CHAIRMAN'S LETTER

The Foreign Exchange Committee and the global community faced a number of complex challenges in 1999. The year opened with the debut of the euro, an event viewed with considerable caution by market participants despite the extensive preparations that preceded it. As the year unfolded, our Committee spent much of its time on force majeure issues. Responding to the foreign exchange disruptions in 1998, the Committee sought to provide new guidelines and standard documentation that would minimize uncertainty for participants in the event of foreign exchange crises.

The Committee's agenda also included efforts to address Y2K settlement concerns, recommend standard practices in the barrier options market, and clarify operational procedures for entities that only occasionally trade in the foreign exchange market. In all of its activities, from issuing best practice recommendations to providing a forum for the discussion of issues, the Committee sought to raise the level of knowledge among market participants and to encourage actions that would reduce global market uncertainty and its associated risks.

The year ended with a smooth transition to a new century for the foreign exchange community. The Committee was untiring in its efforts to make the market work better than in the past, even as the group confronted the uncertainties produced by Y2K. This dedication was apparent in the care taken by the Committee to coordinate its efforts with those of other international organizations so that the new century would begin without mishap.

As I reflect on our Committee's accomplishments in 1999, I am well aware that our success was the product of hard work, a continuing commitment to improving market efficiency, and the ready cooperation of other international associations. Our chief efforts for the year are reviewed briefly below.

PLANNING FOR Y2K

Of all the Committee's efforts in 1999, the Y2K project drew the greatest attention and was supported by the strongest cooperative efforts. The importance accorded this project no doubt reflected a global sense of urgency about preparing for the turn of the century. The

Committee's work on the project began in November 1998, when together with the Singapore Foreign Exchange Market Committee, it released a letter encouraging market participants to reduce settlement risk by limiting settlement activity in the first week of the year 2000. The Committee took further steps in 1999:

- It supported the efforts of the Financial Markets Lawyers Group (FMLG), the legal advisor to the Committee, to prepare *Y2K: Best Practices in the Foreign Exchange Market*. This paper offered guidelines for minimizing the uncertainty that could arise if foreign exchange contracts failed to settle when Y2K-related events affected clearing banks or central banks (see page 39). Before releasing the document in mid-October, the Committee sought broad industry support by sending it to organizations all over the world for review and endorsement.
- The Committee also sponsored a series of informal meetings among members to identify the principal Y2K issues confronting the market. At midyear, the Committee invited senior credit officers in the industry to participate in a roundtable discussion focusing on the potential for Y2K problems.

ADDITIONAL INITIATIVES TO REDUCE SETTLEMENT RISK

In 1999, the Committee pushed for further reduction in foreign exchange risk. In particular, it monitored two specific initiatives meant to reduce the level of settlement risk: the creation of CLS (Continuous Linked Settlements) Bank and the contract for differences (CFD).

- **CLS Services/CLS Bank**

  The Committee recognizes that the introduction of CLS Bank is designed to reduce settlement risk but will also bring major changes to the way foreign exchange settles. When in operation, CLS Bank will settle payment instructions between members through the simultaneous debiting and crediting of funds. In 1999, the Committee monitored CLS' progress in setting up its new system and investigated the system's impact on the foreign exchange market. CLS officials briefed the Committee on their efforts at the February and December meetings.

- **CFDs**

  The Committee followed developments relating to the CFD, a foreign exchange contract that reduces risk by settling without the exchange of principal. The trading of CFDs requires appropriate reference rates; the compilation and posting of these rates is targeted for midyear 2000. The Committee intends to continue monitoring developments with CFDs and will provide best practice recommendations as appropriate.

TRADING PROCEDURE ISSUES

Two Committee projects—one focusing on the issue of force majeure and the other on barrier options agreements—were aimed at reducing market uncertainty by resolving institutional differences in trading procedures.

- **Force Majeure**

  A specialized subgroup of the FMLG undertook to clear up inconsistencies in international trading agreements that might encourage participants in the currency markets to take contradictory positions during times of crisis. Representatives of commercial and investment banks, the Emerging Markets Traders Association, and the International Swaps and Derivatives Association provided input. The project concluded with the recommendation of several new force majeure provisions for standard currency trading agreements (see page 57).

- **Barrier Options**

  A subgroup of the Committee circulated a questionnaire about current procedures pertaining to barrier options, received feedback from twenty-three institutions, and achieved consensus agreement on a number of market practices (see page 71). The subgroup has now turned its attention to composing standard confirmations with respect to the more commonly traded barrier options agreements.

PROVISION OF COMMENTS AND RECOMMENDATIONS

The Committee responded to a general request to the financial community by the Basel Committee on Banking Supervision for comments on its paper *Supervisory Guidance for Managing Settlement Risk in Foreign Exchange Transactions*. In a letter to the Basel Committee, the Committee strongly applauded the paper's intent and endorsed many of its recommendations, having made similar suggestions for many years (see page 89). However, the Committee was concerned that some of the recommendations in the paper might be too constraining and hence difficult for institutions to implement effectively. The Committee suggested that the Basel Committee might want to give financial institutions more latitude in their procedures for measuring settlement risk exposure, their use of netting, and their methods of managing fails and planning for contingencies.

In October, the Committee published a short paper with a long title, *Foreign Exchange Transaction Processing: Execution-to-Settlement Recommendations for Nondealer*

Participants (see page 47). Authored by the Operations Managers Working Group of the Committee, the paper seeks to reduce market uncertainties by providing an easy operations-based reference guide outlining best practices for businesses that may not be frequent participants in the foreign exchange market.

WORK ON LEGISLATIVE AND REGULATORY ISSUES

Throughout the year, our Committee acted as an advocate for the foreign exchange market on issues related to regulatory oversight. Supported by the FMLG, the Committee wrote letters and provided information and comment to legislators and regulators. In March, the Committee submitted a written response to questions raised by the Senate and House Committees on Agriculture about the history of the legislative treatment of the over-the-counter foreign exchange market (see page 77).

In addition, as Chairman of the Committee, I appeared before the House Agricultural Subcommittee on Risk Management, Research, and Specialty Crops on May 20. The testimony I gave emphasized the importance of self-policing for the foreign exchange market (see page 33). The Committee also joined with a group of other industry associations to provide recommendations on the modernization of the Commodity Exchange Act (see page 27). Finally, the Committee responded to proposals of the Commodity Futures Trading Commission that would have a bearing on the foreign exchange market. A comment letter sent in May addressed the proposed rules concerning automated trading systems (see page 83).

COLLABORATION WITH OTHER INDUSTRY GROUPS

Increased proficiency with electronic communication enabled the Committee and other industry groups to collaborate more successfully in 1999. Project work became more efficient as organizations learned that they could tap the resources of other global groups as readily as their own. The dissemination of information also became easier, and the frequency of correspondence between industry groups increased. Many of our Committee's papers, including work on barrier options, force majeure, and Y2K, were distributed electronically for comment and approval of the global community. On-line communication also allowed the Committee to stay abreast of the risk-reducing efforts of other groups and to support those efforts.

Our Committee is proud of the close relationships it has developed with a number of international groups. It is also optimistic about increased global interaction and the benefits that our ties with other groups can bring to the entire financial community. Our relationship with the Singapore Committee in particular has proved fruitful.

On November 5, 1999, I was present when the two committees met in Singapore for their third annual joint session. The meeting started off with a discussion of the outlook for the global foreign exchange market and the Asian economies and moved on to an analysis of Y2K preparations in Singapore and Asia. The committees then turned their attention to the recent barrier options and force majeure projects and considered how these efforts would provide support to the operations of the foreign exchange market. The meeting ended with both groups looking forward to their fourth joint meeting, planned for New York on November 2, 2000.

LOOKING AHEAD: PLANS FOR THE YEAR 2000

In the upcoming year, several projects will be drawing the attention of the Committee. These include

- monitoring the activities of CLS Bank and studying its potential impact on the entire foreign exchange market;
- updating industry best practices to incorporate legal and market-related innovations of the last five years;
- following through on projects begun in 1999, particularly the effort to provide standard confirmations on barrier options; and
- helping the market make the necessary adjustments to an electronic world.

We recognize that many tasks—and perhaps some adventures—await us in 2000. The Committee will continue to disseminate information, provide best practice recommendations, and encourage further risk reduction to support the evolution of the foreign exchange market. We will also continue our active collaboration with other industry bodies. It is our belief that global teamwork, supported by effective communication, creates the best possible conditions for achieving an efficient and high-functioning foreign exchange market.

Paul Kimball

LEGAL INITIATIVES

The Financial Markets Lawyers Group (FMLG) plays an important role in the foreign exchange market by encouraging a greater understanding of the legal environment and recommending sound business practices. The group functions as a prime legal advisor to the Foreign Exchange Committee, and FMLG members actively participate in the Committee's projects. Especially noteworthy in 1999 were the FMLG's efforts to clarify force majeure provisions for the Committee and to provide guidance on Y2K contingency planning.

FMLG members include in-house lawyers who are specialists in foreign exchange at their commercial and investment banking institutions as well as legal staff from the Federal Reserve Bank of New York. An FMLG member from the Bank's legal staff attends all Committee meetings.

In addition to working with the Committee, the FMLG has maintained close working relationships with other industry associations and frequently joins with them on projects that have an impact on the foreign exchange market. In February, the group held a joint meeting in London with the British Bankers' Association. It has also collaborated with the International Swaps and Derivatives Association and the Emerging Markets Traders Association on projects relating to industry documentation. Recently, the FMLG has been supportive of the efforts of the European Central Bank to set up a financial markets legal group.

In 1999, the FMLG undertook a number of specialized projects, often in collaboration with the Committee. These efforts are summarized below.

- **FORCE MAJEURE**

  An effort to update the force majeure provisions of international currency trading agreements was led by a working group of the FMLG. The purpose of the project was to clear up inconsistencies in the agreements that became apparent during the financial market disruptions of 1998. The recommendations transmitted to the foreign exchange market were to (a) shorten the waiting period before a party may liquidate affected transactions, (b) clarify the types of events that are covered, and (c) more precisely specify the party or parties entitled to liquidate transactions and make the necessary calculations.

- ## Y2K: BEST PRACTICE

The FMLG also initiated a project to develop Y2K best practice recommendations. This effort, which involved the assistance of representatives from the Committee and the Operations Managers Working Group, was designed to help market participants resolve contract settlement problems stemming from the century date change. The document that emerged from this initiative—*Y2K: Best Practices in the Foreign Exchange Market*—is reprinted on page 39.

- ## REGULATORY MATTERS

Both the Committee and the FMLG are sensitive to any legislative or other changes that might alter the regulatory treatment accorded the foreign exchange market under the Treasury Amendment. Throughout the year, the FMLG monitored events in Congress that might affect the market's regulatory status and provided the Committee with important guidance on legislative issues. When necessary, the FMLG helped write testimony for the Committee's use. The group also recommended that the Committee join coalitions with other industry groups and routinely provide written responses to questions of legislators and their staff—strategies that might help the Committee disseminate its views more broadly.

- ## OPINIONS

In 1999, the FMLG gathered legal opinions establishing the enforceability of the settlement and closeout netting provisions of the Committee's Master Agreements under local insolvency laws. The Master Agreements include the International Foreign Exchange Master Agreement (IFEMA), the International Foreign Exchange and Options Master Agreement (FEOMA), and the International Currency Options Market Master Agreement (ICOM). The FMLG also updated previously received opinions on this issue. A list of opinions is available on the FMLG's web site, *www.ny.frb.org/fmlg*.

- ## CROSS-PRODUCT NETTING AGREEMENT

The FMLG, along with several other organizations, developed a form of agreement meant to permit cross-product netting. The agreement, published in February 2000, provides a tool that may be useful in managing counterparty risk across different financial product types and widely used master agreements.

- ## COLLATERAL ANNEX

The FMLG continues to work on a collateral annex, which is meant to provide market participants with documentation that they can use for collateral arrangements supporting obligations arising from Master Agreements. The annex is designed to be adaptable to the needs of individual users.

- ## OTHER ISSUES

The FMLG plans to pursue a number of other projects begun in 1999. The group is participating in an effort organized by the United Nations Committee on International Trade Law (UNCITRAL) to write a draft convention on the assignment of receivables. The FMLG has been offering suggestions intended to harmonize the draft with existing law. The group is also reviewing how a proposal to shorten the settlement schedule in the securities market will affect the foreign exchange market. Finally, technology issues remain an important concern for the FMLG even after the successful start of Y2K. Together with the Committee, the FMLG plans to follow the evolution of e-commerce very closely to determine whether participants in the foreign exchange market would benefit from best practice recommendations in this area.

COMMITTEE RELATIONSHIPS WITH OTHER INDUSTRY BODIES

In its effort to enhance the efficiency of the global financial market, the Foreign Exchange Committee benefited greatly from frequent interaction with industry groups in 1999. Industry representatives and Committee members communicated well on a number of pressing issues, including the preparation for Y2K. In addition, by coordinating with other organizations, the Committee was able to take important steps toward limiting the effects of trading disruptions and reducing overall foreign exchange settlement risk.

The global development of electronic communication simplified the exchange of information in 1999. The Committee and its related organizations increasingly turned to e-mail to transmit documents across continents. International associations were able to use their web sites as an efficient means of disseminating reports and recommendations to market users. Easy access to global resources and information on the Internet also enhanced the quality of many projects undertaken by the Committee and its partner organizations.

COORDINATING PROJECTS

The broadest interaction of the Committee with other groups involved the Y2K project. The Financial Markets Lawyers Group led this effort and drew in members of the Committee and the Operations Managers Working Group to compose *Y2K: Best Practices in the Foreign Exchange Market*. Draft copies of the document were electronically circulated to a large number of industry groups, including ACI–the Financial Markets Association, the Australian Foreign Exchange Committee, the British Bankers Association, the Canadian Foreign Exchange Committee, the FX Joint Standing Committee, the Hong Kong Foreign Exchange Committee, the Singapore Foreign Exchange Market Committee and the Tokyo Foreign Exchange Market Committee. The support of these groups ensured the effective global distribution of the report.

The force majeure project, also led by the Financial Markets Lawyers Group, required consultation with various market participants, including trading, legal, and operations staff at a large number of institutions. In addition, the Committee solicited comments and endorsements for a new set of best practices in the barrier options market from the British Bankers Association and the Canadian Bankers Association, organizations that had been involved in writing earlier guidelines for the options market.

COLLABORATING AT MEETINGS

The Committee continued its close relationship with the Singapore Committee by holding a joint meeting for the third consecutive year. Although the two committees communicate frequently through the year, the face-to-face meeting in Singapore on November 4 provided a welcome opportunity to pursue issues of importance to both groups and to coordinate policies for increased efficiency in the global foreign exchange community.

At the meeting, the committees exchanged views on market developments, including the improvement in the Asian economies. The Singapore Committee provided a briefing on Singapore's preparation for Y2K. The Committee shared its own Y2K concerns and reported on its preparations. Other topics discussed included the recent work on barrier options and force majeure and a recently released Basel Committee paper, *Supervisory Guidance for Managing Settlement Risk in Foreign Exchange Transactions*. The committees ended the meeting by scheduling their next joint session for November 2000 in New York.

At other meetings in 1999, the Committee welcomed observers from the FX Joint Standing Committee in London, the Canadian Foreign Exchange Committee, and the Tokyo Foreign Exchange Market Committee. The Committee also exchanged agendas and other meeting information with the newly formed European Central Bank Foreign Exchange Contact Group

ADVISORY ROLE OF THE COMMITTEE

The Committee recognizes the importance of strong leadership in achieving an efficient global foreign exchange market. To fulfill its leadership responsibilities, the Committee works to convey a theoretical and practical understanding of the foreign exchange market by issuing papers, best practice recommendations, letters, and survey findings. It carries out its advisory role through skillful communication with other international bodies, market participants, and its own sponsor organization, the Federal Reserve Bank of New York.

Market issues requiring Committee attention often emerge at the group's regular meetings. The Committee sets an agenda for each meeting that encourages extensive discussion of both market and industry developments. Members air their views of recent events and may point out problems that could benefit from Committee consideration. Federal Reserve Bank of New York representatives frequently ask members for opinions on specific events or developments.

In 1999, the Committee began each meeting with a discussion of the conditions and outlook for the major currencies, including the euro, the dollar, and the yen. The euro elicited particular attention early in the year. At midyear, however, attention shifted to the Latin American currencies, particularly the Brazilian real. The outlook for the Asian economies was highlighted at the Committee's joint meeting with the Singapore Foreign Exchange Market Committee.

A discussion of industry developments usually followed the review of market-related developments. Members identified some industry developments that warranted special study by an ad hoc group and eventually, perhaps, a best practice recommendation. Members also noted developments that required monitoring. Industry issues that generated particular interest at the 1999 meetings are described below.

- **REGULATORY ISSUES**

  Throughout the year, the Committee received updates from the Financial Markets Lawyers Group (FMLG) on developments in Washington that might have an impact on the over-the-counter foreign exchange market. In response, the Committee provided letters and commentary to Congress and the Commodity Futures Trading Commission that explained the importance of excluding the foreign exchange market from unnecessary regulatory burden.

