Market conventions

Management should ensure that individual brokers and dealers are aware of their responsibility to act professionally at all times and, as part of this, to use clear, unambiguous terminology. This is even more important when dealing with non-core principals, whose staff may be less experienced in dealing in these markets.

- 124 The use of clear language is in the interests of all concerned. Management should establish internal procedures (including retraining if necessary) to alert individual dealers and brokers who act in different markets (or move from one market to another) both to any differences in terminology between markets and to the possibility that any particular term could be misinterpreted. The use of generally accepted concise terminology is undoubtedly helpful. In those markets where standard terms and conditions have been published individual dealers and brokers should familiarise themselves with the definitions they contain.
- 125 Standard conventions for calculating the interest and proceeds on certain sterling and currency instruments, together with market conventions regarding brokerage, are set out in Schedule 1. A statement of good practices in obtaining data for mark-to-market purposes can be found in Schedule 3.

Market disruption/bank holidays

- 126 There have been instances of general disruption to the wholesale markets which have, in turn, resulted in interruptions to the sterling settlement systems and consequent delays in sterling payments. It has been agreed that in such unexpected circumstances the FSA, in liaison with the Bank of England, should determine and publish the interest rate(s) which parties to deals affected by such interruptions should use to calculate the appropriate interest adjustment (unless all the parties to the deal agree instead on some other arrangement - such as to continue to apply the existing rate of interest on the original transaction or as provided for in

the relevant documentation). The FSA shall have absolute discretion in its determination of any interest rate(s), and shall not be required to explain its method of determining the same and shall not be liable to any person in respect of such determination.

- 127 Occasionally unforeseen events mean that market participants will have entered into contracts for a particular maturity date only to find, subsequently, that that day is declared a public holiday. It is normal market practice in London to extend contracts maturing on a non-business day to the next working day. But to minimise possible disputes market participants may need to agree settlement arrangements for such deals with their counterparties in advance.

Market Conventions

1 Calculation of interest and brokerage in the sterling deposit market

Interest

On CDs and deposits or loans this is calculated on a daily basis on a 365-day year.

Interest on a deposit or loan is paid at maturity, or annually and at maturity, unless special arrangements are made at the time the deal is concluded.

On secured loans some specialised intermediaries do not pay interest at intervals of less than 28 days. The current general practice is to calculate at the close of business on the penultimate working day interest outstanding on secured loans to the last working day of each calendar month and to pay the interest thereon on the last working day of the month.

Brokerage

All brokerage is calculated on a daily basis on a 365-day year and brokerage statements are submitted monthly.

2 Calculation of interest in a leap year

The calculation of interest in a leap year depends upon whether interest falls to be calculated on a daily or an annual basis. The position may differ as between temporary and longer-term loans.

Temporary loans

Because temporary loans may be repaid in less than one year (but may, of course, be continued for more than a year) interest on temporary money is almost invariably calculated on a daily basis. Thus any period which includes 29 February automatically incorporates that day in the calculation; in calculating the appropriate amount of interest, the number of days in the period since the last payment of interest is expressed as a fraction of a normal 365-day year, not the 366 days of a leap year, which ensures that full value is given for the 'extra' day.

Examples:

Assume last previous interest payment 1 February (up to and including 31 January) and date of repayment 1 April (in a leap year). Duration of loan for final interest calculation = 29 days (February) + 31 days (March) = 60 days.

Calculation of interest would be

$$P \times \frac{r}{100} \times \frac{60}{365} =$$

Assume no intermediate interest payments. Loan placed 1 March and called for repayment 1 March the following year (leap year). Total period up to and including 29 February = 366 days. Calculation of interest would be

$$P \times \frac{r}{100} \times \frac{366}{365} =$$

This is in line with banking practice regarding interest on deposits which is calculated on a 'daily' basis and no conflict therefore arises.

Longer-term loans

The following procedure for the calculation of interest on loans which cannot be repaid in less than one year (except under a TSB or building society stress clause) was agreed between the BBA and the Chartered Institute of Public Finance and Accountancy on 12 December 1978.

