COMMITTEE LETTER

ON HANDLING OF STOP-LOSS ORDERS IN AN ELECTRONIC TRADING ENVIRONMENT

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/fxc.html

January 28, 1998

Dear Foreign Exchange Professional:

The growth of twenty-four hour electronic trading and the corresponding increase in price transparency have had a profound impact on the structure of the foreign exchange market in recent years. Many issues surrounding these changes were addressed by the Foreign Exchange Committee in its publication of *A Survey Assessing the Impact of Electronic Broking on the Foreign Exchange Market*. That survey also highlighted an ongoing need to establish standard market practices and conventions for electronic trading. One such issue that warrants management attention relates to the handling of stop-loss orders in an electronic trading environment.

In recent Committee discussions, members have identified the increased risks and obligations of holding stop-loss orders in an environment in which trades may be matched electronically twenty-four hours a day, seven days a week. Although these risks apply equally to trades matched through conventional voice brokers, members have suggested that the prevalence of electronic trading has made the potential risk of holding stop-loss orders more acute. The most significant concerns expressed by Committee members involve weekend trading when illiquid market conditions might exaggerate price moves and trigger stop-loss orders. Such situations give rise to at least two scenarios that potentially expose institutions to risk, depending upon the course of action taken by the dealer handling the order:

A. Dealer executes stop-loss orders as instructed only to have prices immediately rebound when liquidity returns to the market. Customers in this scenario may question why they were stopped out of positions for an apparent pricing anomaly.

B. Dealer refrains from executing stop-loss orders because the breach occurs during illiquid off-hour conditions, but prices do not rebound when liquidity returns to the market. Stop-loss orders are ultimately executed during routine business hours, but at rates less advantageous than those prevailing during the off-hour period when the orders were first technically triggered. Customers in this scenario may allege that they were harmed because their stop-loss orders were not immediately executed when triggered at the better rate.

To avoid disputes arising from these types of scenarios, the Committee advises that foreign exchange dealers educate customers about the special circumstances that can occur with stop-loss orders in an electronic trading environment. In particular, the Committee recommends that dealers establish guidelines with customers regarding the applicability of electronically traded prices during illiquid off-hour conditions. For example, dealers may wish to inform customers that stop-loss orders will remain valid only from Monday 6:00 am Sydney through Friday 5:00 pm New York, the time frame presently specified in the barrier option addendum to the Foreign Exchange and Option Master Agreement. Copies of the barrier option addendum and other Committee publications may be viewed online or downloaded for later viewing from the Foreign Exchange Committee's World Wide Web site at *www.ny.frb.org/fxc/fxc.html*, or are available by contacting the Committee's Executive Assistant at 212-720-6651.

Please feel free to contact me, members of the Committee, or the Committee's Executive Assistant with any questions or comments regarding this letter.

Sincerely,

John J. Finigan, Jr.
Chairman