- **STEPS TO REDUCE SETTLEMENT RISK**

  At the regular February meeting and a special December meeting, representatives from CLS (Continuous Linked Settlement) Services briefed the Committee on their continuing progress in setting up a global multicurrency settlement bank. The Committee supported

CLS efforts to provide better communication about their efforts within the industry. The Committee also monitored the developments surrounding the introduction of the contract for differences (CFD), a forward foreign exchange contract that settles differences in the contract value rather than principal amounts.

- **DISRUPTION EVENTS AND FORCE MAJEURE**

  At both the June and September meetings, the Committee reviewed the FMLG's proposals on force majeure. Committee members reached an agreement to publish best practice recommendations that limited the duration of waiting periods, clarified events covered by the force majeure provisions, and specified more precisely the party entitled to liquidate transactions.

REPORT OF WORKS IN PROGRESS

The Committee emphasized the importance of planning for Y2K in 1999 and devoted considerable effort to composing *Y2K: Best Practices in the Foreign Exchange Market* last October. The Committee also published new best practice guidelines for force majeure events in December. The guidelines resolved some of the important trading issues that had been extensively debated by members. The Committee also worked on a number of projects in 1999 that will continue into 2000:

- **BARRIER OPTIONS**

  A subgroup of the Committee, including representatives from thirteen institutions, agreed on a new set of best practices with respect to barrier options. In a second stage of the project, the working group will seek to standardize definitions and confirmations for the most commonly traded barrier options instruments.

- **CLS BANK**

  The Committee recognizes that the introduction of CLS (Continuous Linked Settlement) Bank is designed to bring major changes to the settlement and funding of foreign exchange. The Committee plans to monitor CLS's progress in setting up its new system and to focus specifically on assessing the system's impact on liquidity, third-party payments, and operational efficiencies. Finally, the Committee will support the interaction of CLS with the independent advisory groups set up in 1999.

- **NONDELIVERABLE FORWARDS**

  The Committee plans to provide further support to a project undertaken by the Emerging Markets Traders Association to improve documentation of nondeliverable forwards (NDFs). The Committee will participate in the project when needed.

- **LEGAL INITIATIVES**

  The Committee will support ongoing initiatives of the Financial Markets Lawyers Group, including the updating of netting opinions and the monitoring of legislative matters affecting the foreign exchange market. The Committee will also review the impact on the foreign exchange market of a proposed change in the timing of securities settlement to "T+1."

In addition, several new projects have been suggested for 2000. These include the following:

- **TRADING IN ONE NAME**

  The Committee plans to survey, for informational purposes, recent industry initiatives to trade in one legal name.

- **UPDATE OF THE COMMITTEE'S TRADING PRACTICE PAPER**

  The Committee intends to revise its paper on trading practice to incorporate current practices. The Committee hopes to distribute the updated version of the paper to a broad global group that includes small institutions and trading entities.

- **MONITORING OF E-COMMERCE ISSUES**

  The Committee plans to study the trading of foreign exchange on the Internet, particularly as it affects important market issues such as price discovery, transparency, and liquidity.

MEMBERSHIP SUBCOMMITTEE REPORT

The Membership Subcommittee, consisting of senior members of the Committee, selects new candidates for membership. It is the only standing subcommittee of the organization. The group is responsible for ensuring that the Committee operates efficiently. It orients new members and chooses administrative leaders such as the working group liaisons and the issue coordinators. The Subcommittee can also, if needed, recommend organizational changes to the Committee. A representative of the Federal Reserve Bank of New York serves as the chairman of this group.

The Subcommittee begins its membership deliberations for the upcoming year in September. In its initial review session, the Subcommittee first takes note of the current composition of the foreign exchange market. When considering new institutions and new members, the Subcommittee seeks to keep a balanced distribution that reflects the diverse interests of the marketplace.

The Subcommittee then reviews recommendations and requests for membership. It considers nominees who represent leading institutions and are well-respected members of the community. All prospective members must be associated with an institution that is actively involved in the foreign exchange market, and all must have a broad knowledge of the market. In addition, members must hold a senior position so that they may speak for their institutions and have sufficient stature in the market to ensure that their opinions and views will be well respected. All members are expected to participate actively in the work of the Committee, thus guaranteeing a strong collective effort. A complete list of 1999 and 2000 members, grouped by institutional category, appears at the end of this report.

MEETINGS OF THE COMMITTEE

The Committee held nine meetings in 1999. As in past years, six of the sessions were late afternoon meetings that began about 4 P.M. and were followed by a dinner. Various members of the Committee hosted these meetings. On two dates, March 4 and October 7, the Committee met for working luncheons. The final meeting of the year was a special session on the afternoon of December 6 that focused on two topics: Y2K liquidity issues and CLS Bank.

For the third consecutive year, the Committee's November meeting was a joint session with the Singapore Foreign Exchange Market Committee. In 1999, the Committee traveled to Singapore for the event.

The Committee is planning eight meetings in 2000, with a schedule similar to that for 1999. The joint session with the Singapore Foreign Exchange Market Committee is planned for November 2 in New York.

1999 Meetings

January 7

February 4

March 4

May 6

June 3

September 9

October 7

November 4

December 6

2000 Meeting Schedule

January 13

February 3

March 2

May 4

June 8

September 7

October 5

November 2

FOREIGN EXCHANGE COMMITTEE ASSIGNMENTS, 1999

Committee Chairman	*Paul Kimball*
Liaisons for the Working Groups[1]	
Operations Managers	*Adrian Fletcher*[2]
	Robert White
Risk Managers	*John Finigan*[3]
	Peter Gallant
Issue Coordinators for Trading Practices[4]	*David Puth*
	Jamie Thorsen
Membership Subcommittee[5]	*Dino Kos (Chairman)*
	John Finigan
	Don Lloyd
	David Puth
	William Rappolt[6]

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[1]When the Committee made some minor reconfigurations to its organization in 1997, it replaced standing subcommittees with "working groups." The intent was to enhance the effectiveness of the Committee by creating groups that could handle a variety of projects assigned by the Committee. The liaisons to these groups are members of the Committee who agree to attend the working group's sessions, provide guidance on Committee projects when needed, and facilitate communication between the working group and the Committee.

[2]Resigned September 1999.

[3]Resigned June 1999.

[4]Issue coordinators are responsible for alerting the Committee to important trading concerns or developments that appear to warrant the Committee's attention or review.

[5]The Membership Subcommittee is the only standing subcommittee. Its role in the organization is reviewed on page 21.

[6]Resigned February 1999.

FOREIGN EXCHANGE COMMITTEE ASSIGNMENTS, 2000

Committee Chairman	*Paul Kimball*
Liaisons	
Operations Managers Working Group	*Peter Mesrobian*
	Robert White
Risk Managers Working Group	*Peter Gallant*
Issue Coordinators for Trading Practices	*David Puth*
	Jamie Thorsen
Membership Subcommittee	*Dino Kos (Chairman)*
	David Puth
	Mark Snyder
	Michael Williams

RECOMMENDATIONS FOR REFORM OF THE COMMODITY EXCHANGE ACT

TRANSMITTAL LETTER

ACCOMPANYING RECOMMENDATIONS FOR REFORM OF THE COMMODITY EXCHANGE ACT

Honorable Thomas Ewing
Chairman, Subcommittee on Risk
Management and Specialty Crops
Committee on Agriculture
United States House of Representatives
Washington, D.C. 20515

May 18, 1999

Dear Chairman Ewing:

We appreciate your continuing commitment to modernization of the Commodity Exchange Act (CEA) and the opportunity to participate in your CEA Working Group on April 28, 1999. At the conclusion of the meeting, you asked all participants to provide you with written materials on the subjects discussed. This letter and the enclosed memorandum respond to your request.

As we emphasized during the working group discussion, CEA reform is critical in order to enhance competition in the U.S. market and abroad and to ensure the availability of a broad range of risk management tools to U.S. businesses and government agencies. This requires a modernized CEA that provides legal and regulatory certainty for financial contracts, reduces unnecessary regulatory burdens on the futures exchanges, and fosters financial innovation. We are committed to working with the Congress, the relevant regulatory agencies, and others in the private sector to achieve these objectives.

One subject discussed at the working group meeting was the proposal for CEA reform submitted by the Chicago Board of Trade (CBOT) and the Chicago Mercantile Exchange (CME). That proposal contains some features on which there is broad consensus, including the need to provide legal certainty that over-the-counter derivatives are not subject to the CEA and the need to reduce the regulatory burdens on the futures exchanges. We are concerned, however, that the CBOT-CME proposal seeks to achieve these goals within a framework that we believe will inevitably lead to unnecessary and burdensome regulation of additional categories of financial transactions and additional categories of participants in those transactions. We are also concerned that the CBOT-CME

proposal may well create a new round of legal and regulatory uncertainties through repeal of the Treasury Amendment and the introduction of new concepts to distinguish those transactions and participants that would be regulated under the CEA from those that would not be so regulated.

We intend the enclosed proposals for reform as constructive contributions to the dialogue on CEA reform and we look forward to the opportunity to explore them in greater detail with you and your congressional colleagues, as well as with other interested parties.

Very truly yours,

Ad Hoc Coalition of Commercial and Investment Banks

American Bankers Association

ABA Securities Association

Emerging Markets Traders Association

The Foreign Exchange Committee

Futures Industry Association

International Swaps and Derivatives Association

Securities Industry Association

The Bond Market Association

The Financial Services Roundtable

RECOMMENDATIONS FOR REFORM OF THE COMMODITY EXCHANGE ACT

MEMORANDUM OF MAY 18, 1999

PRINCIPLES FOR REFORM

The Commodity Exchange Act (CEA) should be modernized to provide legal and regulatory certainty for financial contracts, to encourage financial innovation, and to facilitate competition in the United States and abroad. A modernized CEA should foster efficient, liquid, and low-cost financial transactions.

Regulatory burdens that increase the cost or reduce the availability of essential risk management tools should be imposed only if Congress determines that other, less burdensome means, including market discipline, have not been effective in addressing the relevant public policy concerns.

U.S. businesses benefit when they are able to choose among different risk management tools, and the continued development of a diverse array of risk management tools will be enhanced by different regulatory approaches, including private regulation through market discipline.

APPROACH TO REFORM

The foregoing objectives can be achieved most effectively by recasting the CEA both to assure "bright line" legal certainty for all transactions and reduced regulatory burdens for all market participants. Such an approach could readily accommodate proposals to modernize exchange regulation and promote market innovation and legal certainty.

The widely shared goals of legal certainty for over-the-counter transactions and regulatory relief for the futures exchanges could also be achieved through such measures as the clarification of exclusions and targeted regulatory reforms. If Congress adopts an incremental approach to reform, we recommend that it pursue that approach in accordance with the recommendations set forth below.

OVERVIEW OF RECOMMENDED AMENDMENTS TO CEA

1. Excluded Transactions

A. Over-the-Counter Contracts

- The existing administrative exemption for swaps should be transformed into a statutory exclusion with modifications that incorporate more objective criteria for exclusion.

- In particular, it should be clarified that the exclusion applies to any category of principal-to-principal over-the-counter transaction, including transactions involving nonexempt securities, between eligible counterparties and contracts that are not part of a fungible class of instruments that are freely transferable without counterparty consent or subject to automatic rights of offset through transactions with third parties.

- It should also be clarified that otherwise qualified over-the-counter contracts do not become subject to regulation under the CEA merely because of the use of clearing and settlement arrangements to mitigate risk.

B. Hybrid Instruments

- Hybrid instruments that are predominantly securities or depository instruments should be excluded from regulation under the CEA.

- "Predominance" should be determined based on the Commodity Futures Trading Commission's existing exemption for hybrid instruments and statutory interpretation concerning hybrid instruments.

- The exclusion should apply equally to hybrid instruments involving nonexempt securities.

C. Treasury Amendment

- The Treasury Amendment should be retained and should be modified to clarify its original purpose. In particular, it should be clarified that the Treasury Amendment excludes all transactions involving the enumerated products that are not conducted on organized futures exchanges—whether or not the transactions are conducted on electronic trading facilities or are subject to clearing and settlement arrangements.

- Further clarification should also be provided with respect to the scope of products covered by the Treasury Amendment.

- Consideration should also be given to the need for additional legislative provisions to ensure a statutory remedy for fraud committed against retail market participants by bucket shops.

2. Electronic Trading

- An increasingly broad range of electronic facilities are available in the marketplace. Not all of these are trading systems. There is also a broad range of electronic trading systems.
- Some electronic trading systems are organized futures exchanges and should be regulated as such, recognizing that electronic trading provides inherent protections that reduce the need for regulation and offer an opportunity to reduce regulatory burdens.
- Electronic facilities that are not trading systems do not require regulation under the CEA and many electronic trading systems likewise do not require regulation under the CEA or under other statutory schemes.
- Some electronic trading systems should perhaps be subject to regulation, but regulation that is less extensive than that applicable to organized futures exchanges. It should be possible for these electronic trading systems to be regulated by agencies other than the Commodity Futures Trading Commission (the specific agency perhaps depending on whether the underlying is a security, interest rate product, physical commodity, etc., or on geographic location).

3. Clearing

Where oversight of clearing is appropriate, a U.S. regulator should be able to rely on the oversight performed by any other Group of Seven regulator and should not impose duplicative regulation or make preemptive assertions of jurisdiction.

4. Derivatives Dealers

There should be no regulation under the CEA for derivatives dealers.

5. Regulatory Relief for Organized Exchanges

Broad regulatory relief for the organized exchanges is desirable and should be provided to the maximum extent such relief is consistent with prudent public policy and does not jeopardize CEA reform.

6. Shad-Johnson Accord

Any amendments to the Shad-Johnson Accord permitting broader exchange trading of futures on nonexempt securities should be subject to the following principles:

- The appropriate role(s) of the Commodity Futures Trading Commission or the Securities and Exchange Commission should be defined by the bona fide policy issues raised by the specific activities.
- Such amendments must not jeopardize CEA reform.

TESTIMONY OF PAUL G. KIMBALL BEFORE THE HOUSE AGRICULTURE SUBCOMMITTEE ON RISK MANAGEMENT, RESEARCH, AND SPECIALTY CROPS

TESTIMONY OF PAUL G. KIMBALL BEFORE THE HOUSE AGRICULTURE SUBCOMMITTEE ON RISK MANAGEMENT, RESEARCH, AND SPECIALTY CROPS

MAY 20, 1999

Chairman Ewing and members of the Subcommittee, I am delighted to be here this morning to talk about the importance of the foreign exchange market in the context of your deliberations over the future of the Commodity Exchange Act and the Commodity Futures Trading Commission. I request that my entire written statement be included in the record, in case I have to abbreviate my remarks because of time constraints.

My name is Paul Kimball. I have been trading foreign exchange for almost twenty-five years, and I am currently a managing director of Morgan Stanley Dean Witter. The Foreign Exchange Committee, which I chair, was formed in 1978 under the sponsorship of the Federal Reserve Bank of New York and includes representatives of major international banks and brokers active in foreign exchange markets. We have decades of experience—not only in foreign exchange, but also in exchange-traded futures and other over-the-counter markets. In that vein I should note that I am on the board of directors of the Chicago Mercantile Exchange—and, moreover, that I am not the only member of the Foreign Exchange Committee to serve in such a capacity.

THE IMPORTANCE OF THE FOREIGN EXCHANGE MARKET FOR THE U.S. ECONOMY

Companies trade foreign exchange for a number of reasons. One simple example would be when industrial concerns, agricultural firms, and other corporations need to buy or sell foreign currency in order to buy or sell products abroad. For example, if a manufacturer of agricultural machinery or an exporter of wheat sells its goods in a foreign country, it will need to convert that foreign money into U.S. dollars in order to bring those profits back to the United States. The same company may need to pay employees or open an office abroad, which means that it may need to convert U.S. dollars into the currency of that foreign country where it is doing business.

A foreign exchange trade itself has three necessary stages that cannot be separated from one another. First, there is trade execution, which is the process by which companies bargain over prices for foreign exchange deals and actually strike a deal. Next, there are trade clearing and trade settlement, the processes by which companies arrange to pay what they owe each other as a result of their deals. Without one, you can't have the others.

Trading is global in scope. This is an astoundingly huge market: the equivalent of almost $1.5 *trillion* of foreign exchange is traded around the world *every day*. We have all admired the growth of the stock market over the past few years, but it is worth noting that in the United States alone, the size of foreign exchange turnover is seven times the size of the stock and bond markets combined.

I could continue to throw out large numbers, but the real story of foreign exchange is the way in which it helps U.S. companies, their employees, and consumers find a place in the worldwide marketplace. Being able to buy, sell, trade, and invest in foreign exchange helps

businesses—not just in New York, Chicago, and Los Angeles, but also in Peoria, Omaha, and Modesto—import, export, expand, employ workers, and compete. A freely functioning over-the-counter marketplace in foreign exchange has been essential to the U.S. economy and should be allowed to play an even greater role in the future.

COMPETITION AND INNOVATION IN THE FOREIGN EXCHANGE MARKET

If you think that a huge global market like foreign exchange is extremely competitive, then you are absolutely right. Competition is fierce, not only among the many financial institutions that deal in foreign exchange, but also among the centers for over-the-counter foreign exchange dealing that have prospered around the world. The United States is by no means the only game in town. Only 25 percent of the world's foreign exchange activity occurs in this country: London has a bigger share of the market than we do, and their lead actually keeps increasing. There are a host of other cities—Tokyo, Singapore, Hong Kong, and Frankfurt among them—that would love to increase their share of business at our expense.