(a) Fixed interest

The total amount of interest to be paid on a longer-term loan at fixed interest should be calculated on the basis of the number of complete calendar years running from the first day of the loan, with each day of any remaining period bearing interest as for 1/365 of a year.

Normal practice for the calculation of interest in leap years is to disregard 29 February if it falls within one of the complete calendar years. Only when it falls within the remaining period is it counted as an additional day with the divisor remaining at 365.

Example: 3 1/2 year loan, maturing on 30 June of a leap year.

$$\text{First 3 years' interest: } P \times \frac{r}{100} \times \frac{360}{365} =$$

$$\text{First 6 months' interest: } P \times \frac{r}{100} \times \frac{182}{365} =$$

Certain banks, however, require additional payment of interest for 29 February in all cases, and it was therefore agreed that:

- both the original offer or bid, and the agent's confirmation, must state specifically if such payment is to be made; and
- the documentation must incorporate the appropriate phraseology.

Interest on longer-term loans should be paid half-yearly, on the half-yearly anniversary of the loan or on other prescribed dates and at maturity. To calculate half-yearly interest payments the accepted market formula is:

$$P \times \frac{r}{100} \times \frac{d}{365} =$$

Where d = actual number of days

Although, with the agreement of both parties, the following is sometimes used:

$$P \times \frac{r}{100} \times \frac{1}{2} =$$

(b) Floating rate

Interest on variable rate loans, or rollovers, which are taken for a fixed number of years with the rate of interest adjusted on specific dates, should be calculated in the same manner as for temporary loans.

3 Brokerage and other market conventions in the foreign exchange and currency deposit markets

Brokerage

(a) General (foreign exchange and currency deposits)

Brokerage arrangements are freely negotiable.

These arrangements should be agreed by directors and senior management in advance of any particular transaction.

(b) Currency deposits

Calculation of brokerage on all currency deposits should be worked out on a 360-day year.

Brokers' confirmations and statements relating to currency deposits should express brokerage in the currency of the deal.

In a simultaneous forward-forward deposit (for example one month against six months), the brokerage to be charged shall be on the actual intervening period (in the above example, five months).

Other Market Conventions

Currency deposits

Length of the year

For the purpose of calculating interest, one year is in general deemed to comprise 360 days; but practice is not uniform in all currencies or centres.

Spreads and quotations

Quotations will normally be made in fractions, except in short-dated foreign exchange dealings, where decimals are normally used.

Call and notice money

For US dollars (and sterling), notice in respect of call money must be given before noon in London. For other currencies, it should be given before such time as may be necessary to conform with local clearing practice in the country of the currency dealt in.

Euro forex conventions

The vast majority of market participants have adopted the convention of quoting the Euro as the certain for all currency pairs, including for sterling and for the US\$. Further guidance will be issued once market practice has become more established.

4 Calculations in the foreign currency asset markets

Euro-commercial paper (and other such instruments)

The net proceeds of short-term interest-bearing and discount Euro-commercial paper, on which interest is determined on a 360-day basis, are calculated in the same manner as those for short-term, interest-bearing and discount CDs.

Formula for non-interest bearing Euronotes quoted on a 'discount to yield' basis:

$$\frac{N}{1 + \left(\frac{Y}{100} \times \frac{M}{360}\right)} = \text{Purchase consideration}$$

where:

N = Nominal amount or face value

Y = Yield

M = Number of days to maturity

Example:

A Euronote with a face value of US \$5 million and with 90 days to run is sold to yield 7.23% per annum.

$$\frac{5,000,000}{1 + \frac{(7.23 \times 90)}{(36,000)}} = \$4,911,229.53$$

US Treasury bills (and other US discount securities such as bankers' acceptances and commercial paper)

The quoted trading rates for such assets are discount rates. The price of the asset is calculated on the basis of a 360-day year.

