FX Rate Fixing. Banks Fined. A Clarification.

The rights and obligations of principal and agent need to be properly defined, particularly in complex business like banking and finance. Five banks have recently been fined $5.5 billion over a rate manipulation scheme that has seen them not act in their clients' best interest.

A bank should be clear about whether it trades as principal or agent when it transacts with a client. If as principal, the rules of disclosure may be relaxed. If as agent the rules of disclosure are clear: the client must be made aware of the detailed economics of the trade including the commissions, costs and expenses. The concept of markup pricing is incompatible with an agency trade. In fact, not only the quantum but the beneficial recipients of commissions, costs and expenses should be transparent, so that there is no ambiguity as to the interests of the agents and their delegates or associates. For principal trades, the client needs only know the all in cost of the transaction. Margins and markups, and their beneficial recipients are irrelevant.

This transforms the issue from one of transparency of pricing to one of the distinction and separation of principal or agent relationships. Client's may want to choose whether the bank they trade with is trading as principal or agent. If there is no liquidity, it may be preferable to do a principal trade since the bank makes market. If there is ample liquidity, an agency trade may be preferable as pricing is transparent. What is required is a Chinese Wall between the principal desk and the agency desk. If a client chooses to call the agency desk, they receive full transparency but have to live with the liquidity available. If they choose the principal desk, they are aware that the bank is trading as principal and does not in any way guarantee best execution but the bank must

guarantee execution.

Incidentally, the complaint against the banks was not that they did not act in the best interest of clients, but that they colluded to create a false market, or lack thereof, and distort prices. In a fair market, even if all transactions were principal ones, clients would have obtained price discovery by shopping around.

The current convention is one where banks trade as principal and therefore, rightly should have no obligation to provide transparency of pricing or best execution. When trading as principal the bank acts in its own best interests, not that of its so-called clients. The clients of the bank, when entering a principal trade become counterparties for the purposes and duration of the trade, and counterparties are owed a different set of obligations than clients or customers. The possible source of confusion is that clients are unaware or unaware of the implications of being in a principal trade. They may be under the impression that the bank acts in any way in their interests, a clearly mistaken assumption. The fault of the banks, if any, is to perpetuate the myth, actively or passively, that they in fact act in clients' best interests. Where there is a fiduciary responsibility to do so, the law compels them to act in the best interests of their clients but where there is no such relationship, clients should beware.

Regulators can clear the situation by distinguishing between principal and agent transactions and setting out the standards of behavior in each relationship.

It would certainly be interesting to see, in a free market, which business, principal or agency, finds more custom and which is more vigorously supplied. Thin and thinning agency margins balance regulatory capital requirements needs to support principal businesses and only an unfettered market providing both alternatives will complete the market for these

services. It is likely that with clarity and the clear distinction between business lines, new entrants and innovation will lead to more efficient markets less prone to abuse.