As a result of the competition among foreign exchange firms and dealing centers, there has been a great deal of technological innovation in the way the foreign exchange business is conducted. I am talking about the trade execution, clearing, and settlement stages of a foreign exchange trade, which I mentioned before. Foreign exchange business that used to be transacted over the phone and on paper is now done by computer: it has revolutionized our business as much as personal computers have changed the way Americans do office work. As a result, trade execution, clearing, and settlement have become more seamless, more efficient, and less risky.

The use of automation in the foreign exchange market has also been the result of regulatory pressures by banking and securities regulators around the world, who are quite knowledgeable about the functioning of our business. For example, the Basel Supervisors Committee, which is composed of supervisors from leading industrialized countries—including the Federal Reserve, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation from the United States—has called upon our industry to make specific technological advances that reduce risks. Some of these techniques enable firms to reduce certain risks as much as 90 percent. In order to ensure the vigor and safety of the U.S. foreign exchange market in the future, the current regulatory environment that has fostered these initiatives must not be changed.

Competition and electronic execution, clearing, and settlement in foreign exchange have meant two things. First, they have made firms like mine deliver our services faster, better, cheaper, and safer for the businesses that use foreign exchange. That is obviously good news for U.S. companies that are dependent on this market. Second, competition makes foreign exchange dealers very wary of doing business in countries where any aspect of foreign exchange trading—especially the use of automation—has unnecessary regulatory burdens.

The over-the-counter foreign exchange market in the United States needs no additional regulation. Accordingly, this business will move overseas and become greatly diminished in the United States if greater regulatory burdens result from this Subcommittee's deliberations. I'll admit that this has strategic and financial implications for my firm and me. But more important, it means that foreign exchange trading would become more difficult and expensive for U.S. firms that need it to grow and compete. That would be bad for U.S. companies, bad for their employees and their communities, and bad for the U.S. economy.

SUPERVISION AND SELF-POLICING IN THE FOREIGN EXCHANGE MARKETS

The foreign exchange market is already subject to a great deal of effective external and internal regulation, which is another reason for the Subcommittee to avoid imposing new regulatory burdens on this business.

First, the vast preponderance of institutions that serve as dealers in the foreign exchange market are very sophisticated financial institutions regulated by any number of state and federal regulators in the United States. The Securities and Exchange Commission, the Federal Reserve, the Comptroller of the Currency—these are among the financial industry regulators that scrutinize trading activities like foreign exchange, depending on the legal entities firms like mine choose to use for this type of activity. Add to that mix the potent laws against fraud that exist at the federal and state levels, which guard

against dishonesty and unfair dealing in the professional market.

Finally, consider the many successful efforts at self-policing that institutions active in foreign exchange have initiated over the past twenty years. Those of us who make our livelihood in foreign exchange take our industry's reputation very seriously; we know that even one bad apple can spoil our record. The Foreign Exchange Committee and other similar groups have, for years, published best practice guides, alerts, and letters that have helped raise standards to a very high level.

The foreign exchange business in the United States has done a better job than even some very heavily government-regulated markets in maintaining the level of integrity with which we do our jobs. No wonder there has been an absence of serious scandals, lawsuits, and disruptions in the professional foreign exchange market. I believe that the effective supervisory oversight of most institutions in the foreign exchange market, combined with the standards that the industry has itself embraced, should be a model—rather than a target—for the Subcommittee to consider as it turns to the future of the Commodity Exchange Act.

VIEWS OF THE FOREIGN EXCHANGE COMMITTEE

Mr. Chairman, we have Congress to thank for the competitive, efficient, and effective over-the-counter foreign exchange market in the United States today. The reason is the enactment of the so-called Treasury Amendment in 1974, which sought to ensure that the Commodity Exchange Act would never interfere with or otherwise affect foreign exchange trading, except when it occurred on futures exchanges like the ones this Subcommittee oversees. The Treasury Amendment represented an insightful decision by Congress to allow the foreign exchange market to flourish and grow—and along with it, the U.S. businesses and consumers that benefit from this market. It was designed precisely to foster advances like those in electronic trading that I've mentioned today.

Our very important foreign exchange market depends on the Treasury Amendment, and because of that, we urge Congress to preserve the intent of the Treasury Amendment going forward. Congress should clarify the Treasury Amendment so that it fully excludes over-the-counter foreign exchange trading from the Commodity Exchange Act—including any elements of trade execution, clearing, and settlement that have or will become automated. In doing so, you can ensure that the innovation, efficiency, safeguards, and economic growth brought to this country by the professional foreign exchange market will continue.

You will notice that I just referred to what I called the "professional" foreign exchange market. By that, I mean foreign exchange trading that is done between entities that are big enough not to need special regulatory protection. The Foreign Exchange Committee feels strongly that the law *should* provide appropriate protections for victims of unregulated "bucket shops" that take advantage of small customers at the retail level.

I understand that Congress may feel pressure to impose new regulatory burdens on the over-the-counter foreign exchange market as a result of the regulatory burdens currently faced by futures exchanges. As an employee of a firm having operations regulated by the Commodity Futures Trading Commission, I know the burdens of the Commodity Exchange Act. But I hope you would agree that regulation for regulation's sake is never a good idea. Moreover, as I learned long before I became a foreign exchange trader or a member of the board of the Chicago Merc, two wrongs don't make a right.

Mr. Chairman and members of the Subcommittee, I deeply appreciate the opportunity to tell you more about what we have accomplished in the over-the-counter foreign exchange market and its importance to our economy. The Foreign Exchange Committee is honored to be included in a discussion of issues that have such tremendous significance for our economic future.

Y2K: BEST PRACTICES IN THE FOREIGN EXCHANGE MARKET

TRANSMITTAL LETTER

ACCOMPANYING *Y2K: BEST PRACTICES IN THE FOREIGN EXCHANGE MARKET*

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October 18, 1999

Dear Foreign Exchange Professional:

The Foreign Exchange Committee, joined by a number of international financial industry associations and committees in Australia, Canada, England, Japan, Singapore, and the United States, today issued guidelines designed to minimize confusion associated with any foreign exchange contracts (including options and swaps) that fail to settle as a result of Y2K-related events that affect clearing banks or central banks.

The recommended guidelines, known as *Y2K: Best Practices in the Foreign Exchange Market*, include background information, the terms of the best practice, general notes, and a statement as to how the best practice is to be used. In general, the best practice guidelines recommend a short waiting period after a Y2K event occurs that affects a clearing bank or a central bank. If the Y2K event is not remedied within the specified waiting period, the guidelines state that some or all affected transactions may be liquidated at then current market prices.

Parties are free to mutually agree to take actions other than those specified in this document. In addition, the guidelines do not apply to a failure to settle as a result of a Y2K problem within the systems of a party to a contract, a development that would be covered by the nonpayment provision of the applicable contract. Parties to transactions will retain the rights and remedies provided in their contractual arrangements. In particular, the best practice guidelines would not change credit provisions and defaults unrelated to Y2K events.

The guidelines reflect commercially reasonable standards for market participants and provide guidance to regulators and tribunals that may be asked to consider the actions of participants in the foreign exchange market if problems result from the millennium date change. It is anticipated that foreign exchange market participants both inside and outside of the United States will use the guidelines.

The guidelines were prepared for the Foreign Exchange Committee by a joint working group of the Financial Markets Lawyers Group and the Operations Managers Working Group. The Foreign Exchange Committee is sponsored by, but independent of, the Federal Reserve Bank of New York.

The Australian Financial Markets Association, the British Bankers' Association, the Canadian Foreign Exchange Committee, the Emerging Markets Traders Association, the International Swaps and Derivatives Association, and the Singapore Foreign Exchange Market Committee have joined in the issuance of this best practice document. In addition, ACI–the Financial Markets Association and the Tokyo Foreign Exchange Market Committee have endorsed these guidelines.

A copy of the best practice document is available at the Foreign Exchange Committee's web site at *http://www.ny.frb.org/fxc*.

Sincerely yours,

Paul Kimball
Chairman
The Foreign Exchange Committee

Y2K: BEST PRACTICES IN THE FOREIGN EXCHANGE MARKET

The Foreign Exchange Committee (sponsored by, but independent of, the Federal Reserve Bank of New York) is today issuing this document to set forth its view of the best practice to be followed in the foreign exchange market concerning the effect of certain Y2K events on foreign exchange contracts, options, and swaps (collectively, the "transactions"). The Australian Financial Markets Association, the British Bankers' Association, the Canadian Foreign Exchange Committee, the Emerging Markets Traders Association (EMTA), the International Swaps and Derivatives Association (ISDA) and the Singapore Foreign Exchange Market Committee are joining in the issuance of this best practice. (These associations and committees, together with the Foreign Exchange Committee, are referred to as the "associations.")

This best practice document reflects extensive review and comment and, in particular, considerable work by a joint working group (the "working group") of the Financial Markets Lawyers Group and the Operations Managers Working Group. The associations expect that this best practice will minimize the confusion associated with the failure to settle transactions by setting forth guidelines for market participants indicating how each should attempt to resolve these Y2K issues, should they arise.

The associations believe that this best practice reflects commercially reasonable standards for market participants and will provide guidance to regulators and courts considering the actions of participants in the foreign exchange market. The associations expect that, by following this best practice, market participants will maintain the basic economics of outstanding transactions as originally agreed by either settling transactions in accordance with their terms or providing for closeout of transactions at then current market prices.

Of course, parties to transactions still have the rights and remedies provided in their agreements. In particular, credit provisions and defaults unrelated to Y2K events are not affected by this best practice, and any rights and remedies in respect of such credit provisions and defaults are still enforceable notwithstanding that a Y2K event has also occurred.

The working group has also discussed this issue with associations of foreign exchange market participants (in addition to the associations cited above) outside of the United States. The Tokyo Foreign Exchange Market Committee has, as a result of these discussions, endorsed this best practice, and it is hoped that others will be endorsing this best practice in due course.

Set forth below are background information and the terms of the best practice that the associations recommend. This is followed by some general notes, and a statement indicating how this best practice is to be used.

In this best practice, the term "Y2K event" is defined as any event that results in an erroneous result caused by any computer software (a) incorrectly reading the date "01/01/00" or any day or year thereafter, (b) incorrectly identifying a date in the year 1999 or any day or year thereafter, and (c) any other computer error that is directly or indirectly related to (a) or (b) above.

BACKGROUND

In March 1999, the working group began considering the possible effect of Y2K on the foreign

exchange market. The working group reviewed a number of issues pertaining to Y2K generally and spent considerable time reviewing the specific issues that Y2K presents for the currency trading community. The working group also consulted with representatives of ISDA, EMTA, and the Global 2000 Coordinating Group who participated in this process.

The working group reviewed various scenarios that could arise as a result of the transition to the year 2000. The working group concluded that two scenarios were appropriately the subject of best practice guidelines, since they are events generally outside the control of an individual market participant yet will impact many (if not all) participants involved in the settlement of a particular currency. These are the occurrence, due to a Y2K event, of (1) the failure of a clearing bank to clear some or all transactions, or (2) the failure of a central bank to effect transfers of its local currency. The working group did not believe that it was necessary or appropriate to address a scenario involving the failure of a counterparty to deliver currency as a result of a Y2K event involving its own systems, since such failures should generally be within the control of the party and are best left to the bilateral contractual relationship between the parties to the transaction.

In some cases, the parties to a transaction have signed a master agreement that provides remedies for nonpayment of amounts when due under the transaction. Some of those master agreements also contain provisions that specify the rights of the parties if performance is impossible due to events beyond the control of the parties, or "force majeure." In some cases, transactions between the parties are not covered by a master agreement, and thus are covered by the applicable confirmation and by the law governing the transaction. These best practice guidelines are intended to apply whether or not the transactions between the parties are covered by a master agreement.

The working group began its discussion of best practices by examining contractual provisions in the widely used forms of master agreement. Ordinarily, a failure to make a payment when due is an event of default under the industry master agreements. In an event of default, the nondefaulting party has the right to close out all (but not less than all) transactions with the counterparty, performing the closeout calculations specified by the master agreement (see, for example, Section 5.1 of the International Foreign Exchange Master Agreement (IFEMA). While failure to make payments is normally deemed to be within the control of a party, the force majeure provisions of the master agreement (see, for example, Section 6.1 of IFEMA) are generally designed to apply where failure to make payment is beyond the control of the party owing payment. When a force majeure event has occurred, generally either party may require the closeout of affected currency obligations. Which party does the closeout calculations depends upon whether one or both parties is affected by the force majeure event. In sum, the remedy for nonpayment, whether or not within the control of the nonpaying party, is to close out affected transactions at their fair market value (although the scope of affected transactions to be closed out in the event of an ordinary payment default or a force majeure event may differ dramatically).

In determining best practices, the working group was mindful of several important factors: First, even a clearing bank or central bank that has taken extraordinary efforts to remediate the Y2K "bug" may experience short-term problems requiring further remediation. Such remediation efforts should be of short duration. Second, the longer a Y2K event continues without resolution, the longer its resolution is likely to take. Third, values in the capital markets change rapidly as a result of changing views of the direction of interest rates, and prices of currencies, commodities, and securities, as well as economic factors involving countries and market participants, and Y2K problems that last longer than a short duration may themselves have a significant effect on the market value of currencies, interest rates, and commodity and security prices. Fourth, two weeks is probably a reasonable period of time in which to change clearing banks. Finally, given the sophistication of most central banks, if a central bank cannot remediate a Y2K event in a short period of time, the likelihood of its recovering within a reasonable period of time is diminished.

The associations are hopeful that these best practice guidelines will promote legal certainty and reduce confusion in the market, and believe that the guidelines generally reflect the realities of the market as well as the requirements of applicable law.

Y2K BEST PRACTICE

Scenario 1: Clearing Bank Fails to Clear

This scenario covers the case in which a clearing bank, because of a Y2K event, fails to clear for one of the parties (the "affected party") to a transaction. In such an event, the recommended best practice for transactions between those parties is as follows:

1. After the failure to clear, there is a three-business-day waiting period to arrange a settlement or to determine whether the issue has resolved itself with no further action being necessary. If a payment under a transaction is due during the waiting period, the due date for that payment is deferred for three business days (so that, if the Y2K event is remedied, all deferred transactions do not settle on the same date).
2. If the Y2K event is not remedied by the close of business on the last business day of the waiting period, the other party (the "nonaffected party") has the right (but not the obligation) to liquidate any or all affected transactions between those parties that would have settled during the waiting period and that would settle within the interim liquidation period. "Interim liquidation period" means the shorter of (a) ten business days commencing on the first business day after the end of the waiting period, and (b) the period through (and including) the sunset date.
3. If the Y2K event is not remedied by the close of business on the last business day of the interim liquidation period, a nonaffected party has the right (but not the obligation) to liquidate any or all affected transactions between those parties.

Scenario 2: Central Bank Fails to Transfer Currency

This scenario covers the case in which a central bank, because of a Y2K event, fails to effect transfers of its local currency, whether or not that failure to pay involves the parties to the transaction covered by this best practice. In such event, the recommended best practice is as follows:

1. After the failure of a central bank to settle a payment in its local currency, there is a three-business-day waiting period for all transactions in that currency to determine whether the central bank resumes transfers of its currency. If a payment under a transaction is due during the waiting period, the due date for that payment is deferred for three business days (so that, if the Y2K event is remedied, all deferred transactions do not settle on the same date).
2. If the Y2K event is not remedied by the close of business on the last business day of the waiting period, either party has the right (but not the obligation) to liquidate any or all affected transactions between those parties.

GENERAL NOTES TO BEST PRACTICE

1. *Sunset date*. This best practice is not applicable to events occurring after January 31, 2000. It is expected that all relevant events will have manifested themselves by that date, and the associations do not want this best practice to remain in effect and potentially be applied (or arguably applied) to unintended factual situations.
2. *Business day and close of business*. For this purpose, business day would include days that would have been business days but for the Y2K event. Close of business is 5:00 p.m., local time, in the principal financial center for the currency in respect to which the Y2K event has occurred.
3. *Application of best practice*. Scenario 2 applies when a central bank fails to effect transfers of its local currency, whether or not the failure has affected a transaction involving the party who wishes to invoke this best practice and the counterparty to that transaction. This best practice is, in part, predicated on the doctrine of anticipatory breach of contract. Market participants may wish to consult with their own counsel as to the applicability to their own transactions of this best practice in general and, in particular, of the doctrine of anticipatory breach of contract or similar doctrines and rights (such as the right to demand adequate assurance of performance).
4. *Compensation for payments deferred during the waiting period*. Compensation for this deferral shall be at then current market rates as determined in a commercially reasonable manner by

the nonaffected party (in the case of Scenario 1) or the parties (in the case of Scenario 2).

5. *No obligation to liquidate*. This best practice would, to the extent noted above, grant the right to liquidate affected transactions, but the nonaffected party (in the case of Scenario 1) or the parties (in the case of Scenario 2) could always determine not to do so.

6. *Liquidation of less than all affected transactions*. The nonaffected party (in the case of Scenario 1) and the parties (in the case of Scenario 2) could elect to liquidate less than all transactions. However, in the case of Scenario 1, where only the nonaffected party has the right to liquidate, that party is expected to have a commercially reasonable basis to distinguish between those affected transactions it has determined to liquidate and those which it has determined not to liquidate (such as, by way of example and without limitation, by maturity, type of transaction, or perceived credit or market exposure).

