Chairman's Letter

THE FOREIGN EXCHANGE COMMITTEE WELCOMED THE NEW CENTURY with a growing appreciation for—and perhaps even a sense of awe at—the technological innovations transforming the financial markets. In 2000, e-commerce applications unheard of just months earlier were being meticulously planned by many institutions. Now, as we look to the year ahead, innovations in the e-commerce arena promise even more change for the foreign exchange market.

Many financial institutions likely breathed a sigh of relief when the costly efforts undertaken to prepare for the new century proved to be a catalyst for the technological innovations. In periods such as these, the Committee's responsibility for supporting market efficiencies and reducing risk by facilitating communication within the industry, broadening market knowledge, and developing recommendations takes on added significance.

Over the past year, the Committee's efforts on behalf of the marketplace included interaction with numerous industry and special working groups, discussions at various meetings, and publication of new materials, such as our updated *Guidelines for Foreign Exchange Trading Activities*. However, much of our work has only begun. Here I refer particularly to the analysis of e-commerce and the CLS Bank and other efforts to facilitate trading and settlement. The preliminary steps taken in 2000 to understand these trends fully will no doubt be refined in the coming months.

We recognize, for example, that we will have to update our *Guidelines* regularly to ensure the document's timeliness. In addition, the barrier options market, because of its complexities, would benefit from a continuous review of its documentation and best practices. Furthermore, we must be prepared to address the many questions about CLS procedures and processes that are likely to arise as we move to the inauguration of this system.

As I reflect on the year and on the Committee's accomplishments and key works in progress—which I describe in this letter—I am proud of our members, who have worked tirelessly to prepare us for this new era. I am equally proud of our increased involvement with the other industry associations. Cooperative efforts such as these have spurred the progress made in improving global market conditions and have helped us all to take meaningful steps to reduce risk.

REVISING THE COMMITTEE'S *GUIDELINES*

The past few years have been busy ones for the Foreign Exchange Committee. The introduction of the euro was followed quickly by concerns about Y2K-related failures. With those issues behind us, we turned our attention last year to a key project, revising the *Guidelines for Foreign Exchange Trading Activities*. The *Guidelines*, last updated in 1996, understandably had become outdated.

When revising the *Guidelines*, we had to bear in mind the fact that the industry is undergoing a great deal of change. For instance, we know how the market currently functions, but how will it operate when most clients convert to on-line trading? Moreover, what will happen to the current best practices once trading platforms are introduced and consortiums offer their services? Rather than waiting for these developments to take place, the Committee opted to address them now in the updated *Guidelines*.

The new *Guidelines*, which appear on pages 69-92 of this report, present some standard best practices while also acknowledging that the industry is undergoing a transformation. The Committee is aware that as the market evolves, changes in procedures could quickly alter today's best practices. Nevertheless, we believe that the best practices that espouse, support, and promote ethical behavior will always be an important part of any core of standards for a successful foreign exchange trading operation.

Of course, we recognize that there are many market participants who may not have ready access to special legal counsel or professional risk managers and therefore may have to consult our *Guidelines* regularly. As such, the document is meant to assist all market participants by providing a clear statement of industry practices—one that is easily accessible and, importantly, provides a variety of suggestions for managing and reducing risk effectively.

Our revised *Guidelines* reflect the solicited comments and recommendations of our colleagues in various industry groups, to whom we are most grateful.

FACILITATING IMPROVEMENTS IN PROCESSING

Efforts with SWIFT

The Foreign Exchange Committee strongly supports efforts that promote and facilitate straight-through processing as a way to reduce settlement and other types of risk. Assisted by our Operations Managers Working Group, the Committee has been working with SWIFT to suggest ways to amend trade confirmation messages to ensure "machine-readability"—the ability of institutional electronic systems to input SWIFT trade information easily.

In addition, the Committee, in conjunction with the Singapore Foreign Exchange Market Committee, formally recommended that SWIFT restrict the type of information that counterparties can add to SWIFT trade confirmation messages (see page 99). This change was suggested to eliminate the confusion in the marketplace that occurs when counterparties amend trade terms on SWIFT confirmation messages.

Steps to Improve Options Procedures

Continuing the prior year's work on revising best practices for barrier options, the Foreign Exchange Committee, in collaboration with a legal subgroup, proposed two new barrier options templates (see page 59). The group created the templates after reviewing several institutional confirmation agreements. Use of these templates is strongly encouraged by the Committee.