The market price (Pm) on a redemption value of \$100 can be calculated as follows:

$$P_m = 100 - \frac{(M \times D)}{(360)}$$

where:

M = days to maturity or days held

D = discount basis (per cent)

Guidelines For Exchanging Standard Settlement Instructions (SSIs)

These guidelines were first drawn up by the Bank of England in consultation with practitioners and are endorsed by the FSA. While the parties to SSIs are free to agree changes to the detail on a bilateral basis, it is hoped that this framework will be useful and will be followed as closely as possible.

When establishing SSIs with a counterparty for the first time these should be appropriately authorised internally before being issued. SSIs must be established by post (and issued in duplicate, typically under two authorised signatories), alternatively, by SWIFT SSI/ FX Directory Service or authenticated SWIFT message.

Cancellation or amendment of SSIs should ideally be undertaken by SWIFT SSI/ FX Directory Service, authenticated SWIFT or tested telex. SWIFT broadcast is **not** an acceptable means for establishing, cancelling or amending SSIs.

A mutually agreed **period of notice** for changing SSIs should be given regardless of the chosen channel for notification. Typically this will be between 10 working days and one month. Some parties may also wish to provide for changes to be made at shorter notice in certain circumstances.

Unless both initiator and recipient are subscribers to SWIFT SSI/ FX Directory, **recipients** have a responsibility to acknowledge acceptance (or otherwise) of the proposed/amended SSI within the timescale agreed (see above). Failure to do so could result in a liability to compensate for any losses that result. In the case of written notification, this should be undertaken by the recipient signing and returning the duplicate letter. Recipients should also confirm the precise date on which SSIs will be activated (via SWIFT or tested telex).

Instructions should be issued for each currency and wholesale market product. Each party will typically nominate only one correspondent per currency for foreign exchange deals and one per currency for other wholesale market deals. The same correspondent may be used for foreign exchange and other wholesale market deals.

As a general rule, all outstanding deals, including maturing forwards, should be settled in accordance with the SSI in force at their value date (unless otherwise and explicitly agreed by the parties at the time at which any change to an existing SSI is agreed).

The SSI agreement for each business category should contain the following:

- The nature of the deals covered (for example whether they include same day settlement or only spot/forward forex deals).
- Confirmation that a single SSI will apply for all such deals with the counterparty.
- The effective date.
- Confirmation that it will remain in force 'until advised'.
- Recognition that no additional telephone confirmation of settlement details will be required.
- Recognition that any deviation from the SSI will be subject to an agreed period of notice.

When operating SSIs on this basis, the general obligations on both parties are to ensure that:

- They apply the SSI which is current on the settlement date for relevant transactions.
- Confirmations are issued in accordance with the London Code of Conduct; the aim should be to send them out on the day a deal is struck.
- Confirmations are checked promptly upon receipt in accordance with the London Code. Any discrepancies should be advised by no later than 3.00 pm on the business day following trade date, if not sooner.

Good Practices in Obtaining Data For Mark to Market Purposes

This Schedule is intended to provide guidance for principals when obtaining external data for the purposes of marking to market OTC transactions and for those brokers whom may be supplying these data. A number of market participants have asked for clarification of where responsibilities lie, and of what the FSA sees as good, or sound, practices in the acquisition and supply of such data. It is clear that there is a wide range of practices among participants; this guidance is intended to outline the main principles which participants should consider, rather than to be overly prescriptive as regards methods.

The General Principles

- Principals who engage in trading should undertake regular prudent and consistent valuation of their mark-to-market trading positions. For many such positions, quoted prices will be the best guide to a fair valuation.
- Principals need to have in place appropriate procedures for the independent checking of mark-to-market trading positions by the middle and/or back office.
- Brokers can play a useful role in the market as one of the sources of external data for valuation purposes. Where they do so, this service should be governed by the same considerations as apply to other relations between brokers and principals as described in paragraph 27 of the Code. Firms may enter into specific bilateral agreements about the reliance to be placed on any service supplied but, absent these, all principals are responsible for their own actions.