7. *Payments under affected transaction*. Once a currency is not deliverable because of a Y2K event, the other currency under those transactions need not be delivered. The parties will rely on their existing contractual rights if a party has paid the other currency under those transactions.

8. *Force majeure events*. If an event is both a Y2K event and a force majeure event under any agreement issued by the FX Committee or ISDA, the associations intend that, until the sunset date, that event be treated as a Y2K event and, after the sunset date, as a force majeure event.

9. *Affected transactions*. Affected transactions include any transaction involving the receipt or delivery of payment in a currency in respect of which the respective Y2K event has occurred, including, without limitation, nondeliverable transactions that settle in that currency.

USE OF THIS BEST PRACTICE

The associations recognize that each market participant retains the freedom to include or exclude particular provisions from some or all of its master agreements or other agreements and to negotiate whatever terms it deems appropriate with each of its counterparts. However, transactions are generally entered into under New York, English, or Japanese law, all of which imply a covenant of good faith and fair dealing.

The associations are releasing this best practice in order to provide guidance as market participants try to comply with their obligations of good faith, by setting forth commercially reasonable standards and trade practices for these specific Y2K events.

The associations are presenting this best practice to the foreign exchange market with the hope and expectation that it will reflect and help strengthen fair dealing in this market and facilitate the maintenance of an orderly market during times of crisis.

FOREIGN EXCHANGE TRANSACTION PROCESSING: EXECUTION-TO-SETTLEMENT RECOMMENDATIONS FOR NONDEALER PARTICIPANTS

TRANSMITTAL LETTER

ACCOMPANYING *FOREIGN EXCHANGE TRANSACTION PROCESSING: EXECUTION-TO-SETTLEMENT RECOMMENDATIONS FOR NONDEALER PARTICIPANTS*

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October 27, 1999

Dear Foreign Exchange Professional:

Enclosed you will find “Foreign Exchange Transaction Processing: Execution-to-Settlement Recommendations for Nondealer Participants,” a new pamphlet from the Operations Managers Working Group of the Foreign Exchange Committee.

The pamphlet highlights sixteen operations-related topics and issues that a business may want to review before transacting in the foreign exchange market. Each issue includes a list of related risks as well as recommendations (also referred to as “best practices”) that could help minimize the noted risks.

The recommendations were drawn from the experiences of a variety of dealers on the Committee that have been active in the foreign exchange market. As you will note, the paper concludes with a bibliography listing other Committee publications that may provide additional insight into many of the issues raised in the paper. We hope you find this document useful.

We would also like to remind you that this and other Committee publications are available on our website at *www.ny.frb.org/fxc*. We encourage you to visit the site on a regular basis to view recent announcements and publications.

Please do not hesitate to contact me or other members of the Committee if you have questions or comments regarding this paper or other publications of the Foreign Exchange Committee.

Sincerely yours,

Paul Kimball
Chairman
The Foreign Exchange Committee

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FOREIGN EXCHANGE TRANSACTION PROCESSING: EXECUTION-TO-SETTLEMENT RECOMMENDATIONS FOR NONDEALER PARTICIPANTS

Once a foreign exchange trade is executed between two institutions, a three-step process unfolds:

- First, each participant's front office system captures the trade.
- Second, the trade is recorded and confirmed.
- Third, the trade is settled to each participant's satisfaction.

Much effort has been made in the past to regularize and perfect this process among dealer institutions.

Recent statistics from the Bank for International Settlements estimate the average daily volume of transactions in the global foreign exchange market to be valued at $1.5 trillion. If even a small percentage of these trades fail to settle correctly, the economic cost to the affected market participants would be considerable.

The purpose of this paper is to share the experiences of financial institutions (those firms that are most active in the huge foreign exchange market) with nondealer participants (the businesses that may participate in the foreign exchange market on a more occasional basis). We highlight sixteen issues that are meant to heighten risk awareness for nondealers and provide "best practice" options or recommendations.

The bibliography at the end of this paper cites publications that provide additional insight into some of the issues raised in this paper. As the bibliography demonstrates, the Foreign Exchange Committee has on several occasions issued best practices guidelines for trade processing to the industry in general. (Copies of these papers may be viewed on-line or downloaded from the Foreign Exchange Committee's web site at www.ny.frb. org/fxc.)

Although the emphasis of this paper is on transactions with nondealer participants, the recommendations are equally applicable to any transactions involving dealer participants. We hope that the implementation of these recommendations by both dealer and nondealer participants alike will work to reduce risk and increase efficiency within the foreign exchange market.

RECOMMENDATIONS

Counterparty Identification

Issue: Nondealer participants should aim to clearly identify the legal entity on whose behalf they are making the transaction.

The issue becomes complex when

- the organization has multiple legal entities (subsidiaries, branches, offices, and affiliates) that are trading in the foreign exchange market;
- employees adopt casual use of marketing nomenclature, for example, in identifying themselves;
- the organization has been subject to recent acquisitions or restructuring that has led to name changes;
- participants are transacting in an agency capacity; or
- trades are allocated to different underlying accounts.

Risks: Failure to properly identify a nondealer participant can lead to

- incorrect assessment of the credit risk by the dealer counterparty;
- erroneous bookings and/or misdirected settlements, creating potential losses for either counterparty to the transaction; or
- misallocation of collateral.

Recommendation: Each counterparty to a transaction should make sure its organization recognizes the importance of clear identification. All organizations should also understand the expediency of accurately specifying, at the time of transaction, the legal entity on whose behalf they are acting.

Capacity/Authority

Issue: A dealer or nondealer may wish to inquire whether a counterparty or an individual acting for a counterparty has the capacity and/or authority to enter into a dealing relationship or transaction.

Risks: A dealer or nondealer may feel that dealing entails legal risk and/or potential financial loss when evidence of a counterparty's capacity to enter into trades or evidence of the authority of a trader acting for a counterparty is absent.

Recommendation: A dealer's or nondealer's standards regarding evidence of capacity and authority should be communicated clearly within a firm so that operations, legal, and compliance staff understand their responsibilities. Staff should know who is to collect any required documentation from a counterparty and who is to review either solicited or unsolicited documentation regarding authority and capacity. All institutions should try to respond to a counterparty's request for proof of capacity and authority.

Segregation of Duties

Issue: Nondealer participants should avoid a situation in which individuals who transact and confirm trades also perform trade (accounting and general ledger) reconciliation.

Risks: When trading duties are not segregated, the potential for fraud may increase. For instance, an individual who both transacts trades and performs trade reconciliation is in a position to hide trades and any resultant losses.

Recommendation: Duties of performing trade transactions, confirmations, and general ledger reconciliation should be separated. Firms with small treasury staffs and an overlap in employee responsibilities should set up a system of checks and balances. An example would be to require two-person approval on every transaction.

Timely Trade Entry

Issue: Trades should be recorded in a timely manner.

Risks: A delay in recording a trade could disrupt processing, including the communication of transaction information between counterparties, and could result in

- inaccurate accounting records,
- mismanagement of market risk,
- misdirected or failed settlement, and
- the failure of a trade to be booked at all.

Recommendation: All trades should be booked immediately after a transaction is entered into, and accounting records should be updated as soon as possible.

Block-Trade Breakdown

Issue: Block trades transacted by agents should be allocated or "split" to individual obligor accounts on a timely basis.

Risks: The failure to allocate a block trade on a timely basis could result in increased credit, legal, and operational risk. Specifically, a delay in allocation hampers

- the allocation and management of credit exposure to the underlying client obligors (if the trade is allocated to a previously unidentified account, the delay prohibits credit analysis of the obligor entirely);
- the linking of counterparties to their respective credit exposures; and
- timely confirmation, which in turn interrupts the settlement process and, in extreme cases, may cause payment failures.

Recommendation: Block trades should be allocated and confirmed to individual obligor accounts as soon as possible. To minimize errors caused by

manual intervention, trade allocations should be provided electronically to the counterparty.

Trade Confirmation

Issue: Transactions need to be confirmed on a timely basis. If transactions are confirmed verbally, written or electronic confirmations should follow.

Risks: Trade discrepancies may go undetected when transactions are not confirmed on a timely basis. In addition, the incidence of error tends to increase when nonautomated confirms, or verbal confirmations, are not followed up with written or electronic confirmation. If a business lacks an independent means of confirmation, the resolution of trade discrepancies can be further hindered. Trade discrepancies can

- lead to disputes, disrupt the settlement process, and increase processing costs;
- result in failed trades;
- affect any underlying security settlement;
- lead to inaccurate accounting records; and
- result in the mismanagement of market risk, which can be especially costly during times of increased market volatility.

Recommendation: We make several recommendations regarding trade confirmations:

- All nondealer participants should have their own independent confirmation process.
- Transactions should be confirmed no later than twenty-four hours after the dealing date but preferably on the trade date.
- The preferred method of confirmation is electronic. Automated confirmation matches one party's trade details to its counterparty's trade details. It also minimizes manual error and is the most timely and efficient method because it requires no subsequent confirmation or manual check. Automation also reduces the potential for fraud.
- If trades are confirmed verbally, it is strongly recommended that the succeeding confirmation be sent electronically or in writing. In some instances, follow-up confirmation may be legally necessary to bind both parties to the trade. With verbal confirmations, most dealers employ recorded telephone lines. Nondealers may want to consider adopting this practice.
- Sending confirmation by fax requires extra diligence to ensure receipt by the correct counterparty. It should be noted that fraudulent fax messages can be sent. A faxed confirmation, however, is better than no confirmation.

Trade Confirmation of Forward Transactions

Issue: Forward transactions should be confirmed on a timely basis.

Risks: The risks outlined in the preceding section,"Trade Confirmation," also apply to forward transactions. In the case of forward transactions, however, the overall level of risk—including market risk—tends to be higher. The longer the term of the forward transaction, the greater the chance that applicable standing instructions may have changed.

Recommendation: In addition to the recommendations in the preceding section, we suggest

- that settlement instructions on forward transactions be reconfirmed two to five days before the settlement date, and
- that amended confirmations be sent promptly when changes in the original confirmation occur.

Timely Resolution of Confirmation Discrepancies

Issue: Discrepancies between a confirmation received by a nondealer participant and a dealer's own trade detail record should be brought to the dealer's attention in a timely manner.

Risks: Trade discrepancies not brought to the attention of a counterparty in a timely manner may

- disrupt the settlement process and increase processing costs,
- result in failed trades,
- affect an underlying security settlement,
- lead to inaccurate accounting records, and
- result in mismanagement of market risk, especially during times of increased market volatility.

Recommendation: Trade discrepancies should be brought to a counterparty's attention as soon as possible. Automated trade confirmation systems are strongly preferred; these systems can highlight discrepancies and mitigate potential problems.

Accurate/Complete Settlement Instructions

Issue: Always provide complete and accurate settlement instructions.

Risks: Incomplete or inaccurate settlement instructions may result in

- a disrupted settlement process,
- inflated processing and compensation costs;
- failed trade(s), and
- disruption of an underlying transaction.

Recommendation: Settlement instructions should clearly reference the following information:

- the recipient's account name, account address, and account number;
- the name of the receiving bank, a SWIFT/ISO address, and a branch identifier/short code; and
- the identity of any intermediary bank used by the recipient.

Exchange of Standing Settlement Instructions

Issue: Exchanging settlement instructions on a trade-by-trade basis should be avoided.

Risks: Exchanging settlement instructions solely on a trade-by-trade basis increases the chances for incorrect or incomplete settlement instructions. Even if settlement instructions are delivered correctly and completely, repetitious manual recording is inefficient, increases the cost of trade processing, and invites error. Also, the untimely delivery of settlement instructions delays the trade confirmation process. Incorrect, incomplete, erroneously recorded or untimely settlement instructions have the same impact as the risks outlined under "Timely Resolution of Confirmation Discrepancies."

Recommendation: To ensure that instructions are delivered successfully, we recommend that the parties adopt the following procedures:

- Standing settlement instructions should be exchanged whenever possible.
- An effective date should be included in the transmission of standing (or any settlement) instructions.
- All standing settlement instructions should be delivered electronically if possible and preferably through authenticated media. Electronic delivery minimizes manual error and is the most timely method of delivery. Using authenticated media reduces the potential for fraud. If settlement instructions cannot be delivered electronically, then they should be delivered in writing.
- Even with standard settlement instructions on file, staff should consider calling the counterparty to confirm the accuracy of the settlement information.

Third-Party Payments

Issue: Third-party payments are extremely risky transactions. In the event that a dealer has agreed to process such a transaction, the nondealer's settlement instructions may direct payment to a third party that is legally unrelated to the nondealer.

Risks: Third-party payments contain an extremely high degree of legal risk. Such payments impose additional obligations and potential legal liability on the party making the payment. If the third-party payment is directed to an incorrect beneficiary, the payment may be delayed or even lost.

Recommendation: Third-party payments should be avoided whenever possible. If a dealer agrees to process a third-party payment, the nondealer should provide as much information as possible (for example, the third-party account's name, address, account number) to satisfy the dealer making the payment. Also, third-party payment instructions should be provided electronically or in writing, and they should be verified prior to settlement.

Netting

Issue: Transaction payments should be netted when possible and gross transaction settlements should be avoided.

Risks: Settlement on a gross basis not only increases the actual number of settlements that are necessary but also raises settlement risk and the likelihood of error. A netting agreement has the benefit of entitling parties to reduce the number and size of payments.

Netting should be implemented with the legal protection of a netting agreement. Without a full netting agreement, a party contemplating closeout netting may be at risk if the other party approaches insol-

vency. The insolvency of a party could result in the counterparty's loss of its entire gross payment amount.

Recommendation: It is strongly recommended that parties engage in netting by

- entering into standard netting agreements that are legally enforceable in the event of insolvency or bankruptcy, and
- encouraging counterparties to automate the actual netting calculation so that errors introduced by manual calculation are reduced.

Confirmation of Bilateral Amounts

Issue: When counterparties have entered into a netting agreement, they should be certain the transactions can be netted.

Risks: Parties that do not correctly identify and confirm contracts that can be netted may risk

- exchanging incorrect settlement payments, which could boost processing and compensation costs;
- including contracts that may not be netted, resulting in incorrect settlement calculations and, in some cases, artificially reduced settlement exposure; and
- excluding contracts that could be netted, thereby missing the opportunity to reduce settlement risk. Such exclusion might inflate settlement exposure and could restrict business between the parties given applicable settlement limits.

Recommendation: Netted trades should be confirmed individually on the date of the trade, and net settlement amounts should be confirmed no later than one day prior to settlement. Parties should establish cutoff times for confirming bilateral netted amounts. Such deadlines will ensure that parties agree on which transactions are included in the net amounts.

Timely Account Reconciliation

Issue: Account reconciliation—the process of comparing expected and actual cash movements—should be performed in a timely manner.

Risks: Failure to reconcile expected and actual cash movements could result in an inability to recognize an underfunding of transactions and/or an overdraft to the cash account. On the one hand, when cash is used to overfund a position, opportunity costs for the counterparty rise because cash cannot be invested. On the other hand, overdraft charges may be imposed without the knowlege of the counterparty when positions are underfunded.

Recommendation: Expected cash flows should be reconciled against actual cash flows at the earliest possible date (in most cases no later than one day after settlement date).

Reporting of Payment Failures

Issue: Parties that do not receive payments should report the nonreceipt to their counterparty in a timely manner.

Risks: Parties that do not report nonreceipt of payment within a reasonable amount of time may prevent their institution from claiming full compensation from the counterparty.

Recommendation: All instances of nonreceipt of payment should be reported immediately to a counterparty's operations and/or trading units.

Compensation Claims

Issue: Parties that have failed to make a payment on a settlement date should arrange for proper value to be applied and should pay compensation costs.

Risks: The counterparty that has not received payment may risk covering the costs associated with nonpayment, including obtaining alternative funding on the settlement date (for example, interest costs associated with overdraft lines) and taking on the added expenses of processing and administering payment.

Recommendation: Compensation claims for nonreceipt, or late receipt of payment, should be made expeditiously. Parties may want to consider using the U.S. Council on International Banking's Interbank Compensation rules as a guide for approximate costs. Under these rules, compensation is calculated based on the dollar amount of payment multiplied by the number of days plus a $200 administrative fee. The administrative fee is meant to compensate a bank for its costs in adjusting value on a payment.

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NEW FORCE MAJEURE PROVISIONS FOR CURRENCY TRADING AGREEMENTS

USER'S GUIDE TO THE NEW PROVISIONS

TRANSMITTAL LETTER

ACCOMPANYING PROPOSED REVISIONS TO FORCE MAJEURE PROVISIONS IN STANDARD CURRENCY TRADING AGREEMENTS

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December 2, 1999

Dear Foreign Exchange Professional:

The Foreign Exchange Committee today published recommended revisions to the Force Majeure, Act of State, Illegality and Impossibility Section of the International Foreign Exchange Master Agreement (IFEMA), the International Foreign Exchange and Options Master Agreement (FEOMA), and the International Currency Options Market Master Agreement (ICOM). The new provisions are accompanied by a user's guide and a form of contractual amendment that counterparties can execute if they wish the new provisions to apply to their agreements.

