Chairman's Letter

THIS HAS BEEN A PARTICULARLY CHALLENGING YEAR FOR THE GLOBAL financial community. Few of us were left untouched by the tremendous loss of life and destruction caused by the September 11 attacks on the World Trade Center and the Pentagon. These tragic events did not, however, diminish the power of the human spirit to overcome disaster. I am particularly proud of the contributions that the Foreign Exchange Committee made to enable the financial system to remain functional on September 11 and in the days and weeks that followed. Committee members and affiliates worked tirelessly to ensure that essential trading and settlement operations continued. The effectiveness of their efforts demonstrates the importance of committed individuals and industry groups to the smooth functioning of the marketplace, even in difficult times.

The crucial importance of communication gained even greater prominence as the events of September 11 illustrated the global nature and resilience of the foreign exchange market. Throughout the year, the Committee made a priority of improving communication and strengthening relationships with other industry groups such as the Singapore Foreign Exchange Market Committee. The Committee also endeavored to support the functioning of the market by publishing relevant papers and letters and by issuing press releases in response to critical market events. All of the Committee's actions were focused on providing the foreign exchange community with information and contributing to its overall development.

SUPPORTING THE MARKET AFTER SEPTEMBER 11

The attack on the World Trade Center destroyed both the front- and back-offices of many financial firms. Much of New York City's financial district was evacuated and firms activated contingency sites elsewhere. Immediately following the attacks, the Operations Managers Working Group of the Foreign Exchange Committee began to conduct conference calls to address issues that arose from the disaster and affected foreign exchange transactions. The group met two to three times daily from September 11 to September 19. During conference calls, members were able to provide crucial marketwide status reports and to identify problems as they developed. In addition, because the relocation of firms and disruption of communications made it difficult for counterparties simply to find one another on September 11, within hours of the disaster the group helped market participants locate one another by creating a contact list and circulating it by e-mail.

In an early conversation, members of the group considered whether changes in the settlement conventions were needed to accommodate settlement disruptions, but the majority agreed that trades were settling sufficiently well and no change was warranted. The conference calls also provided a forum for immediate information sharing and an opportunity for the Federal Reserve Bank of New York to engage in dialogue with the marketplace about trading and settlement conditions in foreign exchange and money markets.

The group's efforts proved critical in keeping foreign exchange markets functioning and reestablishing settlement operations. Consequently, the foreign exchange markets experienced fewer disruptions after the attacks than other markets. The Foreign Exchange Committee recognizes that having the Operations Managers Working Group already in place enabled the Committee to respond quickly and to mobilize efforts to identify essential issues and resources. After witnessing the effectiveness of the Operations Managers Working Group, many other industry participants have established similar standing groups to aid the marketplace in any future disruptions.

Nonetheless, the September 11 attacks highlighted a number of risks specific to the foreign exchange market that the Committee wishes to emphasize as market participants examine their preparedness for market events in the future. Toward that end, the Committee issued a paper in November 2001, *Contingency Planning: Issues and Recommendations*, summarizing specific events in the foreign exchange market and offering recommendations to help avert or minimize any such future event.

The Committee also reassessed its own preparedness for emergencies and instituted several changes. The Committee's public web site was enhanced to provide more tools for information sharing in the event of an emergency. In addition, meetings with other industry groups, such as the Singapore Foreign Exchange Market Committee and the Canadian Foreign Exchange Committee, were initiated to discuss ways to coordinate contingency planning efforts and to foster increased communication between secretariats in the future. The Committee is continuing those initiatives.

MARKET VOLATILITY

Before September 11, the Committee was already at work addressing issues of market volatility and disruptions. Throughout the years, market participants have learned that prudent market practices and optimal communication become particularly necessary in times of uncertainty. The Committee has consistently aimed to alleviate concerns about market volatility and disruption by providing a forum for sharing information and, in certain instances, recommending best practices.

In 2000, a group of central banks sponsored a forum to discuss market disruptions specifically. This meeting of the Financial Stability Forum Working Group of Highly Leveraged Institutions resulted in a list of key measures titled *Trading Principles*. Although the *Guidelines for Trading Activities in Foreign Exchange* promote many of these principles, the *Guidelines* were amended in 2001 to include Addendum C, which highlights practices that take on particular importance during periods of significant market volatility.

Nonetheless, the Committee thinks that good planning and clear internal guidelines are equally important in more ordinary times and can help market participants position themselves to react more effectively to market events. With this in mind, the Committee issued S*upplementary Guidance for Market Disruptions* as an aid to participants in preparing for such circumstances.

MONITORING E-COMMERCE ISSUES

The Committee understands the important role played by e-commerce in the foreign exchange industry. Surveys such as the Bank for International Settlements' Triennial Survey of Foreign Exchange indicate growing interest among market participants in using web portals for transacting trades. The Committee continues to monitor the effect of e-commerce on price discovery, transparency, and liquidity in the marketplace.

In 2001, several multidealer portals began operations that allowed customers to use a single web interface for trading with several counterparties. To better understand these developments, the Committee established a subgroup to study them. The group as a whole felt that it was too early in the evolution of e-commerce to warrant any substantial change in the structure or practice of foreign exchange, but will continue to evaluate trends going forward. However, with the cooperation of the Operations Managers Working Group, the Committee offered special guidance on the use of electronic validation, a feature offered by many electronic trading platforms. The document, *Supplementary Guidance on Electronic Validations and Confirmation Messaging*, outlines some of the key risks of replacing trade confirmation with electronic validation.