Acquisition of Data

Where principals are seeking to acquire external data for valuation purposes, they should also consider the following:

- Where possible, the FSA would expect the prices (and volatilities) used in mark-to-market calculations to be checked by an area of the principal that is independent of the front office.
- Screen services, brokers and other third party providers can all be useful sources of data. In some areas such as where markets are particularly thin or illiquid, principals may consider exchanging historical data with other principals.

- Where independent prices are not available, a series of checks should be put in place to ensure that all prices are measured on a prudent basis.
- Screen prices showing the bid-offer spread are widely available for many products. Where available, these will often be the most appropriate source, though principals should also consider how these data have been constructed and what they represent. Are they, for example, last actual trade and if so how long ago did it occur? From which market were they obtained and at what time? If the prices are not actual trades on what basis were they calculated (e.g. interpolation)? What size was the trade representative of? Is this price based on a liquid market?
- Where principals seek external data for specific transactions/instruments, they should specify in appropriate detail what data they require. Principals should state the appropriate characteristics on which they want the estimate to be based e.g. mid-market, indicative or firm prices, close-out prices, the size of deal for which the price is generally good, at the money prices etc.

Supply of Data by Brokers

In supplying data, brokers should consider:

- Whether appropriate back office controls are in place to ensure the data are appropriately calculated and recorded. The procedures for supplying data should be fully documented.
- Stating the precise conditions under which the estimates were constructed (mid-market, at-the-money, last trade, size etc.) They should also ensure that they provide data to principals on a consistent basis.
- Indicating an appropriate disclaimer of liability where appropriate, in addition to the general presumption of the Code outlined above.
- Where possible, data should be provided by the broker's back office function independent of the brokers.
- Where data are provided by fax (or fax equivalent), particular care is taken to ensure that the appropriate procedures are followed.
- Where markets are particularly illiquid, whether the broker can give any guidance on, say, the number of principals trading the product to which the price refers.
- Subjecting the supply of data procedures to periodic compliance and internal and external audit review.

Requirements For Participants in The Forex Market 'Points' Arrangements.

Notice first issued by the Bank of England, 24 October 1989*

- 1 The Bank of England's enquiries of foreign exchange market participants in March 1989 established that opinion was divided on use of the 'points' system in London**. The Bank considered with the FECDBA and the Joint Standing Committee the kind of steps necessary to allow those institutions wishing to retain the use of points to do so, whilst ensuring that points are not used in deals with banks which reject this system. The general arrangements below were agreed and established.
- 2 Management in all banks (and other active market participants) will be expected to have internal rules for their dealers to minimise the scope for differences and to discourage dealers from acting unprofessionally, for example by 'stuffing' brokers.

Participating banks

- 3 Each broking firm will approach all their clients (based in the UK or overseas) at the appropriate management level to establish whether, in order to be provided as far as possible by the broker with the current firm price service, they are prepared to sign a client letter accepting the broker's involvement in points arrangements. Those banks which do agree client letters are referred to here as 'participating banks'.
- 4 Banks which explicitly accept the use of points in this way will be assumed to have given their informed consent to the practice. The arrangements described here are deemed satisfactory in the foreign exchange market because it is a professional market in which best execution is not normally expected. Obviously in abnormal circumstances, where a broker agrees to provide best execution to a client or the client is not a market professional or the broker performs an advisory or discretionary function*** to a client, there must be full disclosure to the client of the broker's interest and explicit informed prior consent.
- 5 Signing such a client letter will not of itself commit any bank to lending points to brokers or to the use of positive points in lieu of cash payment for any differences. Any such decision should be taken quite separately by management and would require appropriate record keeping and reporting arrangements to be established.

* The Bank introduced a complementary notice (February 1994) to all banks and brokers setting out the detailed requirements for brokers operating a 'points' broking system in London; copies are available from the FSA's Markets & Exchanges Division. Note: this Notice may be amended from time to time.