The new provisions were drafted in response to a study by the Financial Markets Lawyers Group that examined the operation of the agreements in connection with disruptions in various international financial and currency markets. During the drafting process, the subcommittee in charge of the project received extensive comment from representatives of a large group of commercial and investment banks and representatives of the Emerging Markets Traders Association (EMTA) and the International Swaps and Derivatives Association (ISDA).

The new provisions are designed to reflect current market practice and to minimize the inconsistencies in various industry documents that could result in market participants' taking contradictory positions in times of market disruption. The new provisions are intended to increase the level of legal certainty and to reduce confusion in the markets. The Foreign Exchange Committee expects that the new provisions will help strengthen best practices and facilitate the maintenance of orderly markets during disruptions.

Compared with the force majeure provisions in the current agreements, the new provisions greatly shorten the waiting period before a party may liquidate affected transactions, clarify the types of events that are covered, and more precisely specify the party or parties entitled to liquidate transactions and perform the necessary calculations.

Under the new provisions, if a force majeure event occurs in a particular currency, there is a waiting period of three business days during which neither party can liquidate transactions. After the waiting period ends, some or all transactions in that currency covered by an agreement may be liquidated at then current market prices, even if the date on which the transactions were to settle is months or years in the future. Of course, parties must mutually

agree to amend their existing documentation to adopt the new provisions, and they can also mutually agree to take actions other than those specified in the new provisions.

The Foreign Exchange Committee believes that the new provisions and related materials will be useful generally in the international derivatives markets, and understands that ISDA is now also studying these issues.

The new provisions, user's guide, and form of amendment are available at the Foreign Exchange Committee's web site: *http://www.ny.frb.org/fxc*. The new provisions are not related to the Foreign Exchange Committee's document "Y2K: Best Practices in the Foreign Exchange Market," which can also be accessed on the Committee's web site.

Sincerely yours,

Paul Kimball
Chairman
The Foreign Exchange Committee

NEW FORCE MAJEURE PROVISIONS FOR CURRENCY TRADING AGREEMENTS

IFEMA

Section 6. Force Majeure, Act of State, Illegality and Impossibility

6.1 *Liquidation Rights*. If a force majeure event occurs and is still in effect, then (but subject to Section 6.2) either party may, by notice to the other party on any day or days after the waiting period expires, require the closeout and liquidation of the currency obligations under any or all of the affected transactions in accordance with the provisions of Section 5.1 and, for such purposes, the party unaffected by such force majeure event shall perform the calculation required under Section 5.1 as if it were the non-defaulting party (or, if both parties are affected parties, both parties shall so calculate in respect of all affected transactions which either party determines to liquidate and the average of the amounts so determined shall be the relevant amount in respect of each affected transaction, except that if a party fails to so determine an amount, the amount determined by the other party shall govern). If a party elects to so liquidate less than all affected transactions, it may liquidate additional affected transactions on a later day or days if the relevant force majeure event is still in effect.

6.2 *Waiting Period.* If the value date of an FX transaction which is an affected transaction under Section 6.1 falls during the waiting period of the relevant force majeure event, then such value date will be deferred to the first business day (or the first day which, but for such event, would have been a business day) after the end of that waiting period (or, in the case of split settlement, the first local banking day or the first day which, but for such event, would have been a local banking day, after the end of the waiting period). Compensation for this deferral shall be at then current market rates as determined in a commercially reasonable manner by the calculating party or parties under Section 6.1.

6.3 *Notice by Affected Party*. If a force majeure event has occurred, an affected party shall promptly give notice thereof to the other party.

6.4 *Force Majeure Event and Event of Default.* Nothing in this Section 6 shall be taken as indicating that the party treated as the defaulting party for the purpose of calculations required by Section 5.1 has committed any breach or default. If an event occurs that would otherwise constitute both a force majeure event and an event of default, that event will be treated as a force majeure event and will not constitute an event of default.

Also add the following definitions:

"Force Majeure Event," on any day determined as if such day were a value date of an FX transaction (even if it is not), means (i) either party, by reason of force majeure or act of state, is prevented from or hindered or delayed in delivering or receiving, or it is impossible to deliver or receive, any currency in respect of a currency obligation, and which event is beyond the control of such party and which such party, with reasonable diligence, cannot overcome, or (ii) it is unlawful for either party to deliver or receive a payment of any currency in respect of a

currency obligation. A party whose delivery or receipt of currency has been or would be so prevented, hindered or delayed or made unlawful or impossible is an "affected party," and an FX transaction under which performance has been or would be so prevented, hindered or delayed or made unlawful or impossible is an "affected transaction," unless the parties have expressly agreed in an agreement, another writing or in regard to a particular FX transaction that other disruption events or disruption fallbacks will apply to that FX transaction; in such event, that FX transaction will be subject to such disruption events or disruption fallbacks as the parties have otherwise agreed.

"Waiting Period," in respect of a force majeure event, means the first three days after such event occurs which are business days or which, but for such event, would have been business days.

FEOMA

Section 9. Force Majeure, Act of State, Illegality and Impossibility

9.1 *Liquidation Rights.* If a force majeure event occurs and is still in effect, then (but subject to Section 9.2) either party may, by notice to the other party on any day or days after the waiting period expires, require the closeout and liquidation of the currency obligations under any or all of the affected transactions in accordance with the provisions of Section 8.1 and, for such purposes, the party unaffected by such force majeure event shall perform the calculation required under Section 8.1 as if it were the non-defaulting party (or, if both parties are affected parties, both parties shall so calculate in respect of all affected transactions which either party determines to liquidate and the average of the amounts so determined shall be the relevant amount in respect of each affected transaction, except that if a party fails to so determine an amount, the amount determined by the other party shall govern). If a party elects to so liquidate less than all affected transactions, it may liquidate additional affected transactions on a later day or days if the relevant force majeure event is still in effect.

9.2 *Waiting Period.* If the value date of an FX transaction, or the settlement date of an option, which is an affected transaction, under Section 9.1 falls during the waiting period of the relevant force majeure event, then such value date or settlement date (as applicable) will be deferred to the first business day (or the first day which, but for such event, would have been a business day) after the end of that waiting period (or, in the case of split settlement, the first local banking day or the first day which, but for such event, would have been a local banking day, after the end of the waiting period). Compensation for this deferral shall be at then current market rates as determined in a commercially reasonable manner by the calculating party or parties under Section 9.

9.3 *Notice by Affected Party.* If a force majeure event has occurred, an affected party shall promptly give notice thereof to the other party.

9.4 *Force Majeure Event and Event of Default.* Nothing in this Section 9 shall be taken as indicating that the party treated as the defaulting party for the purpose of calculations required by Section 8.1 has committed any breach or default. If an event occurs that would otherwise constitute both a force majeure event and an event of default, that event will be treated as a force majeure event and will not constitute an event of default.

Also add the following definitions:

"Force Majeure Event," on any day determined as if such day were a value date of an FX transaction or the settlement date of an option (even if it is not), means (i) either party, by reason of force majeure or act of state, is prevented from or hindered or delayed in delivering or receiving, or it is impossible to deliver or receive, any currency in respect of a currency obligation or option, and which event is beyond the control of such party and which such party, with reasonable diligence, cannot overcome, or (ii) it is unlawful for either party to deliver or receive a payment of any currency in respect of a currency obligation or option. A party whose delivery or receipt of currency has been or would be so prevented, hindered or delayed or made unlawful or impossible is an "affected party," and an FX transaction or option under which performance has been or

would be so prevented, hindered or delayed or made unlawful or impossible is an "affected transaction," unless the parties have expressly agreed in an agreement, another writing or in regard to a particular FX transaction or option that other disruption events or disruption fallbacks will apply to that FX transaction or option; in such event, that FX transaction or option will be subject to such disruption events or disruption fallbacks as the parties have otherwise agreed.

"Waiting Period," in respect of a force majeure event, means the first three days after such event occurs which are business days or which, but for such event, would have been business days.

ICOM

Section 9. Force Majeure, Act of State, Illegality and Impossibility

9.1 *Liquidation Rights.* If a force majeure event occurs and is still in effect, then (but subject to Section 9.2) either party may, by notice to the other party on any day or days after the waiting period expires, require the closeout and liquidation of any or all of the affected options in accordance with the provisions of Section 8.1 and, for such purposes, the party unaffected by such force majeure event shall perform the calculation required under Section 8.1 as if it were the nondefaulting party (or, if both parties are affected parties, both parties shall so calculate in respect of all affected options which either party determines to liquidate and the average of the amounts so determined shall be the relevant amount in respect of each affected option, except that if a party fails to so determine an amount, the amount determined by the other party shall govern). If a party elects to so liquidate less than all affected options, it may liquidate additional affected options on a later day or days if the relevant force majeure event is still in effect.

9.2 *Waiting Period.* If the settlement date of an option which is an affected option under Section 9.1 falls during the waiting period of the relevant force majeure event, then such settlement date will be deferred to the first business day (or the first day which, but for such event, would have been a business day) after the end of that waiting period. Compensation for this deferral shall be at then current market rates as determined in a commercially reasonable manner by the calculating party or parties under Section 9.1.

9.3 *Notice by Affected Party.* If a force majeure event has occurred, an affected party shall promptly give notice thereof to the other party.

9.4 *Force Majeure Event and Event of Default.* Nothing in this Section 9 shall be taken as indicating that the party treated as the defaulting party for the purpose of calculations required by Section 8.1 has committed any breach or default. If an event occurs that would otherwise constitute both a force majeure event and an event of default, that event will be treated as a force majeure event and will not constitute an event of default.

Also add the following definitions:

"Force Majeure Event," on any day determined as if such day were the settlement date of an option (even if it is not), means (i) either party, by reason of force majeure or act of state, is prevented from or hindered or delayed in delivering or receiving, or it is impossible to deliver or receive, any currency in respect of an option, and which event is beyond the control of such party and which such party, with reasonable diligence, cannot overcome, or (ii) it is unlawful for either party to deliver or receive a payment of any currency in respect of an option. A party whose delivery or receipt of currency has been or would be so prevented, hindered or delayed or made unlawful or impossible is an "affected party," and an option under which performance has been or would be so prevented, hindered or delayed or made unlawful or impossible is an "affected option," unless the parties have expressly agreed in an agreement, another writing or in regard to a particular option that other disruption events or disruption fallbacks will apply to that option; in such event, that option will be subject to such disruption events or disruption fallbacks as the parties have otherwise agreed.

"Waiting Period," in respect of a force majeure event, means the first three days after such event occurs which are business days or which, but for such event, would have been business days.

FORCE MAJEURE: USER'S GUIDE TO THE NEW PROVISIONS

This user's guide is released by the Foreign Exchange Committee to accompany revisions published by the Committee on this date (the "new provisions") to the Force Majeure, Act of State, Illegality and Impossibility Section ("force majeure provision") of the International Foreign Exchange Master Agreement (IFEMA), International Foreign Exchange and Options Master Agreement (FEOMA) and International Currency Options Market Master Agreement (ICOM and, collectively with IFEMA and FEOMA, the "agreements"), previously issued by the Committee in association with the British Bankers' Association, the Canadian Foreign Exchange Committee, and the Tokyo Foreign Exchange Market Practices Committee. This user's guide will provide background and other information to assist foreign exchange market participants in implementing the new provisions. The new provisions and this user's guide are not intended to interpret or define the scope of the agreements as now in effect.

BACKGROUND

In May 1998, in the wake of crises in various international financial and currency markets, the Committee's Financial Markets Lawyers Group formed a subcommittee to consider these events. In particular, the subcommittee was charged with considering whether, in the event of major market dislocations, the force majeure provisions of the agreements and other existing industry standard documentation would lead to a market-responsive result that was appropriate from a risk management perspective. The subcommittee received extensive comment from, and held meetings with, representatives of a large group of commercial and investment banks. In addition, nonvoting representatives of the International Swaps and Derivatives Association (ISDA), the Emerging Markets Traders Association (EMTA) and the Federal Reserve Bank of New York participated in this process.

PRELIMINARY CONCLUSIONS

The first conclusion of the subcommittee was that, in the event of the occurrence of an impossibility, illegality, or other force majeure event, the results under the agreements, as well as under other standard industry documentation such as the ISDA Master Agreement and relevant ISDA definitions, were not always consistent and did not appear to reflect current market practices or market needs. There also appeared to be some disagreement over how to interpret certain key terms of these documents. The subcommittee was concerned that these inconsistencies could cause market participants to take contradictory positions in times of market difficulty, leading to a reduced level of legal certainty and increased confusion in the market. Although the subcommittee members were aware that, in the wake of last year's disruptions, quick, decisive, and generally consistent action by market participants had prevented potentially destabilizing market reactions, the subcommittee as a whole was concerned that the result could be different in the future.

The subcommittee determined that the best way to achieve the goals the Committee had set for it would be to draft revised provisions that would address current market practice and needs. After consultation with the Committee, the subcommittee prepared the new provisions. The Committee believes the new provisions will provide guidance to the foreign

exchange market on current best practices and respond to a perceived need to revise the force majeure provisions of the Committee's agreements.

USE OF THE NEW PROVISIONS

The subcommittee recognizes that each market participant retains the freedom to include or exclude particular provisions from some or all of its agreements and to negotiate whatever terms it deems appropriate with each of its counterparts. Accordingly, the new provisions will apply only to the extent that market participants choose to include them in new agreements or to amend existing agreements to replace current force majeure provisions with the new provisions. Nonetheless, because the Committee believes that the new provisions both reflect and promote best practice in the market, it expects that the new provisions will be used by many market participants.

The new provisions are designed to be amendments to the agreements and, as such, are generally intended to apply to deliverable foreign exchange transactions and options ("transactions"). Parties can, of course, elect to apply the new provisions to nondeliverable transactions. In addition, if the parties to an agreement are entering into nondeliverable transactions under that agreement, or using a comparable provision in an ISDA schedule, then any nondeliverable transaction governed by that agreement or by the ISDA Master Agreement would be covered by the new provisions. If the parties would prefer that specific disruption events—such as those cited in the 1998 ISDA, EMTA, and Committee Foreign Exchange and Currency Option Definitions (the "1998 foreign exchange definitions")—apply to their nondeliverable transactions, they should so provide in the applicable documentation.

The subcommittee also notes that there will undoubtedly be transactions under which, to meet the specific needs of the parties, the parties choose to allocate risk and elect specific disruption fallbacks that provide for outcomes different from those set forth in the new provisions. Even if parties to one or more of the agreements have adopted the new provisions, they can still elect to apply specific disruption events and disruption fallbacks to one or more transactions. The subcommittee refers market participants to the 1998 foreign exchange definitions, which contain many helpful definitions and other provisions in this regard.

To enable parties to give effect to the new provisions under outstanding documentation, the Committee has also released a "Form of Amendment to Incorporate the New Force Majeure Provisions into the IFEMA/FEOMA/ICOM Agreements." This form may be executed as an amendment or addendum to the appropriate agreement. It may also be adapted for use with ISDA or other master agreements, such as versions of the IFEMA and ICOM agreements published prior to 1997. The form makes clear that the new provisions govern all transactions, unless (as discussed in the preceding paragraph) the parties agree upon specific disruption events or disruption fallbacks for one or more transactions.

In March 1998, in connection with the publication of the 1998 foreign exchange definitions, the Committee published the 1998 Foreign Exchange and Currency Option Definitions Addenda for the IFEMA, ICOM, and FEOMA agreements. If the parties to an agreement have executed such an addendum, it is effective as a "bridge agreement" for the 1998 foreign exchange definitions. If these parties also adopt the new provisions, they agree to reverse a presumption in the bridge agreement that, unless otherwise specified in the confirmation, certain disruption events and disruption fallbacks automatically apply to all transactions executed by the parties under the relevant IFEMA, FEOMA, or ICOM agreement. (See the Guide to the 1998 Foreign Exchange Definitions Addenda for further information.) The new provisions are intended to supersede this provision of the bridge agreement by requiring the parties to expressly agree (in a manner contemplated by the relevant agreement) if they wish to apply specific disruption events or disruption fallbacks to one or more of their transactions in lieu of the new provisions.

EXPLANATION OF THE NEW PROVISIONS

The new provisions include a proposed new Section 6 for the IFEMA agreement and a proposed new Section 9 for the FEOMA and ICOM agreements, which would replace these sections of the agreements as published in 1997 (the "1997 provisions"). The subcommittee understands that an ISDA committee is reviewing the same issues at this time.

The principal changes from the 1997 provisions are as follows:

Definition of Force Majeure Event

To provide a more precise statement of the types of events that trigger the rights under the revised master agreements, the new provisions define the term "force majeure event." In addition to being more exact than the 1997 provisions, the new provisions entail the following substantive changes:

1. *Events covered*. The new provisions, like the 1997 provisions, cover any force majeure, act of state, illegality, or impossibility event that has the specified effect based on the particular facts and circumstances of that event. However, the new provisions make clear that, for an event to be a force majeure event, it must be beyond the reasonable control of the affected party to overcome.
2. *Events that will affect transactions in the future.* Under the 1997 provisions, a triggering event is deemed to occur in advance of the day on which a transaction is to settle if a party has a good faith belief that a force majeure or other relevant event will occur. The subcommittee was of the view that one party's good faith belief about a future event was not a high enough standard to permit early termination of transactions. However, the subcommittee was also of the view that, once a force majeure event affecting a currency had occurred, all transactions in that currency should be subject to early liquidation, even if the date on which the transactions were to settle was months or years in the future. This concept is now incorporated into the definition of the term "force majeure event."
3. *Termination of less than all transactions.* Of course, even if a party has the right to liquidate all affected transactions, a party may elect not to do so. This is particularly true when the force majeure event is one generally referred to as an act of God (such as a fire, earthquake, flood, or other natural event), the effect of which reasonably can be expected to pass within a period of time. However, there may be other force majeure events in respect of which a party chooses not to liquidate all affected transactions immediately after the waiting period. In order to grant the parties reasonable flexibility should they determine not to liquidate all transactions, the new provisions clarify that any party that elects to liquidate only some transactions can liquidate additional transactions on any later day or days if the relevant force majeure event is still in effect.

