BARRIER OPTIONS: NEW BEST PRACTICES
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
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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.