Chairman's Letter

THE PAST YEAR BROUGHT MANY CHANGES TO GLOBAL FINANCIAL markets that in turn made for a dynamic time in the foreign exchange industry. The long-awaited launch of CLS Bank, the growing reliance on electronic trading, and the increased use of prime brokerage arrangements all provided evidence that the foreign exchange industry continues to evolve as global financial markets become increasingly interdependent. In 2002, the Foreign Exchange Committee (the Committee) supported the foreign exchange market by publishing papers and letters, sponsoring an educational seminar, and issuing press releases in response to critical market events. All of these actions were undertaken to provide the entire foreign exchange community with information that would facilitate the smooth operation of the market and enhance its overall development.

MARKET GUIDANCE

The Committee dedicated much of the past year to improving its guidance on foreign exchange trading and operational practices. In 2002, the U.S. subsidiary of a foreign bank announced substantial financial losses as a result of alleged fraudulent trading and operations activity. This event reminded all industry participants of the need for maintaining effective practices and operational controls. The Committee responded by reevaluating its written guidance on these matters: the *Guidelines for Foreign Exchange Trading Activity* (the *Guidelines*), and *Management of Operational Risk in Foreign Exchange*, a list and discussion of sixty best practices for sound operational risk management.

The *Guidelines* had been revised in 2000 and required only minor adjustments. *Management of Operational Risk in Foreign Exchange*, however, had not been revised since its original publication in 1996 and required substantial updating. Not surprisingly, the majority of best practices in the first version of the document continued to reflect sound advice for managing operational risk. Yet the current landscape of the foreign exchange market has developed new standards, and the Committee has revised its best practices accordingly. In preparing this revision, the Committee's Operations Managers Working Group (the Operations Managers) worked closely with the Financial Markets

Lawyers Group (FMLG) and industry groups such as the Singapore Foreign Exchange Market Committee to achieve a global view of current standards and practices. The revised best practices are scheduled for release in the first quarter of 2003. Their publication will be accompanied by symposiums in New York, Europe, and Asia that will promote the best practices and encourage additional discussion of new developments in foreign exchange operations.

ENCOURAGING STANDARDIZATION FOR NON-DELIVERABLE FORWARDS

For several years, the Committee has partnered with the International Swaps and Derivatives Association (ISDA) and the Emerging Markets Traders Association (EMTA) to encourage standard trading documentation for non-deliverable forwards (NDFs) and related emerging-market transactions. Interest in this effort was revived in 2002, after Argentine authorities replaced the Argentine peso-dollar convertibility regime with a partial floating rate regime. The change resulted in an extended period of market closure for Argentine peso trading that made it difficult to price and settle Argentine peso NDFs. During that time, the Committee issued a statement recommending that market participants defer settlement of open contracts with the expectation that Argentine authorities would quickly clarify the new exchange regime.

Confusion over the process of settling trades during and after the market closure prompted ISDA, EMTA, and the Committee to reconsider the common methods of response to unexpected market closures. The Committee recommended that EMTA work with market participants to develop a new valuation methodology for all NDF master agreement templates in the event of unscheduled market closures and holidays.

The Committee continued to liaise with EMTA as it developed a new architecture for the Argentine peso NDF master agreement template. In December 2002, EMTA, ISDA, and the Committee jointly released an update to Annex A of the *1998 Foreign Exchange and Currency Options Definitions* reflecting this new architecture. The Committee will continue to work with EMTA on further standardization of contracts by introducing the new NDF architecture for the Argentine peso into other NDF contract templates.

The Committee also made strides toward improving efficiency in the documentation and confirmation of NDFs. For many years, market participants have faxed long-form confirmation messages for each NDF trade. Because this process was not automated, it increased the chances of miscommunication regarding trade terms. To minimize this problem, the Committee issued an *NDF Master Agreement Supplement* with the assistance of the Operations Managers group and the FMLG. This supplement allows counterparties to agree on the common terms of an NDF contract before trading, eliminating the need to exchange faxes for each individual trade. The Committee is pleased to report that the application of the master agreement supplement has resulted in fewer confirmation errors and significant improvements in the efficiency of the confirmation process.

ENCOURAGING STRAIGHT-THROUGH PROCESSING

The Committee has participated for several years in an effort led by the Securities Industry Association (SIA) to encourage straight-through processing in financial markets. The Committee agrees with the SIA that straight-through processing eliminates the double entry of data and minimizes the risk of trade and settlement errors. In 2002, the Committee's participation in the SIA's Foreign Exchange Subcommittee culminated in the publication of the *SIA Foreign Exchange Subcommittee T+1 White Paper*. The paper examines a proposal to shorten the settlement cycle for U.S. securities from three days to one (T+1) and also evaluates the significance of the current two-day settlement cycle for foreign exchange. While adoption of T+1 settlement was dropped from the SIA's agenda last summer, the paper has continued to serve as a resource for market participants as they set priorities in automating their operations. This *Annual Report* contains an executive summary of the paper and a letter to the SIA supporting the paper's findings.[1] The full white paper is available on the SIA's web site.[2]

ENCOURAGING SOUND TRADING PRACTICES

The Committee has become increasingly concerned by the risks associated with foreign exchange trading on an unnamed basis and the threats that this practice poses to the broader financial market. The Committee believes that trading on an unnamed basis limits the ability of dealers to assess the creditworthiness of their counterparties, to complete "know your customer" procedures, and to succeed in efforts against money-laundering. To highlight these risks to the financial community, the Committee has established discussions with several U.S.-based industry groups that represent asset managers, in addition to contacting other concerned industry associations.

