

CHAIRMAN'S REPORT

The Foreign Exchange Committee reached several important milestones in 1997. As part of its ongoing effort to forge closer links with international bodies that share a similar mission, the Committee held a meeting overseas for the first time in its history. In November, Committee members traveled to Singapore for a joint meeting with the Singapore Foreign Exchange Market Committee to discuss recent market developments and to address industry issues of mutual concern. Domestically, in February, the U.S. Supreme Court rendered a decision in the case of William C. Dunn v. The Commodities Futures Trading Commission that validated many of the views expressed by the Committee in its 1996 amicus brief for the case. The Dunn decision marks an important step in providing legal certainty for foreign exchange trading in the United States. In the interest of improving its internal operation, in 1997 the Committee instituted a new organizational structure that replaced the standing subcommittees with adhoc working groups. This reorganization has given the Committee greater flexibility in responding to industry issues and in mobilizing the Committee's expertise and resources accordingly. Finally, the Committee continued existing projects and initiated new endeavors in the areas of trading practices, market structure, and risk management, while devoting considerable attention to the ongoing market developments that made 1997 a memorable year in foreign exchange.

The joint meeting with the Singapore Foreign Exchange Market Committee proved to be one of the highlights of the Committee's year. The early November meeting was especially timely given the intensity of market attention on developments in Southeast Asia and Korea. Members of the Singapore Committee led a market discussion outlining the events leading up to the turmoil in the region, and members from New York shared their experiences in coping with similar Latin American crises. The two Committees also compared their research findings on the effects of electronic broking on the structure of the foreign exchange market. The works shared many observations, including a narrowing in interbank spreads, an increase in price transparency, and greater competitive pressures on the voice brokers. The day after the Singapore meeting, the Committee's Operations Managers Working Group presented its paper "Management of Operational Risks in Foreign Exchange." By the standing-room only attendance and the spirited question and answer session that followed, it was clear that the Singapore community shares the Committee's interest in this critical topic. Rapid global integration and recent market developments underscore the importance of establishing close relationships with organizations that seek to promote a smoothly functioning foreign exchange market. The Committee hopes that the success of this meeting will foster greater communication between Singapore and New York, and will serve as an impetus to forge closer links with similar organizations around the world.

One of the most significant events of the year was the Supreme Court's decision in the Dunn case. The Committee has long maintained that the so-called Treasury Amendment excludes from coverage under the Commodity Exchange Act (CEA) activities of foreign exchange dealers entering into over-the-counter foreign exchange transactions—including over-the-counter foreign exchange options. The opinion delivered by the Court closely parallels key positions advanced by the Committee in its 1996 amicus brief on the subject. Also during the year, on two occasions I had the privilege of representing the Committee before the U.S. Congress on proposed modifications to the Treasury Amendment. While there, I articulated the Committee's strong support of the revisions as a major step in providing legal certainty for foreign exchange markets in the United States. The Committee will continue to monitor ongoing developments related to the Treasury Amendment in an effort to ensure that any revision provides all types of foreign exchange transactions, including foreign exchange options, with the broadest exclusion from CEA coverage.

The Committee's 1997 structural changes involved its meeting schedule and organization. Reflecting the increasing seniority of members within their firms, as well as the greater geographic dispersion of the membership, the Committee reduced the number of meetings per year from ten to eight. Given the abbreviated schedule, the Committee strove to make each meeting more issue-oriented, focusing on particular subjects such as the technical issues associated with European Economic and Monetary Union (EMU), the growing interest in contracts for differences as a mechanism to reduce foreign exchange settlement risk, and efforts to standardize market practices and promote transparency in emerging markets. At the same time, the Committee decided to organize itself around ad hoc working groups, formed in response to particular issues as they arise, rather than around standing subcommittees. The Committee also formalized its relationship to the Operations Managers Working Group and the Risk Managers Working Group by designating liaisons to each body. These structural modifications have enhanced the Committee's work by permitting greater flexibility in allocating the Committee's resources to particular issues and by fostering greater communication between the working groups and the Committee.

The year also proved to be one of exceptional productivity for the Foreign Exchange Committee:

- The Operations Working Group published "Managing Operational Risk in Collateralized Foreign Exchange," a report highlighting best practices to reduce operational risks in this rapidly growing business.