Waiting Period

In the 1997 provisions, before a party can exercise its right to terminate and liquidate transactions affected by a relevant event, it may be required during a twenty-day waiting period to attempt to transfer its obligations to another office through which it can perform (that is, transfer or receive the affected currency). The ISDA Master Agreement has a similar provision for illegality, but the waiting period extends to thirty days. In either case, the Committee recognizes that the concept of an extended waiting period is inconsistent with the operation of today's global foreign exchange marketplace. As a result, the new provisions remove this concept from the agreements.

In its place, the new provisions establish a standard "waiting period" of three business days before affected transactions can be terminated as a result of a force majeure event. During the waiting period, the parties would be unable to take any action to terminate or liquidate affected transactions solely by reason of the occurrence of a force majeure event. The Committee believes that, in many cases, waiting three business days will allow the precipitating event to pass, thereby avoiding what might be an unnecessary and disruptive liquidation of a market. In formulating the new provisions, many participants pointed to the financial crisis in Indonesia as a case in which the immediate termination and liquidation of transactions would have proved to be premature and unnecessary. However, if the force majeure event does not pass by the end of the waiting period, the waiting period will allow the marketplace to prepare for an orderly termination and liquidation of affected transactions.

Definition of Business Day

The subcommittee wished to clarify whether a force majeure event could cause a day not to be a business day (thereby extending the waiting period). The new provisions specify that a business day includes any

day that, but for the force majeure event, would have been a business day. Accordingly, the occurrence of a force majeure event triggers, but does not affect the length of, the waiting period of three business days. (For example, December 31 would ordinarily be a business day since banks are generally open on that date unless it falls on a weekend; however, for 1999, it would not be a business day in any jurisdiction that announced significantly in advance of that date that it would be a banking holiday.)

Early Termination

If a force majeure event continues after the expiration of the waiting period, then the new provisions, in a manner similar to the 1997 provisions, grant each party the right (but not the obligation) to elect to liquidate any or all outstanding transactions involving the affected currency and to settle mark-to-market differences in U.S. dollars (or another unaffected currency), regardless of when the settlement date is scheduled to occur. As explained above, termination would apply to transactions involving the affected currency even when the settlement date for such transactions is several months or even years in the future.

The new provisions include one substantive change in this regard. Under the 1997 provisions, if both parties were affected by the relevant event, then the party that gave notice of the event made the necessary calculations. On consideration, the subcommittee did not view who gave notice as relevant to which party should calculate. In addition, this provision could result in a party's rushing to give notice at the first sign of a possible force majeure event in order to control the calculation, rather than waiting until the situation became clearer and, perhaps, resolved itself. The new provisions, by contrast, provide that if both parties are affected by the event, then both parties do the calculations in good faith, and the relevant amounts are the average of the calculations of the two parties. However, to avoid the situation in which one party elects to liquidate but the other refuses to provide the necessary calculations (even though this would clearly be a breach of the good faith requirement), the new provisions expressly state that if a party fails to so determine an amount, the amount determined by the other party shall govern.

If there is only one affected party, the new provisions and the 1997 provisions both specify that the nonaffected party performs the calculations. Although the new provisions permit liquidation of less than all affected transactions, the fact that only the nonaffected party performs the calculations when there is only one affected party should not present any concerns about "cherry picking"—that is, the possibility that the nonaffected party would liquidate those affected transactions favorable to it but not those which are unfavorable to it—because either party can elect which affected transactions are to be liquidated. Accordingly, if the nonaffected party elects to liquidate only some affected transactions, the affected party (even though it cannot perform the calculations) can determine that additional affected transactions are to be liquidated. It should be noted that cherry picking is generally a significant issue in the event of a party's insolvency, because the insolvent party could attempt to force performance of transactions favorable to it while rejecting or defaulting under transactions unfavorable to it, with damages to be paid at a fraction of full value. By contrast, when both parties are solvent, all obligations will eventually be satisfied (although in the interim, significant mark-to-market issues could arise).

The new provisions also make clear that it is the occurrence of a force majeure event, not notice of that event, that triggers the waiting period and any subsequent early termination of affected transactions.

It should be understood that at any time, including the waiting period, any two parties can agree to take an alternate action. It should also be understood that a party can still, of course, terminate and liquidate any transactions to the extent that its counterparty's failure to perform was not caused solely by a force majeure event (such as a bankruptcy or insolvency of a counterparty or its credit support provider, or a failure to provide adequate assurance or otherwise perform, even if caused, in part, by the force majeure event).

Treatment of an Event That Is Both a Force Majeure Event and an Event of Default

The subcommittee wished to avoid any confusion about the effect of an event that is both a force majeure event and an event of default. The new provisions make clear that such an event is treated as a force majeure event, not as an event of default. Of course, if an event occurs that is a force majeure event, and at the same time another event (other than the mere failure to make payment as a result of

that force majeure event) occurs that constitutes an event of default under an agreement (for example, if a party becomes bankrupt or insolvent, even if that bankruptcy or insolvency is caused by the force majeure event), that other event would be an event of default under that agreement.

The Committee is presenting the new provisions to the foreign exchange market with the expectation that they will reflect and help strengthen best practice in this market and facilitate the maintenance of an orderly market during times of crisis.

FORM OF AMENDMENT TO INCORPORATE THE NEW FORCE MAJEURE PROVISIONS IN THE IFEMA/FEOMA/ICOM AGREEMENTS

WHEREAS, ____________ and ____________ (the "Parties") have entered into one or more of the International Foreign Exchange Master Agreement ("IFEMA"), International Foreign Exchange and Options Master Agreement ("FEOMA") and International Currency Options Market Master Agreement ("ICOM" and, collectively with IFEMA and FEOMA, the "Agreements"), issued by The Foreign Exchange Committee of the Federal Reserve Bank of New York (the Committee) in association with The British Bankers' Association, The Canadian Foreign Exchange Committee and The Tokyo Foreign Exchange Market Practices Committee; and

WHEREAS, the FX Committee has issued amendments to the Agreements which revise Section 6 of IFEMA and Section 9 of FEOMA and ICOM, and the Parties wish to amend the Agreements between them to reflect these revisions and certain other matters as set forth below;

NOW, THEREFORE, the Parties agree as follow:

1. *Each Agreement between the Parties now in effect is hereby amended by (a) deleting Section 6 (if it is an IFEMA) and Section 9 (if it is a FEOMA or ICOM), (b) inserting in its place the replacement Section attached hereto, and (c) making the other changes in the Agreement that are reflected on the attachment.*
2. *Notwithstanding any provision of the 1998 ISDA, EMTA and FX Committee FX and Currency Option Definitions (the "1998 Definitions"), any "Bridge Agreement" incorporating the 1998 Definitions, or the fact that the 1998 Definitions apply to any Agreement or Transaction, Article 5 of the 1998 Definitions does not apply to any Agreement or Transaction unless (and then only to the extent that) the Parties expressly agree that Article 5 is to apply and, in such event, Article 5 shall apply only to the specific Transactions as to which the Parties have so agreed. [Add if the Parties have a Bridge Agreement in effect: To the extent this Amendment is inconsistent with any such Bridge Agreement, this Amendment supersedes and is expressly intended to amend such Bridge Agreement.]*
3. *"Transaction" means an FX Transaction, Option or any other transaction as defined in any Agreement. Except as amended hereby, each Agreement remains in full force and effect.*

   [NOTE: If the Parties wish to use this form to incorporate comparable provisions into an ISDA or other Master Agreement, the Parties should define Agreements to include any other relevant Agreement, and refer to the appropriate amendments in the second WHEREAS clause and in paragraph 2.]

___________________________________	___________________________________
[Name of party]	[Name of Party]
By:________________________________	By ________________________________
Name:	Name:
Title:	Title:

BARRIER OPTIONS:
NEW BEST PRACTICES

TRANSMITTAL LETTER

ACCOMPANYING *BARRIER OPTIONS: NEW BEST PRACTICES*

New York, NY 10045
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February 17, 2000

Dear Foreign Exchange Professional:

The Foreign Exchange Committee wishes to recommend to the foreign exchange community a new set of best practices for the barrier options market. These best practices, set forth in the attached document, have been compiled by a special working group composed of representatives from thirteen institutions (the Barrier Options Subcommittee). The intent of the group was to address the numerous differences in trading practices that have proved increasingly disruptive to the barrier options market.

To begin this effort, the working group distributed a survey eliciting information on current practices and institutional preferences in the market. The survey covered issues such as the best opening time in Sydney on Monday morning and the types of trades to trigger transactions. Twenty-three institutions responded to the survey.

The working group was encouraged by survey results indicating that market consensus was possible on a number of issues. In a series of meetings and conference calls held last summer, the group used the survey results as a basis for discussion and hammered out consensus agreement on many trading procedures.

The attached document incorporates new recommendations along with some of the Committee's existing best practices for barrier options. A few of the existing best practices were clarified to reflect market changes. The Foreign Exchange Committee endorsed this package of best practices at a meeting on October 7, 1999.

In the next stage of this project, the Committee is planning to publish a revision to the *International Currency Options Market Master Agreement User Guide* to reflect the new recommendations. In addition, the working group has begun efforts to incorporate these best practices into industry-acceptable barrier options confirmations.

If you have any questions or comments about the recommended best practices, please feel free to contact either myself or members of the Foreign Exchange Committee.

Sincerely yours,

Paul Kimball
Chairman
The Foreign Exchange Committee

BARRIER OPTIONS: NEW BEST PRACTICES

1. In each barrier option, the parties are expected to name a "barrier determination agent." If a dealer is a party to a barrier option with a non-dealer, the barrier determination agent should be the dealer. If both parties to a barrier option are dealers, the Barrier Options Subcommittee suggests that the barrier determination agent be the "nonaggressor," that is, the party who provided the price quotation for the option.
2. It is the responsibility of the barrier determination agent to determine in good faith and in a commercially reasonable manner whether a barrier has been breached. Transactions deemed to breach a barrier must meet a number of prerequisites:

   - They must be actual transactions in the foreign exchange markets, verifiable by the barrier determination agent in a timely manner.

   - In most circumstances, the information concerning actual transactions that is available from an electronic broker service is recognized as the most suitable source for determining whether a barrier has been breached.

   - Breaching transactions may include actual transactions obtained from a voice broker service and transactions between foreign exchange dealers, provided that the barrier determination agent can objectively verify such transactions in a timely manner.

   - Breaching transactions should not include transactions between parties who are not dealing at arm's length or who are otherwise not providing good-faith fair market prices.

   - Quotations, whether firm or indicative, obtained from a foreign exchange broker or dealer or a quotation screen or other information source that does not provide evidence of an actual transaction are not acceptable evidence that a barrier has been breached.

   - Transactions executed at off-market prices or, unless otherwise agreed by the parties, between affiliates (even if such transactions are entered into at arm's length and in good faith) are not evidence that a barrier has been breached.

   - Transactions must occur between 5:00 A.M. Sydney time on Monday and 5:00 P.M. New York time on Friday. The opening time in Sydney has been advanced by one hour from the Barrier Options Subcommittee's previous recommendation (of 6:00 A.M. Sydney time) because it is now recognized in the global financial markets that the Sydney spot market opens at 5:00 A.M. Sydney time.

   - Transactions must be of commercial size, but this amount will vary with such factors as the currency pair that is the subject of the transaction and the then-current level of liquidity for transactions in that currency pair. In liquid markets, dealers generally accept that commercial-size transactions are a minimum of $3 million (which could comprise two or more substantially contemporaneous transactions.) The barrier determination agent may, in its discretion, use transactions below $3 million in illiquid

markets or other extraordinary market circumstances.

- The barrier options determination agent may use cross-currency rates to determine whether a barrier has been breached in respect of a currency pair that is not commonly quoted. The barrier options determination agent should use two or more substantially contemporaneous transactions in the most liquid applicable currency pairs to calculate the cross rate. In those cases where more than three currencies are to be used to determine the cross rate, the Committee recommends that the parties agree in advance which currency pairs will be used to calculate such a rate.

- In line with current market practice, the working group recommends the elimination of the exercise time window unless parties specifically agree to use the window.

COMMITTEE LETTER

RESPONDING TO REGULATORY QUESTIONS RAISED BY THE SENATE COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY AND THE HOUSE AGRICULTURE COMMITTEE

The Honorable Richard O. Lugar
Chairman
Committee on Agriculture, Nutrition, and Forestry
Russell Senate Office Building
Washington, DC 20510

March 11, 1999

Dear Chairman Lugar:

The Foreign Exchange Committee (FX Committee) appreciates the opportunity to address in writing some of the questions jointly raised by the Senate Committee on Agriculture, Nutrition, and Forestry and the House Agriculture Committee. The FX Committee was formed in 1978 under the sponsorship of the Federal Reserve Bank of New York and includes representatives of major domestic and foreign commercial and investment banks and foreign exchange brokers. The FX Committee represents many of the most significant participants in foreign currency trading in the United States. The FX Committee's mission is to enhance knowledge and understanding of the foreign exchange and related international financial markets, foster improvements in the quality of risk management in these markets, and develop recommendations on specific market-related topics for circulation to market participants.

1. QUESTION 36:

What Public Policy Is Served by Excluding Certain Financial Products from the Commodity Exchange Act through the Provision Known as the Treasury Amendment? Are There Appropriate Reasons to Expand or Narrow the List of Products?

Before 1974, the Commodity Exchange Act (CEA) only regulated transactions in agricultural commodities. In that year, the CEA was amended to cover all commodities, including financial commodities. The so-called Treasury Amendment was added to the CEA at that time in order to unambiguously exclude certain financial products, such as foreign exchange transactions, from the scope of the CEA. This amendment was added for three reasons. First, these products had traditionally been traded in over-the-counter financial markets. Second, there was no perceived need to mandate that sales of these products for forward or future delivery be conducted on an exchange. Lastly, the participants in these markets were largely institutional and were not in need

of the protections of a CEA, designed to ensure that market participants such as farmers (who were generally individuals) were not subject to market manipulation and fraud. As is expressly stated in the letter dated July 30, 1974, from the Treasury Department's Acting General Counsel to the Chairman of the Senate Agriculture Committee (Treasury Letter), the Treasury Department "[felt] strongly that foreign currency futures trading, other than on an organized exchange, should not be regulated by the new agency." In the Treasury Letter, the Treasury Department cites various policy reasons why off-exchange trading of foreign currency futures should be allowed to continue without regulatory oversight, including the following: (i) the market has proved to be highly efficient in serving the needs of international business, (ii) market participants in the foreign exchange markets are sophisticated and informed and do not need to be protected, and (iii) any future need for regulation could be adequately addressed by the Comptroller of the Currency and the Federal Reserve. It, therefore, urged the Senate to adopt language "to make it clear that [the CEA's] provisions would not be applicable to futures trading in foreign currencies or other financial transactions" of the nature described in the Treasury Letter.

The Treasury Letter's reasons for excluding these financial products from CEA coverage continue to be applicable today. The foreign exchange market is still largely an institutional over-the-counter market. According to the latest Bank for International Settlements (BIS) figures, each day, over $1.42 trillion dollars' worth of foreign currency transactions are conducted in the over-the-counter markets. The principal participants are highly sophisticated institutions such as banks (including the central banks of most countries in the world), investment banks, foreign exchange dealers and brokerage companies, corporations, money managers (including pension and mutual funds), and insurance companies.

Unfortunately, continuing uncertainty over the scope of the exclusion under the Treasury Amendment has perpetuated increased legal risk in the foreign exchange markets. These legal risks arise because if certain over-the-counter financial contracts are not covered by the Treasury Amendment, they could be deemed off-exchange futures contracts and, therefore, illegal under the CEA. This legal risk is unacceptable given the size of many participants' exposures and the importance of the foreign exchange market to the economy generally. If certain types of over-the-counter financial contracts were suddenly held not to be enforceable, it would have a seriously

adverse effect on dealer capital and have an equally serious effect on the overall domestic banking system.

This legal uncertainty has undermined market participants' ability to respond to the mandate from U.S. banking regulators, along with the banking regulators of other countries who belong to the Basel Committee on Banking Supervision, that banks reduce the foreign exchange settlement risk in the banking system.[1] Although the private sector has responded swiftly to this mandate by attempting to develop and adopt a number of positive risk-reducing mechanisms, the Commodity Futures Trading Commission (CFTC) has taken the position that utilization of these new facilities may transform an otherwise lawful over-the-counter transaction into one that violates the CEA. The CFTC's position on this issue has seriously limited the ability of the foreign exchange markets to meaningfully reduce settlement risk.[2]

A Treasury Amendment that more clearly excludes transactions that are based on, involve, or are indexed to foreign currencies and that makes clear that those products are excluded from the CEA's regulatory scheme even if they are ultimately cleared and settled through a clearinghouse would greatly enhance the ability of foreign exchange market participants to reduce settlement risk and address the important public policy objectives raised by the BIS and federal bank supervisors.