In another initiative, the Committee, working with the Federal Reserve Bank of New York's Markets Group, updated the series on implied volatility rates for foreign exchange options (published monthly by the Federal Reserve Bank of New York) in line with the industry's needs. The revisions to the series, made on the basis of responses to an industry survey, include:

- obtaining and posting mid-level rates of bid-and-ask indications, rather than separate bid- and ask-rates,
- adding one-week and two-month maturities to the already published one-, three-, six-, and twelve-month maturities and two-year maturities,
- shifting the pricing time to 11 a.m. New York time so that the series can be compiled and posted on the Federal Reserve Bank of New York's web site on the month-end date.

As always, we encourage market participants to use these data and publicize their availability to others in the market. A more detailed description of the series can be found on page 107 as well as on the Federal Reserve Bank of New York's web site, <www.newyorkfed.org>.

Preparations for the Introduction of CLS

Over the past year, the Foreign Exchange Committee helped members to gain a fuller understanding of the new CLS Bank, which, when operational, will provide a streamlined payment system for foreign exchange transactions. To that end, we identified several CLS issues that required further review and discussion, such as liquidity, third-party payments, and operational efficiencies. At our May meeting, for example, the liquidity discussions centered on such topics as the potential providers of liquidity and their expected roles, the criteria to be used to determine the cost of funds, and the possibility of spikes in liquidity needs.

By focusing on these and other key issues related to the CLS Bank start-up, we provided our membership with opportunities to ask important questions, make vital decisions, and take additional steps to ensure that their organizations as well as the industry are prepared for the introduction of this new system.

OTHER ISSUES

On several occasions during the year, some Foreign Exchange Committee members raised specific industry concerns with the full Committee with the intention that a joint action might improve both market conditions and general risk management. Some of the key discussions and subsequent actions are summarized below.

- The posting of new European holidays early in the year prompted a discussion of the problem of changing settlement dates when holidays are announced with relatively short notice. After a thorough review, the Committee agreed that the circumstances surrounding these infrequent occurrences tend to be complicated and event-specific, and therefore they might be addressed more effectively through ad hoc solutions. The Committee believed that an official recommendation on this issue was unnecessary and might even be counterproductive.

- The Committee was updated frequently on the progress made in developing a market for contracts for differences (CFDs): foreign exchange contracts that do not exchange principal. We had reviewed the pros and cons of a CFD market in prior years, and published a study in our *1998 Annual Report*. We will continue to examine developments in this area going forward.

- In March and April, the Committee surveyed twenty-two financial firms, many of which are represented on the Committee, to assess the industry's progress in reducing the number of legal-entity names used by a single institution's trading operation. As the survey results indicate, most firms considered this a worthwhile objective (see page 27). However, for various reasons—mostly institutional in nature—many organizations are falling short of meeting the objective of dealing under one legal-entity name.

CONTINUING OUR COLLABORATION WITH THE SINGAPORE COMMITTEE

One of the key events of 2000 was our annual meeting with the Singapore Foreign Exchange Market Committee. Throughout the year, the two committees exchanged agendas and kept each other apprised of activities, which culminated in the November meeting in New York. The committees plan another meeting in November 2001, in Singapore, and will continue to update one another on important developments.

Our close relationship with the Singapore Committee yields valuable benefits, as it enables both committees to maintain an ongoing dialogue on issues such as regional price-disruption events, which affect the entire global foreign exchange community.

LOOKING TO 2001 AND BEYOND

As 2001 progresses, the foreign exchange market may very well look and operate differently than it did in 2000. Nevertheless, the Foreign Exchange Committee plans to stay ahead of market changes through our continuous review of new systems and our efforts to understand and anticipate ways in which the industry might evaluate and manage risks more effectively.

This year, I ended my two-year tenure as Chairman of the Foreign Exchange Committee, a highlight of my career in the foreign exchange market. At the start of 1999, when I assumed this role, the Committee worked diligently to ensure that there would be no unpleasant surprises related to Y2K. Now, ironically, the market and the Committee are moving into a new century in which the effects of technology surprise us almost every day. Even with these uncertainties, I feel that we on the Committee, working closely with our sister global organizations, must continue to strive to create a foreign exchange industry that is more transparent, cooperative, and grounded in a set of best practices reflecting the highest standards of integrity and sound business behavior.

Paul Kimball