** Examples of typical situations generating 'negative' and 'positive' points are set out at the end of this Schedule.

*** See paragraphs 29 and 30 of the Code regarding the role of brokers.

Non-participating banks

- 6 For 'non-participating banks' which decline to provide a client letter, a broking firm will need to consider on a case-by-case basis whether it is prepared to continue to provide a broking service, and if so on what terms. Where a service continues to be provided, the broking firm will be required to take the following steps to ensure that these banks are not unwittingly involved in deals where there is an undisclosed benefit to the broker:
- (i) The broker will advise the management of these non-participating banks that it may no longer provide as firm a price service; banks will be expected to take steps to inform their dealers that the broker cannot be held to a price. Any attempts to 'stuff' a broker should in the first instance be brought to the attention of management in the broking firm; they in turn should raise it at the appropriate level with the bank(s) concerned. Any bank dealers attempting to pressurise a broker should be subject to internal disciplinary procedures. Furthermore, if necessary, brokers will have recourse to the FSA to complain.
 - (ii) Each broking firm will establish to the FSA's satisfaction appropriate arrangements to enable it to distinguish non-participating from participating banks. The precise means by which this distinction is achieved are likely to vary between broking firms depending, inter alia, on the number of non-participating clients each broker has; the manner in which they receive a service (whether over an open voice box system or over an ordinary telephone line); and the number and volume of deals involved.
 - (iii) Any differences payable by the broker resulting from mistakes will normally be settled by cheque; where London banks are concerned, it is recommended that cheques be paid through the FX Joint Standing Committee's mechanism as per paragraph 118 of the Code. As a matter of equity, banks should also accept that any differences resulting from mistakes on the part of their dealers should be payable to the broker through the same procedures.
 - (iv) An up-to-date list of names distinguishing participating from non-participating banks will be maintained by the broker, with copies provided to all appropriate members of staff. The FSA will also be provided with a copy of the current list.
 - (v) Any 'cross-overs' involving a non-participating bank will, subject to acceptability of names, be completed either at a mutually acceptable middle rate or by the introduction of an intermediary bank; if an intermediary is introduced, none of the benefit to it from such a deal will accrue to the broker.
 - (vi) In the event of a 'name switch' becoming necessary involving one or more non-participating banks, the broker will reserve the right to adjust the brokerage charges to compensate. Any such adjustment should be arranged between management in both the broking firm and the bank(s) concerned.
- 7 Management in broking firms active in forex have indicated that this framework forms an acceptable basis for accommodating banks' differing requirements for broking services. Its operation will be kept under close review by the FSA and by the Joint Standing Committee.
- 8 The FSA will require brokers to maintain records of deals involving points, including any such deals arranged involving correspondent brokers. These must ensure that accurate and verifiable points' tallies are kept on a deal by deal basis, and must be backed by rigorous management systems and controls. These requirements have been discussed with the broking firms concerned and are set out in a separate paper that has been provided to all listed brokers for implementation to the FSA's satisfaction.

- 9 The FSA accepts that on rare occasions individuals will inevitably make mistakes, when (positive) points may wrongly be taken by a broker from a deal involving a non-participating bank. Systems will therefore need to be in place in each broking firm to identify any such errors promptly and to ensure that full rectification takes place immediately so that no positive points accrue to the benefit of the broker. Any such adjustment will leave the original deal undisturbed. The FSA will monitor closely the frequency of any such errors in each firm; if they reveal an inability to distinguish participating from non-participating banks, the FSA may require a broking firm to give up the use of points altogether.

Arrangements for monitoring participating banks

- 10 In parallel to these arrangements for brokers, the appropriate Financial Supervision Division within the FSA will wish to be notified by those UK authorised banks which decide that they may be prepared to accept positive points to settle differences arising with broking firms. They will wish to discuss with these banks from time to time how these arrangements will work, including importantly the record keeping arrangements in place to enable individual transactions involving points (both negative and positive) to be identified.