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[1] *Bank for International Settlements,* Reducing Foreign Exchange Settlement Risk: A Progress Report *(July 1998) and* Settlement Risk in Foreign Exchange Transactions *(March 1996).*

[2] *The CFTC's decision to narrowly interpret the Treasury Amendment in this circumstance is not unique. In the twenty-five years since the Treasury Amendment was enacted, there have been numerous innovations in the markets for financial products. In the case of many of these innovations, including foreign exchange options, the CFTC has repeatedly taken the position that they are not covered by the Treasury Amendment and, therefore, unenforceable. In the case of currency options, the issue was litigated all the way to the Supreme Court in* Dunn v. CFTC, *519 U.S. 465 (1997). The Supreme Court unanimously held that the Treasury Amendment broadly excludes foreign exchange options from the CEA.*

2. QUESTION 37:
Should Board of Trade Be Defined by Statute? How Would This Affect the Current Interpretation of the Treasury Amendment?

We believe that the better reading of the term "board of trade" in the Treasury Amendment is "organized futures exchange." However, recent CFTC enforcement and investigative actions as well as the CFTC's focus on clearing entities for over-the-counter contracts in its concept release indicate that the CFTC has a broader view of the term "board of trade" as used in the Treasury Amendment. These actions have included investigations of the Delta Clearing Corporation's and the Government Securities Clearing Corporation's offerings of clearing and settlement facilities for new products that involve transactions in government securities exempted from the CEA by the Treasury Amendment. These and other developments have resulted in renewed concern as to the legal enforceability of over-the-counter contracts in Treasury Amendment products. As a consequence, the development of a number of proposed mechanisms for the clearing of foreign exchange contracts entered into on a bilateral basis has been impeded by concerns over applicability of the CEA to products using those facilities.

We believe it is essential that the term "board of trade" not be extended to entities that facilitate the execution or clearing of bilateral over-the-counter transactions between parties acting for their own account. Technological developments have fostered new mediums for trading and settlement in the foreign exchange markets. These positive risk-reducing developments are beneficial to dealers and end users alike and reflect a natural evolution of this market. Banking regulators have, therefore, quite reasonably concluded that such innovations should not be stifled unnecessarily. The term "board of trade" should be defined to exclude entities or systems that are available only to sophisticated parties and that are designed to: (i) facilitate more efficient execution or settlement of foreign exchange transactions, (ii) provide greater liquidity to these markets, or (iii) reduce counterparty risk in these markets generally.

The existence of foreign exchange "bucket shops"—small, solely retail operators that prey on unsophisticated consumers—needs to be addressed. The FX Committee supports the objective of protecting retail investors. However, sophisticated counterparties do not need to be protected by government regulators from fraud. Moreover, if the retail investor's agent or counterparty (or such agent or counterparty's affiliate) is otherwise supervised or regulated by a

federal banking or securities regulator, CFTC jurisdiction over a foreign exchange transaction is unnecessary because the retail investor is already protected by the supervisory regimes that apply to its counterparty. However, one of the more troubling aspects of the CFTC's actions in the area of retail fraud is that the CFTC—instead of proving fraud—argues that the structure, execution, or clearing of the fraudulent transactions make them illegal off-exchange futures that are void. That approach has troubling repercussions for legitimate over-the-counter transactions. Consequently, the CFTC should not have the authority to unilaterally challenge and invalidate transactions, including retail transactions, as illegal off-exchange futures as a means of pursuing fraud.

3. QUESTION 38:
Are Regulatory Inequities Inherent in the Amendment's Distinction between Instruments Traded on a "Board of Trade" and Those That Are Not? How Do Recent Court Decisions Affect the Amendment's Application?

Any current disparity in the regulatory and legal treatment of exchange-traded foreign currency futures, on the one hand, and options and over-the-counter transactions in financial products, on the other hand, is to a large extent a reflection of the vast differences between these two products and the parties they serve. The FX Committee continues to support the idea that organized futures exchanges deserve regulatory relief that takes into account these differences to the extent necessary.

Recent case law supports the view that the term "board of trade" is meant to encompass only formally organized futures exchanges and that the term does not refer to any execution or clearing function independent of a CFTC-designated contract market. In 1996, the Ninth Circuit held in *Commodity Futures Trading Commission v. Frankwell Bullion Ltd.* that the term "board of trade" in the Treasury Amendment meant "on-exchange" and "exempt[ed] from all off-exchange transactions."[3] Therefore, an entity that provides only execution, clearing, and/or settlement services for over-the-counter foreign exchange transactions and does not do so for a CFTC-designated contract market is not a board of trade.

[3]*See* Commodity Futures Trading Commission v. Frankwell Bullion Ltd.*, 99 F.3d 299, 303 (9th Cir. 1996).*

Unfortunately, as mentioned above, the CFTC's stated view on this issue has had a chilling effect on the development and availability of risk-reducing execution, clearing, and settlement systems in the United States. Private sector initatives that use technology to mitigate counterparty and systemic risk arising from over-the-counter trading are essential from both market and supervisory perspectives. These systems should be free to develop and flourish outside of the regulatory scope of the CEA and regulatory threats from the CFTC. Otherwise, financial institutions located in the United States will be at a competitive disadvantage relative to those located in jurisdictions where such initiatives are fostered and encouraged—an outcome that could encourage the movement of business not in the direction of futures exchanges, but rather away from the United States altogether.

Sincerely yours,

Paul Kimball
Chairman
The Foreign Exchange Committee

COMMITTEE LETTER

COMMENTING ON PROPOSALS CONCERNING AUTOMATED TRADING SYSTEMS PROVIDING ACCESS TO ELECTRONIC BOARDS OF TRADE OPERATING PRIMARILY OUTSIDE THE UNITED STATES

May 21, 1999

Jean A. Webb
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre, 1155 21st Street, N.W.
Washington, D.C. 20581

Dear Ms. Webb:

The Foreign Exchange Committee respectfully submits this letter in response to the issuance by the Commodity Futures Trading Commission (the Commission or the CFTC) of proposed rules concerning automated trading systems providing access to electronic boards of trade operating primarily outside the United States, which were published in the *Federal Register* on March 24, 1999 (the "release"). This letter highlights some of the Foreign Exchange Committee's general concerns with the regulatory framework that would be created by the adoption of the rules and the legal basis under which the Commission proposes to assert jurisdiction over foreign boards of trade that would allow for electronic access from U.S. locations.

The Foreign Exchange Committee greatly appreciates this opportunity to comment on the release and the proposed rules. The Foreign Exchange Committee, formed in 1978 under the sponsorship of the Federal Reserve Bank of New York, includes representatives from major domestic and foreign commercial and investment banks and foreign exchange brokers. The Foreign Exchange Committee represents many of the most significant participants in foreign currency trading in the United States.

OVERVIEW

The Foreign Exchange Committee believes that the approach taken in the release and the proposed rules is fundamentally at odds with the express language of the Commodity Exchange Act (CEA) and raises several important public policy concerns. Specifically, we have three objections to the release and the proposed rules:

- First, we disagree with the Commission's statement in the release that a foreign board of trade is no longer "located outside the U.S." solely by virtue of having terminals in the United States. In our view, this approach is problematic as a matter of sound statutory construction and wholly unnecessary in order to address the Commission's legitimate concerns over electronic access to foreign boards of trade from within our borders.
- Second, the similar treatment of Automated Order Routing Systems (AORSs) and Direct Execution Systems (DESs) is inappropriate. We do not believe that the CFTC should equate terminals that are directly connected to a board of trade's electronic execution system with automated order routing systems that are under the control of participants in the system. Such an approach does not take into account some important differences between AORSs and DESs and would unnecessarily impose regulatory burdens on futures commission merchants and foreign boards of trade.
- Third, the notion that the foreign board of trade must be subject to a regulatory regime that is "generally comparable to that in the U.S." is counterproductive and inconsistent with important policies underlying the CEA. We do not believe it would be appropriate for the CFTC to engage in a "merit review" of the comparability of a foreign regulatory scheme as a condition to approval of terminal access from the United States. Instead, we respectfully suggest that the CFTC should extend greater deference to the *bona fide* home country regulator of any foreign board of trade.

FOREIGN BOARDS OF TRADE LOCATED WITHIN THE UNITED STATES

The Commission's notion that a foreign board of trade that is accessible from within the United States via an AORS or a DES is no longer "located outside the U.S." for purposes of Section 4(a) of the CEA is legally insupportable and factually inaccurate. The ability to access a foreign board of trade's electronic execution system from within the United States is simply not the same as locating the board of trade itself within the United States. As a matter of law, this interpretive position is inconsistent with the express language contained in of Section 4(b) of the CEA. Section 4(b) clearly prohibits the Commission from adopting rules or regulations that require Commission approval of, or govern in any way, any contract, rule, regulation or action of any foreign board of trade, exchange, market, or clearinghouse therefor. By regarding foreign boards of trade having U.S. DESs and AORSs as being "located" within the United States, however, the Commission is trying to invent a jurisdictional predicate in order to inappropriately regulate most aspects of the operation of these boards of trade.

The Commission's interpretive position is also inconsistent with the plain meaning and underlying purpose of Section 4(b), which was intended to require deference to home country regulators of foreign boards of trade so as to promote greater cooperation and coordination among regulators and facilitate increased cross-border trading. Because of its proximity to and familiarity with the board of

trade's management and operations, the home country regulator of a board of trade is invariably in the best position to provide comprehensive regulation with the least amount of burden on the board of trade. Moreover, where a foreign board of trade has terminals located in multiple jurisdictions, deference to the home country regulator is the only practical regime.

The practical effect of the proposed rules is that foreign electronic trading systems (be they Boards of Trade or private systems) will not allow U.S. firms—including U.S. dealers—to have access to these systems through terminals located domestically. This outcome will deny the benefits of easy access to those systems to numerous large, sophisticated U.S. parties that do not need the protection of the CFTC in this connection.

COMMISSION APPROVAL OF HOME COUNTRY REGULATION

While the Commission clearly has an interest in preventing attempts to evade the CEA by organizing boards of trade in jurisdictions lacking *bona fide* regulatory regimes, the proposed rules' requirement that the Commission undertake a broad review of a foreign board of trade's home country regulatory scheme is an inappropriate and unnecessary solution to this problem. Proposed rule 30.11 (b)(ii) would require that the petitioner's home country have "established a regulatory scheme that is generally comparable to that in the U.S." and Proposed Rule 30.11(b)(v) requires that the home country regulator's review of the petitioner's automated trading system comply with the relevant International Organization of Securities Commissions (IOSCO) standards. Any such review is inconsistent with the important policies underlying Sections 4(a) and 4(b) of the CEA. In adopting Section 4(b) of the CEA in 1982, Congress clearly intended to prohibit the Commission from regulating foreign boards of trade and other exchanges and markets. A substantive review of a foreign regulatory regime in order to determine whether it is sufficiently comparable to the U.S. model is fundamentally inconsistent with the important principles of international cooperation and deference among regulators.

AUTOMATED ORDER ROUTING

Finally, the proposed rules discount important distinctions between DESs, which provide nonintermediated access to a foreign board of trade's systems, and AORSs, which provide electronic entry of orders through an intermediary. Because AORSs are installed by a foreign board of trade's members—and not the exchange itself—they should not affect the board of trade's status as foreign, especially since the Commission already has adequate authority to regulate intermediaries.

CONCLUSION

For the reasons described above, we believe that the approach to electronic trading systems reflected in the proposed rules is misguided. The proposed rules would unnecessarily complicate access from the United States. to foreign boards of trade, and they rely upon an approach that is inconsistent with the express language of the CEA and the legislative intent of Congress in enacting 4(b) of the CEA. Finally, the proposed rules would impede technological innovation and global market access. We recognize the need to implement an appropriate regulatory framework for permitting terminal access from the United States to foreign boards of trade. However, we believe that such a framework should focus on intermediaries dealing with U.S. customers and, with respect to issues related to the foreign boards of trade, defer to home country regulators in jurisdictions having *bona fide* regulatory schemes.

If you have any questions or would like further information regarding this letter, please feel free to contact the undersigned at 212-761-2860 or Michael S. Nelson at 212-720-8194.

Sincerely yours,

Paul Kimball
Chairman
The Foreign Exchange Committee

cc: The Honorable Brooksley E. Born
The Honorable Barbara P. Holum
The Honorable David D. Spears
The Honorable James E. Newsome
Michael Greenberger

COMMITTEE LETTER

REAFFIRMING THE COMMITTEE'S Y2K RECOMMENDATIONS

New York, NY 10045
Telephone: *212 720-6651*
Facsimile: *212 720-1655*
E-Mail: *fx.committee@ny.frb.org*
http://www.ny.frb.org/fxc

June 25, 1999

Dear Foreign Exchange Professional:

Y2K preparation has been an important focus of the Foreign Exchange Committee over the past year. Last November, at a joint meeting of the Committee and the Singapore Foreign Exchange Market Committee, the members endorsed a proposal advocating a reduction in discretionary transactions in the first days of 2000. Members agreed that with less activity, institutions might be afforded extra time, staff, and other resources to respond to possible systems and operational problems stemming from Y2K. A letter was later circulated to the foreign exchange community that included the following suggestions:

- Traders and other market makers might recommend that counterparties, if appropriate, settle transactions on days other than Monday, January 3, through Friday, January 7, 2000.
- Market makers might explain this option to all counterparties, including both interbank and corporate customers in the process of negotiating forward contracts settling in early January.
- Financial institutions might want to take steps to limit their discretionary interbank trades in the first week of 2000.

These recommendations were specifically made to the institutions, market makers, and other participants that have flexibility in scheduling their transactions. The Committee recognizes that the foreign exchange market facilitates international business operations and that for many businesses, trade-based transactions cannot and should not be postponed or delayed.

Over recent months, the Committee has continued to monitor the industry's Y2K preparations and contingency planning. With only about six months remaining until the start of the

new year, the Committee wishes to remind the community of its Y2K recommendations and to encourage their implementation. Making plans now to reduce transactions with settlements that fall in the first week of January 2000 might prove to be particularly beneficial because a number of countries are in the process of planning holidays for the period from late December through early January. Even if transaction volume were appreciably reduced in response to Y2K concerns, business days following these holidays might still be particularly active.

If you have any questions or comments regarding this proposal, please feel free to contact me or the executive assistant of the Foreign Exchange Committee. Copies of this letter are also available on-line at *www.ny.frb.org/fxc*.

Sincerely yours,

Paul Kimball
Chairman
The Foreign Exchange Committee

TRANSMITTAL LETTER

ACCOMPANYING COMMENTS ON THE CONSULTATIVE PAPER *SUPERVISORY GUIDANCE FOR MANAGING SETTLEMENT RISK IN FOREIGN EXCHANGE TRANSACTIONS*

Mr. William Coen
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland
Fax: 41 61 280 9100

November 30, 1999

Dear Mr. Coen:

The Foreign Exchange Committee appreciates the opportunity to comment on the July 1999 consultative paper *Supervisory Guidance for Managing Settlement Risk in Foreign Exchange Transactions*.

We wish to congratulate the Basel Committee on its commendable work in producing this paper. We believe the paper helps to further define and encourage market measures to reduce settlement risk. As indicated by your bibliography, our Committee has been at the forefront of identifying settlement risk since 1994, when we introduced a definitive method of settlement risk measurement.

We were unanimous in our approval of the paper's intent and most of its content. The thoroughness and specificity in covering the subject's complex issues were very much admired. However, we did feel that there were areas within the paper and the appendices that could be modified. Attached are the comments that represent our concerns and suggestions on several specific topics. I also attach, for your reference, a list of the current membership of the Foreign Exchange Committee. Please feel free to contact me or the Committee's Executive Assistant regarding any aspect of these comments.

Sincerely yours,

Paul Kimball
Chairman
The Foreign Exchange Committee

THE FOREIGN EXCHANGE COMMITTEE'S COMMENTS ON THE BASEL COMMITTEE PAPER *SUPERVISORY GUIDANCE FOR MANAGING SETTLEMENT RISK IN FOREIGN EXCHANGE TRANSACTIONS*

The Foreign Exchange Committee (the Committee) supports the efforts of the Basel Committee on Banking Supervision (the Basel Committee) to reduce foreign exchange settlement risk. In the interest of encouraging successful implementation of further measures to reduce settlement risk, the Committee welcomes the opportunity to comment on the recommendations made in *Supervisory Guidance for Managing Settlement Risk in Foreign Exchange Transactions*.

The Committee respectfully submits its comments in two parts. The first section provides general observations and recommendations concerning settlement exposures, contingency planning, and policy involving fails. The second section suggests specific clarification or correction to several paragraphs discussing settlement exposures, setting and using limits, netting, and the role of supervisors.

SECTION 1

(1) The Measurement of Settlement Exposures

The Committee acknowledges the efforts of the Basel Committee to establish a common approach to the measurement of settlement exposures. The Committee understands that banks might be more willing to subscribe to such an approach if other institutions pursue the same course.

