Y2K: BEST PRACTICES IN THE FOREIGN EXCHANGE MARKET

TRANSMITTAL LETTER

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

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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.