EXAMPLES OF SITUATIONS GIVING RISE TO POINTS IN FOREIGN EXCHANGE DEALING

'Negative Points'

- 11 Suppose a broker quotes sterling at \$1.8030/1.8035. Bank A hits the \$1.8030 bid for 5mn. However, before the broker could let Bank A know, this price had been withdrawn by the market maker who had originally indicated to the broker a willingness to deal at the rate. The market for sterling has moved to \$1.8025/1.8030.
- 12 When told that the bid price of \$1.8030 was no longer available, the trader at Bank A insists on selling 5mn at the original price.
- 13 Suppose the broker accepts responsibility for not withdrawing the price quickly enough, or values highly his relationship with Bank A, and therefore agrees to be held to the price. He searches the market and finds Bank B (a participating bank) who is willing to help the broker by agreeing to buy from Bank A at \$1.8030 (and hopefully sell to the current bidder in the market at \$1.8025); the broker is committed to make good the \$2,500 loss which results from Bank B doing the two trades. This dealer has lent the broker 25 'points' (ie 5 'points' per 1mn in a 5mn deal).

'Positive Points'

- 14 The \$2,500 (25 'points') obligation of the broker in the above example to Bank B could obviously be settled in cash if Bank B so wished. Or Bank B may be prepared to see it reduced by the broker's ability to put to Bank B other transactions that produce a profit to Bank B's dealing position of at least \$2,500. This might be achieved in various ways, one of which is as follows.
- 15 Suppose at some later time the market for sterling stands at \$1.8070/75. This might reflect prices put into the broker as follows: Bank A bidding at 1.8070; Bank C is offering at 1.8075. Suppose two unrelated Banks, X and Y, simultaneously have a respective need to sell/buy 5mn. Bank X hits the 1.8070 bid; Bank Y the 1.8075 offer. The broker now has these latter two banks committed to deal in opposite directions at overlapping rates (in this example equal to the market spread). The broker may, at its discretion, offer both these deals to Bank B.

16 The consequences of this would be:

- (i) Bank X has sold sterling at the (market) rate desired;
- (ii) Bank Y has bought sterling at the (market) rate desired;
- (iii) by being given both deals Bank B earns a profit of \$2,500 equal to the spread; it may, or may not, decide to reward the broker for this 'service' in the form of offsetting these 'positive points' against the 25 negative points the broker owes.

London Instruments

- 1 The issuance of Certificates of Deposit (CDs), Commercial Paper (CP) and other debt securities may involve the acceptance of deposits in terms of the Banking Act 1987. Issuers of CDs are always banks or building societies, and other issuers of debt securities may, depending on the circumstances, have to be either authorised or exempt under the Banking Act, or issue under the Banking Act (Exempt Transactions) Regulations 1997 (ETRs). In addition, issuers of some debt securities may have to comply with regulations made under the listing or prospectus regulations.
- 2 The act of issuing debentures (including CDs, CP and other debt securities) is not an investment activity under the FS Act, and so is not covered by the London Code, which defines best market practice for secondary market transactions. However, issues of CDs, CP issues by non-banks and issues of debt securities under the ETRs are expected to comply with the Bank of England's market notices and the British Bankers' Association's (BBA) market guidelines. The Bank of England and the FSA believe a degree of homogeneity in the primary and secondary markets assists good order in these markets.
- 3 Such homogeneity is achieved in the CD market by the Bank of England's Notice on CDs in London, together with market guidelines issued by the BBA setting out in detail the requirements covering the issuance of CDs. These identify the standard terms and conditions under which London CDs are issued. A similar degree of homogeneity is also achieved in the CP market and in the market in debt securities issued under the ETRs through the Bank of England's Notice and the BBA's market guidelines on CP.
- 4 Copies of the Bank of England's current notices on these instruments may be obtained from the Bank of England's website (www.bankofengland.co.uk) or its Gilt-Edged and Money Markets Division (telephone 0171-601 5980); any questions on these notices should also be directed to the Bank of England on the same number. The BBA's market guidelines are available directly from the BBA. The Bank of England and the FSA are willing to discuss with market participants in any other wholesale market proposals for the development of similar standards of homogeneity.