The Committee recognizes that the measurement of settlement risk advocated in the paper diverges from models developed at financial institutions and still in widespread use in the private sector. At the very least, the proposed methodology requires more precise calculations and an extensive restructuring of the existing models.

The Committee believes that the difficulties in implementing the "limit-monitoring" practice of settlement risk as defined by the Basel Committee lie in the pre-transaction checking required of banks. Today's market practice typically necessitates a check of availability for a transaction's notional amount against a gross settlement limit for a given day. The proposed checking process would require a more complicated "what-if" analysis incorporating variables such as currency pair, purchase or sale, netting capability, payment cutoff times, and estimated reconciliation completion times.

These calculations would need to be available and monitored for any day on which a counterparty may settle a foreign exchange transaction, resulting in a significant logistical challenge for many institutions. It is felt that the time involved to generate a "what-if" check of limits might seriously impede the timely execution of routine transactions.

Finally, the benefits of such a cumbersome process are likely to be fewer than expected (this is also discussed in Section 2). Many banks have signed settlement-netting agreements with their most active counterparties. The extension of a settlement period can, in practice, have little impact on the amount of netted exposure between two active trading counterparties precisely because they trade so frequently with each other. When this trading activity involves the purchase and sale of multiple currencies, there is often little net settlement risk remaining, regardless of the definition of the settlement window.

Counterparties who trade infrequently often do not have settlement-netting documentation in place, but in this instance the use of the Basel settlement definition also rarely increases the amount of

settlement risk actually incurred, simply because the counterparties by definition do not trade very frequently.

Suggested Change in Recommendation

In reviewing institutional adherence to settlement-risk-reduction procedures, supervisors should recognize the work of many banks in developing settlement risk measures and internal risk procedures. It is the Committee's opinion that the validity of the internally developed methods should be allowed by supervisors, particularly when the methods are viable and when settlement risk is not underestimated. This opinion is consistent with comment by the Committee on Payment and Settlement Systems (CPSS) in *Reducing Foreign Exchange Settlement Risk: A Progress Report* (July 1998).

A bank could, for example, periodically take "snapshots" of its portfolios, calculate settlement risk according to the Basel definition, and contrast these measures with its internal settlement risk measurements. If the internal measures prove to be reasonably accurate proxies for the Basel Committee definition of settlement risk, their use should be allowed subject to frequent verification and periodic review by regulatory authorities. In that way, the financial community's significant progress over recent years in measuring and curtailing settlement risk would be encouraged and supported.

The Committee also suggests that Appendix 2, "Possible Questions for On-Site Reviews," include an introductory paragraph indicating that the questions are meant as a broad guide for an interviewing regulator. The Committee encourages regulators to modify questions according to the type of institution and the institution's role in the foreign exchange market.

(2) Managing Fails

The Committee agrees that fails should be identified and properly monitored. However, the Committee is concerned that undue emphasis may be placed on fails. In the opinion of the Committee, fails are a routine part of a business characterized by high volume and complexity. Given the routine nature of fails, many banks already have in place systems to quickly address and remedy the situation. It is suggested that regulators should judge an institution's approach to fails accordingly. Concern is that an overreaction to each fail could, in itself, slow processes and cause systemic problems.

(3) Contingency Planning

The Committee is cognizant of the limited resources available for contingency planning in many organizations and is concerned that too many contingency plans could make applications unduly difficult. It is suggested that an institution may want to prioritize events based on its individual needs and circumstances and emphasize the most likely event in its contingency plans. In addition, planning can be made more efficient if foreign-exchange-related contingencies dovetail other business contingencies, for example, those related to the trading room.

(4) Suggested Additions to the Paper

The Committee notes that the paper would benefit from the inclusion of a substantive discussion of other important settlement-risk-reduction measures, such as improved payment cutoff times, enhanced nostro communication, and a heightened focus on large exposures and activities of less creditworthy counterparties. The Committee also sees benefit in supplementing the report with updates on bilateral netting systems and the multilateral settlement system of CLS (Continuous Linked Settlement) Bank.

SECTION 2

Measurement of FX Settlement Exposures

Paragraph 11, page 3

The wording of this paragraph appears to provide a misleading picture of the amount at risk. It focuses on the amount of each currency under currency trades as opposed to actual amounts of currency that the relevant branch of each party is legally obligated to settle on a given day. As a result, the paper appears initially to suggest that the correct measure of risk is always the aggregate gross settlement obligations under all transactions to be settled on a given day. Netting as it appears in paragraphs 21 and 22 is not effectively linked to this discussion.

It is suggested that the second sentence of paragraph 11, which states that "the full value of the trade is at risk," be revised to start with the following:

During the period of irrevocability, the amount of currency that a party is obligated to settle will be at risk. If a party has entered into a legally enforceable settlement netting agreement, as described in paragraphs 21and 22 below, the amount of risk will be the netted amount of each currency for the applicable office of the party. If a legally enforceable settlement-netting arrangement is not in place, then the full face value of the trade is at risk during this period, which can last overnight or up to two or three full days.

Paragraph 13, page 4

If the parties have agreed to settlement netting—the method known as running account—the individual currency pairs of the original transactions will be irrelevant. As a result, the second sentence of the paragraph focuses somewhat inaccurately on currency pairs, rather than on the net amount of each currency to be settled. As currently drafted, this sentence continues the misleading focus on *gross* settlement and individual transactions that is evident in paragraph 11.

Setting and Using Limits

Paragraph 15, page 5

Because the paragraph seems to suggest that settlement limits must be enforced after an event occurs, it seems to indicate that a bank can control the consequences of such an event. This is not correct. Settlement obligations arise from transactions that have been agreed upon in advance of the settlement date. If a market disruption event occurs after the date that transactions are entered into, but on or prior to the settlement date, it may be the case that settlements will be delayed and may roll over to the succeeding business day(s).

This type of market disruption occurred in the case of the Indonesian rupiah in 1998. The same may be true of operational problems. It is not uncommon for a payment failure to occur, resulting in an increased settlement amount on the next business day. The only time that a market disruption or operational problem should become a credit decision is when an amount of time has elapsed such that any applicable cure period for the failure has elapsed and a decision is being made to wait an additional amount of time, or if another intervening event has occurred that would give rise to the potential exercise of legal rights to close out the affected currency obligation. At this point in time, there is a credit decision as to whether any payments should continue to be made to the affected party.

As a result, it is suggested that paragraph 15 be written as follows:

The limits applied by the bank to its FX settlement exposures should be binding—i.e., any excesses should be subject to approval by the appropriate credit management personnel. If an event occurs that causes a settlement to be delayed, such as an operational problem or market disruption event, credit management personnel should be advised of such a delay as soon as possible. The consequences of any continuing delay should be evaluated with credit management personnel and legal advisors in order to adequately evaluate the credit risks arising from any ongoing delay in settlement.

Managing FX Settlement Exposure

Paragraph 18, page 5

Although this paragraph appropriately suggests that payment cancellation deadlines should be managed carefully, it does not remind readers that payment cancellation is a remedy that should be resorted to only when a party has the legal right to do so. The following could be added after the last sentence of the paragraph:

Banks should be careful in using cancellation of payment as a risk management tool. In general, a bank is entitled to cancel a payment only when its counterparty has defaulted on its obligations to the bank. The effect of cancellation underscores the need to evaluate a bank's legal rights: cancellation of a payment to a counterparty can have a domino effect, causing the counterparty to have insufficient funds to settle other obligations, leading to further defaults and potentially resulting in settlement gridlock. As a result, a bank should carefully consider its legal rights and the legal consequences of cancellation before taking such action.

Managing FX Settlement Exposure and Use of Netting

Paragraphs 20-22, page 6

The Committee suggests amending the following paragraphs (the suggested additions or changes to the text are italicized) to read as follows:

20. Appropriately managed collateral arrangements *and written agreements governing netting of payments* settlement (see below) are also important risk management tools that can reduce the amount of a bank's exposure to a particular *level of trading*.

21. Banks can reduce the size of their counterparty exposures by entering into legally binding agreements for the netting of settlement payments.[1] *Such agreements provide that payment obligations in the same currency with the same settlement date will be netted within a pair of trading offices—for example, Bank A's London Office will enter into FX transactions with Bank B's Tokyo office*. Legally binding *payment* netting arrangements permit banks to offset trades against each other *entered into within a designated branch or designated pair of branches* so that only the net amount in each currency is paid or received by each institution. *Such payment netting agreements are contemplated in the industry standard bilateral master agreements covering FX transactions, but must be elected by counterparties to such agreements*. Depending on trading patterns, *payment* netting can significantly reduce the value of currencies settled. *Payment* netting also reduces the number of payments to one per currency either to or from each counterparty. *Payment* netting is most valuable when the counterparties have a considerable two-way flow of business; as a consequence it may only be attractive to the most active banks. To take advantage of risk-reducing opportunities, banks should be encouraged to establish procedures for identifying *payment-netting* opportunities.

22. To allow exposures to be measured on a net basis, the legal basis for *payment*-netting arrangements should be sound. (*It is suggested the second sentence in the original paragraph be removed.*) *It should be noted that the enforceability of payment-netting agreements is a contractual rather than a statutory matter. In contrast, the enforceability of closeout netting arrangements most frequently is governed by local and other relevant insolvency or bankruptcy laws.*

[1]Netting of payment obligations should not be confused with "closeout netting," which requires counterparties to settle on a net basis all contracted but not yet due obligations immediately upon the occurrence of a defined event, such as the appointment of a liquidator to one of the counterparties. Although closeout netting may be a useful part of a bank's overall risk management, it is not discussed further here as it does not, by itself, reduce FX settlement exposures.

PRESS RELEASE

NEW BRAZILIAN REAL RATE DEFINITIONS PUBLISHED BY EMTA, ISDA, AND THE FX COMMITTEE

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February 3, 1999

The Emerging Markets Traders Association (EMTA), the International Swaps and Derivatives Association (ISDA), and the Foreign Exchange Committee (FX Committee) jointly announced today the addition of two new Brazilian real rate source definitions to Annex A of the 1998 FX and Currency Option Definitions.

The following is the wording of the new definitions, amending Annex A of the definitions as of February 1, 1999:

(I) "BRL PTAX" and "BRL09" each mean that the spot rate for a rate calculation date will be the Brazilian real/U.S. dollar offered rate for U.S. dollars, expressed as the amount of Brazilian reias per one U.S. dollar, for settlement in two business days (where such days are business days in both São Paulo and New York) reported by the Banco Central do Brasil on SISBACEN Data System under transaction code PTAX-800 ("Consultas de Câmbio" or Exchange Rate Inquiry), Option 5 ("Cotacões para Contabilidad" or Rates for Accounting Purposes) as of 8:30 p.m., São Paulo time, on that rate calculation date.

(J) "BRL PTAX BRFR" and "BRL10" each mean that the spot rate for a rate calculation date will be the Brazilian real/U.S. dollar offered rate for U.S. dollars, expressed as the amount of Brazilian reias per one U.S. dollar, for settlement in two business days (where such days are business days in both São Paulo and New York) reported by the Banco Central do Brasil on SISBACEN Data System under transaction code PTAX-800 ("Consultas de Câmbio" or Exchange Rate Inquiry), Option 5 ("Cotacões para Contabilidad" or Rates for Accounting Purposes), which appears on the Reuters screen BRFR page at PTAX-800 as of 8:30 a.m., São Paulo time, on the first business day following that rate calculation date.

The text of the definitions is also being posted on the websites of EMTA (*www.emta.org*), ISDA (*www.isda.org*), and the FX Committee (*www.ny.frb.org/fxc*).

The 1998 FX and Currency Option Definitions are intended for use in confirmations of individual transactions governed by master agreements such as the ISDA master agreements, FEOMA, IFEMA and ICOM.

DOCUMENT OF ORGANIZATION

It was generally agreed that any new forum for discussing matters of mutual concern in the foreign exchange market (and, where appropriate, offshore deposit markets) should be organized as an independent body under the sponsorship of the Federal Reserve Bank of New York. Such a Committee should

1. be representative of institutions participating in the market rather than individuals;
2. be composed of individuals with a broad knowledge of the foreign exchange markets and in a position to speak for their respective institutions;
3. have sufficient stature in the market to engender respect for its views, even though the Committee would have no enforcement authority;
4. be constituted in such a manner as to ensure fair presentation and consideration of all points of view and interests in the market at all times; and
5. notwithstanding the need for representation of all interests, be small enough to deal effectively with issues that come before this group.

THE OBJECTIVES OF THE COMMITTEE ARE

- *to provide* a forum for discussing technical issues in the foreign exchange and related international financial markets;
- *to serve* as a channel of communication between these markets and the Federal Reserve and, where appropriate, to other official institutions within the United States and abroad;
- *to enhance* knowledge and understanding of the foreign exchange and related international financial markets, in practice and in theory;
- *to foster* improvements in the quality of risk management in these markets;

A feasibility study recommending the creation of the Foreign Exchange Committee was first conducted in June 1978. The resulting Document of Organization *represents the study's conclusions and has been periodically updated (most recently in January 1997) to reflect the Committee's evolution.*

- *to develop* recommendations and prepare issue papers on specific market-related topics for circulation to market participants and their management; and
- *to work* closely with FOREX and other formally established organizations representing relevant financial markets.

THE COMMITTEE

In response to the results of the study, the Federal Reserve Bank of New York agreed to sponsor the establishment of a Foreign Exchange Committee. It was agreed that

1. The Committee should consist of no more than thirty members. In addition, the president of FOREX is invited to participate.
2. Institutions participating in the Committee should be chosen in consideration of a) their participation in the exchange market here and b) the size and general importance of the institution. Selection of participants should remain flexible to reflect changes as they occur in the foreign exchange market.
3. Responsibility for choosing member institutions rests with the Federal Reserve Bank of New York. The Membership Subcommittee, chaired by a Federal Reserve Bank official, advises the Federal Reserve on membership issues.
4. The membership term is four calendar years. A member may be renominated for additional terms; however, an effort will be made to maximize participation in the Committee by institutions eligible for membership.
5. Members are chosen with regard to the firm for which they work, their job responsibilities within that firm, their market stature, and their ongoing role in the market.

The composition of the Committee should include New York banks; other U.S. banks; foreign banks; investment banks and other dealers; foreign exchange brokerage firms (preferably to represent both foreign exchange and Eurodeposit markets); the president of FOREX USA, Inc. (*ex officio*); and the Federal Reserve Bank of New York (*ex officio*).

COMMITTEE PROCEDURES

The Committee will meet at least eight times per year (that is, monthly, with the exception of April, July, August, and December). The meetings will follow a specified agenda; the format of the discussion, however, will be informal.

Members are expected to attend all meetings.

Any recommendation the Committee wishes to make on market-related topics will be discussed and decided upon only at its meetings. Any recommendation or issue paper agreed to by the Committee will be distributed not only to member institutions, but also to institutions that participate in the foreign exchange market.

The Membership Subcommittee will be the Committee's one standing subcommittee. A representative of the Federal Reserve Bank of New York will serve as Chairman of the Membership Subcommittee. The Membership Subcommittee will aid in the selection and orientation of new members. Additional subcommittees composed of current Committee members may be organized on an ad hoc basis in response to a particular need.

There will be two standing working groups: the Operations Managers Working Group and the Risk Managers Working Group. The working groups will be composed of market participants with an interest and expertise in projects assigned by the Committee.

Committee members will be designated as working group liaisons. The liaison's role is primarily one of providing guidance to the working group members and fostering effective communication between the working group and the Committee. In addition, a representative of the Federal Reserve Bank of New York will also be assigned as an advisor to each working group.

The Committee may designate additional ad hoc working groups to focus on specific issues.

Depending on the agenda of items to be discussed, the Committee may choose to invite other institutions to participate in discussions and deliberations.

Summaries of discussions of topics on the formal agenda of Committee meetings will be made available to market participants by the Federal Reserve Bank of New York on behalf of the Committee. The

Committee will also publish an annual report which will be distributed widely to institutions that participate in the foreign exchange market.

Meetings of the Committee will be held either at the Federal Reserve Bank of New York or at other member institutions.

In addition to the meetings provided for above, a meeting of the Committee may be requested at any time by two or more members.

RESPONSIBILITIES OF COMMITTEE MEMBERS

The Foreign Exchange Committee is composed of institutions that participate actively in the foreign exchange markets as well as other financial markets worldwide. As a senior officer of such an institution, the Committee member has acquired expertise that is invaluable to attaining the Committee's objectives. The member's continuous communication with the markets worldwide generates information that is necessary to the Committee's deliberations on market issues or problems. Effective individual participation is critical if the collective effort is to be successful. The responsibilities of membership apply equally to all Committee members.

The specific responsibilities of each member are:

- *to function* as a communicator to the Committee and to the marketplace on matters of mutual interest, bringing issues and information to the Committee, contributing to discussion and research, and sounding out colleagues on issues of concern to the Committee;
- *to present* the concerns of his or her own institution to the Committee; in addition, to reflect the concerns of a market professional as well as the constituency from which his or her institution is drawn or the professional organization on which he or she serves; and
- *to participate* in Committee work and to volunteer the resources of his or her institution to support the Committee's projects and general needs.

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[5] *Resigned February 1999.*

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