Given the integration of the financial marketplace, the Committee recognizes the global nature of this issue. In November, the Committee wrote to the Bank of England's Joint Standing Committee (JSC) to support proposed changes to the JSC's Non-Investment Products (NIPs) code[3] intended to eventually eliminate trading on an unnamed basis. The Committee will continue to seek ways of alerting market participants to the risks associated with trading on an unnamed basis and support alternative means of ensuring confidentiality without impairing risk management.

The Committee also examined the recent growth of prime brokerage in the foreign exchange market in recent years. In conjunction with the FMLG, the Committee brought together a group of prime brokers and executing brokers

[1]For additional information on the SIA's T+1 effort, see the "Advisory Role" section of this report on page 17.

[2]The white paper is available on the SIA's web page at <http://www.sia.com/stp/pdf/Foreign_Exchange_White_Paper_v6.0.pdf>

[3]The NIPs code is a reference source used for regulatory review of financial institutions and investment managers in the United Kingdom.

to discuss industry practices and explore the possibility of developing industry-standard master documentation for foreign exchange prime brokerage. These discussions, along with the work of the FMLG, identified several issues for which standard documentation would be premature. Consequently, the FMLG decided not to publish industry-standard documentation at this time but will periodically revisit the proposal to determine if setting such standards becomes appropriate in the future.

CONTINGENCY PLANNING

Throughout the year, the Committee discussed best practices for contingency planning as the marketplace continued to reflect on the events of September 11, 2001, and prepare for future market disruptions. Although the foreign exchange market weathered the destruction of the World Trade Center with impressive agility, it was apparent that contingency planning could be improved. The increased level of interdependency in the marketplace has made it more important than ever for firms to integrate their continuity plans with those of key liquidity providers and utilities to ensure that all users of a utility are operating on the same contingency assumptions. As the marketplace has strengthened its plans, communication networks have improved, system interoperability has increased, and the market is generally better prepared for future market disruptions.

The Committee continues to participate in the global financial community's dialogue on long-range contingency planning as well. At the annual joint meeting with the Singapore Foreign Exchange Market Committee in September, we discussed lessons learned from September 11 and various recommendations proposed for the complex planning needed for global foreign exchange operations. In the fall, the Committee provided public comments on a proposal for new standards for contingency planning for U.S. financial institutions and related utilities. The Committee will continue such efforts to educate the market concerning how firms with global operations can leverage operations in different geographic regions in times of market stress.

MONITORING THE DEVELOPMENT OF CLS

After years of preparation, CLS Bank, which provides continuous linked settlement (CLS), began full operation in the fall of 2002, thereby introducing one of the largest structural changes to the market in the last decade. CLS Bank seeks to eliminate settlement risk by providing a single multicurrency settlement service that will consolidate the foreign exchange settlement activities of foreign exchange providers. At the Committee's May meeting, representatives from CLS Bank updated the Committee on liquidity measures for CLS and discussed testing efforts before the launch. The Committee will continue to monitor CLS's evolution as the number of active members of the bank grows and as CLS begins to integrate third-party participants.

E-COMMERCE

The Committee continues to observe with interest the adoption of electronic trading in the dealer-to-customer arena. While the number and variety of electronic trading platforms has steadily grown in recent years, trading volume on these systems has remained surprisingly low. In 2002, however, a growing number of market participants began to use Internet-based trading systems instead of the telephone. The Committee continues to examine some of the potential structural implications of this trend. In the spring of 2002, the Committee's Chief Dealers Working Group sponsored an Electronic Trading Forum at the Federal Reserve Bank of New York. Representatives from several multidealer platforms debated the impact of electronic trading on the traditional market mechanism, and representatives from the buy-side and sell-side of the market discussed their perspectives on electronic trading. The Committee will seek additional opportunities to educate the broader market on electronic trading developments. In addition, the Operation Managers will provide guidance on practices for confirming trades conducted over electronic trading platforms.

LOOKING AHEAD: PLANS FOR 2003

Many of the projects that dominated the Committee's attention in 2002 will extend into next year as well, and will be joined by new goals:

- publish a revised version of *Management of Operational Risk in Foreign Exchange* and sponsor forums to discuss changing operational risk management practices,
- collaborate with the Joint Standing Committee and other industry groups to support the eventual elimination of trading on an unnamed basis,
- collaborate with EMTA and the Singapore Foreign Exchange Market Committee to establish global standards for NDF documentation,
- monitor the development of CLS Bank, and
- provide best practices for confirmation practices concerning transactions conducted by way of electronic trading systems.

As the Committee begins its twenty-fifth year, it is worthwhile to consider the impressive variety of projects it has supported in the foreign exchange community during its remarkable growth and evolution. Our upcoming anniversary is a time not only to reflect on issues that have arisen over the past few years, but also to recall the long-term improvements we have all witnessed in the foreign exchange community in the United States and the world. I look forward to the challenges and achievements that 2003 will bring. I invite you to read the remainder of this *Annual Report* for details about the Committee's contributions in 2002 and our plans for the future.

David Puth
Chairman of the Foreign Exchange Committee