- The Committee completed a paper initiated in 1996 assessing the impact of electronic broking on the foreign exchange market. The Committee envisions this paper as the first in a series of publications that will address the ongoing effects of technology on the marketplace.
- The Committee's electronic broking survey highlighted a need to establish standard market practices and conventions for electronic trading. The Committee issued a letter related to this subject advising dealers of the increased risks and obligations of holding stop-loss orders in an environment in which trades may be matched twenty-four hours a day, seven days a week. The Committee intends to include the advice contained in this letter, as well as other measures, in its next revision to "Guidelines for Foreign Exchange Trading Activities," which was last updated in 1996.
- The Financial Markets Lawyers Group, in a joint endeavor with the International Swap and Derivatives Association and the Emerging Markets Traders Association, developed a set of FX and Currency Option Definitions that standardize trading documentation for nondeliverable forwards and related emerging market transactions. Supplementing the Definitions, the FMLG published addenda to the Foreign Exchange and Options Master Agreement, the International Foreign Exchange Master Agreement, and the International Currency Options Market Master Agreement that coordinate use of the Definitions with these documents.

We present these publications and letters as part of the *Annual Report's* selected documents, and trust that they will provide value to market participants and encourage productive discourse.

In addition to distributing formal publications in 1997, the Committee sponsored a series of seminars to increase public awareness and understanding of the Committee's work. Early in the year, as part of its ongoing commitment to help foreign exchange market participants reduce settlement risk, the Committee presented its 1996 paper "Guidelines for Foreign Exchange Settlement Netting" to audiences in New York and London. Meanwhile, in June, the Committee served as a joint sponsor, with the International Swap and Derivatives Association and the New York State Bar Association, of a forum at the Federal Reserve Bank of New York on the impact of EMU on U.S. financial markets. The forum's primary purpose was to educate U.S. participants on the operational, technical, and legal challenges posed by monetary union, and featured

representatives from the Bundesbank, the Banque de France, the Bank of England, and the European Monetary Institute, among others. The Committee intends to build on these efforts by hosting a similar forum on EMU in 1998.

The Committee also launched a number of initiatives that will carry over into next year. The most prominent of these efforts relates to the Committee's ongoing interest in settlement risk. During the course of the year, the Committee received periodic updates on the progress made by the Group of Twenty in developing a continuous linked settlement (CLS) system that incorporates the most advanced delivery versus payment settlement methods. The CLS approach addresses the settlement risk issue from the perspective of the payments system, leaving existing front-office trading conventions intact. The Committee also examined two alternative netting mechanisms that would alter conventional trading practices—netting plus, which makes use of a series of tom-next swaps to reduce bilateral settlement exposure, and the creation of a foreign exchange derivative contract for differences (CFD). Interest in CFDs has been sparked by the recognition that cash delivery is required in only a small percentage of foreign exchange transactions. Rather than settling underlying currencies in a transaction, a viable CFD market would permit market participants to settle only the mark-to-market difference between the contract rate and the fixing rate, potentially providing a cost-effective means to reduce settlement risk substantially. Under its revised organizational structure, the Committee formed an ad hoc working group to assess the viability of CFDs as an alternative mechanism for reducing foreign exchange settlement risk. The group anticipates presenting its conclusions to the Committee in 1998.

As always, the Committee also devoted considerable attention in 1997 to ongoing market developments. Anticipation of EMU, the deterioration of economic and financial conditions in Japan, and the turmoil in Southeast Asia and Korea provided rich material for stimulating market discussions. Despite the extreme volatility associated with many of these events, particularly the Asian crisis, the foreign exchange market cleared huge volumes without complication. This performance suggests that structural improvements advocated by the Committee with respect to documentation, netting, and operations have proved their worth.

As the Committee prepares to enter its twentieth year, I am confident that the body of work completed in 1997, and the initiatives launched during the year, will prove valuable to market participants and encourage productive discourse on many topics. Our upcoming anniversary serves as a useful reminder of the important contributions the Committee makes in promoting a well-functioning foreign exchange market in the United States and abroad.

John J. Finigan, Jr.