Supplementary Guidance on Electronic Validations and Confirmation Messaging

One of the most significant developments to affect the foreign exchange market in recent years has been the growth of electronic trading for foreign exchange. Rapidly, screen based systems have replaced the phone as a conduit for conducting trades. These systems continue to enhance the efficiency of the trading process and help to eliminate trade errors given that trade information is entered just once rather than re-keyed multiple times throughout the trade and settlement process.

Electronic front-end trading systems are also changing the way in which counterparties validate or confirm trades with one another. For example, industry best practices recommend that counterparties confirmed each trade with one another via confirmation messages (ie. SWIFT MT300, fax, paper, or phone confirms). However, some counterparties have chosen, on a bilateral basis, to eliminate confirmation messages with one another in lieu of electronic affirmation facilities offered by electronic trading systems. These facilities provide for an independent (ie. non-dealer) validation of trade details. Alternatively, some trade systems send trade summaries directly to each counterparty's back office for verification purposes. Market participants can affirm that the trade details reflected in the electronic trading system correspond to their own internal books and records and that proper controls are being followed. Importantly, however, these validation exercises do not confirm that trade details have been correctly entered into the books and records of each counterparty.

The Committee continues to recommend back-office confirmation messaging as a means of controlling operational and settlement risks. However, market participants who replace confirmation messaging with trade validation from electronic front end trading systems should carefully consider both the benefits and risks of doing so.

Benefits

- Electronic trade validation automates the confirmation phase, minimizing the need for dual entry of trade data and enhancing straight through processing.

- Electronic trade validation eliminates the cost of sending confirmation messaging as well as the operational expense of processing confirmations manually.

- Electronic trade validation offers a consistent system for both small and large market participants to verify trade information in a timely and efficient manner.

- Two counterparties using a common electronic trading platform can validate trade information against an independent and unbiased third party record.

Risks

- Affirmation facilities connected with electronic front-end systems allow counterparties to validate the trade details are accurate, but may not allow counterparties to validate whether the trade has been accounted for properly in the books and records of each firm.

- Electronic front-end systems may provide sufficient data for matching the trade terms, but may not capture sufficient data to provide a robust audit trail in the event of a dispute.

- Without confirmations, trade amendments or adjustments may not be accurately reflected in electronic databases, increasing the chance of settlement errors.

- Eliminating confirmations may limit the independence of the trade validation process by the back office and may increase the risk of unauthorized (ie rogue) trading.

- In the absence of standard settlement instructions (SSI's), eliminating confirmation may compromise the ability of each counterparty to ensure that settlement instructions are accurate.

- Electronic trading systems that do incorporate SSI's may not be updated correctly without per-trade confirmation. New accounts open and settlement instructions change, but this may not be communicated to all counterparties.

Summary

Market participants who eliminate confirmation messaging are urged to have sufficient measures in place to mitigate the risks noted above. The Committee recognizes that going forward, new developments in electronic trading systems may further safeguard trade validation. However, careful analysis is necessary to be certain that risks are sufficiently recognized and managed. The Committee will continue to monitor the evolving electronic marketplace and provide guidance as necessary.