REDUCING SETTLEMENT RISK

The Committee continues to make reducing settlement risk a priority. In 2001, the Committee worked on two initiatives that aim to bolster the certainty that foreign exchange trades will be settled efficiently and correctly. Continuous Linked Settlements (CLS) Bank, which, as its name implies, will provide continuous linked settlements for its customers, is scheduled to begin operation in the fall of 2002. At the Committee's May meeting, representatives from CLS Bank updated the attendees on the effort to establish a single multicurrency settlement service that will consolidate the foreign exchange settlement activities of large foreign exchange providers. CLS representatives also reported on continuing efforts to minimize liquidity risk by the introduction of "inside-outside swaps," a function that will allow participants to settle one leg of a foreign exchange swap inside CLS and the other leg outside CLS, minimizing the variance in daily balances within the CLS system.

The Operations Managers Working Group and the Financial Markets Lawyers Group (FMLG) continue to consult with CLS Bank on several issues of market practice recommended by CLS. Both groups continue to participate in periodic meetings with the CLS User Group—a U.S.-based advisory group created to consider the establishment of CLS. In April, the Committee issued a letter to the CLS User Group expressing support for a proposed recommendation that counterparties may choose, on a bilateral basis, to eliminate trade confirmations in lieu of a trade match in the CLS system.

The Committee also continued to collaborate with SWIFT in an ongoing effort to simplify trading procedures and limit settlement error and confusion. Together with the Singapore Foreign Exchange Market Committee, the Committee wrote a letter to SWIFT proposing stricter guidelines for trade documentation. A second letter to SWIFT communicated the Committee's support for proposed changes in the definitions for certain SWIFT confirmation fields.

ESTABLISHMENT OF THE CHIEF DEALERS WORKING GROUP

As trade issues in foreign exchange have become increasingly complex, the Committee thought that it would be prudent to revive the Chief Dealers Working Group. Committee members nominated chief dealers to participate in the Group. Among its purposes will be to advise the Committee on emerging trade issues and to address specific concerns and questions raised by the Committee.

In the Working Group's first year of revival, it discussed a range of issues, including the impact of electronic dealing in the customer market, trade practices for emerging market currencies, and current trends in trade disputes. Concerning the latter, the Group recognized the need for improved communication between counterparties by clarifying standard terminology for stop-loss orders. In consultation with the FMLG and the Committee, the Group composed a new section on "Stop-Loss Order Definitions" to be added to the *Guidelines for Foreign Exchange Trading Activities*.

REACTING TO TRADING DISRUPTIONS

The Committee monitored disruptions in the trading and settlement of the Indonesian rupiah, Taiwan dollar, and Argentine peso. In February, Bank Indonesia, the central bank of Indonesia, announced certain restrictions with regard to foreign exchange transactions involving the rupiah. The Singapore Foreign Exchange Market Committee coordinated with the Foreign Exchange Committee to seek clarification from Bank Indonesia on the scope of these restrictions to mitigate uncertainty in the marketplace. Subsequently, both groups advised counterparties affected by the restrictions to contact one another in order to discuss the treatment of rupiah trade positions.

In September, the Singapore Committee issued a statement regarding the treatment of fixing rates and settlement dates for Taiwan dollar nondeliverable forwards (NDFs) after questions arose regarding fixing rates.

Subsequently, the Foreign Exchange Committee endorsed the Singapore Committee's recommendation regarding Taiwan dollar NDFs.

In July, the Committee, along with its co-sponsors the Emerging Markets Traders Association (EMTA) and the International Swaps and Derivatives Association (ISDA), included new documentation for Argentine peso NDFs in Annex A of the *1998 Foreign Exchange and Currency Option Definitions*. That document supplements the Committee's master agreement templates for NDF trades. The new documentation introduces settlement procedures in the event of an unexpected market holiday.

On December 21, 2001, officials in Argentina announced that local financial markets would be closed. The announcement followed months of mounting pressure on Argentina's bank and foreign exchange reserves. Argentine banks remained closed until January 11, 2002. After the banks reopened, the peso-dollar convertibility regime was replaced by a partial floating rate regime. Throughout this period, market participants looked to the Committee and other industry groups, including EMTA, for guidance on the trade and settlement of Argentine peso NDFs.

The Committee collaborated with EMTA on several other initiatives in 2001. Changes in currency spot rate definitions for the Korean won culminated in additional updates to Annex A of the *1998 Foreign Exchange and Currency Option Definitions*. The Committee recognizes that there is more work to be done to enhance NDF documentation and market certainty for trading in emerging market instruments and will continue to support EMTA's work to supplement existing standard trade documentation.

LOOKING AHEAD: PLANS FOR 2002

Although the Committee made great strides in 2001 toward helping market participants prepare and respond to market events, more remains to be done. In 2002, the Committee will concentrate on a number of projects, including:

- Updating operational guidance to incorporate market-related innovations over the past five years,
- Monitoring the activities of CLS Bank,
- Collaborating with the Securities Industry Association (SIA) to examine cross-border implications of proposed efforts to shorten securities settlement from three days to one day,
- Evaluating the developments of electronic dealing with the assistance of the Chief Dealers Working Group,
- Supporting the efforts of EMTA to improve the documentation of NDFs, and
- Examining changes in risk management structures for foreign exchange markets.

In my first year as Chairman of the Foreign Exchange Committee, I am gratified to report the progress made by the Committee in its support of the marketplace. Thanks to the dedication and expertise of Committee members and affiliates, the foreign exchange community stands better prepared to weather both systemic changes to the industry as well as future market events. Many of this year's achievements are discussed in greater detail in later sections of this report, and I encourage readers with particular interests to find them there for their convenience.

I look forward to the continuation of the Committee's efforts to encourage the foreign exchange marketplace to strive for the highest standards of integrity and sound business practices.

David Puth
Chairman of the Foreign Exchange Committee