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COMMITTEE LETTER

Commenting on the Draft Interagency White Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System

October 21, 2002

Jennifer Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, Northwest
Washington, D.C. 20551

Re: Docket No R-1128

Dear Ms. Johnson:

We write in response to the recently released *Draft Interagency White Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System*. As an industry group representing senior professionals in the foreign exchange marketplace, the Foreign Exchange Committee considers it a priority for all market participants to create robust contingency plans to enhance the resilience of the marketplace in emergencies. However, the Committee also recognizes that each firm must match its contingency plans with the size and scope of its business. The Committee therefore encourages the Federal Reserve, the Office of the Comptroller of the Currency (OCC), and the Securities and Exchange Committee (SEC) to highlight these two goals in their efforts to prescribe contingency planning guidelines. The comments and recommendations below are submitted with those goals in mind and to enhance the clarity and scope of the white paper's proposed guidelines.

SCOPE OF THE PROPOSAL

The proposal encourages firms to prepare for a "wide-scale, regional disruption," and recommends that they develop the capacity to meet material end-of-day funding and collateral obligations within a four-hour window in response to a disruption event. This emphasis on developing contingency facilities around an alternative labor force implies a catastrophic disruption event. Many of the performance targets outlined in the proposal, however, appear to be somewhat disproportionate to the large-scale implications of a catastrophic disruption event. Currently available technology may enable firms to prepare for highly robust recovery in a short time for *concentrated regional disruptions* within a single metropolitan area. However, a *catastrophic event* would likely imply significant damage to infrastructure and communication systems far beyond a single metropolitan area. Recovery from catastrophic events would in all likelihood necessitate more than four hours, unless a firm maintains full-scale, twenty-four-hour parallel operations. Requiring parallel operations would result in anticompetitive consequences for all but the largest firms and greater concentration of risk for the marketplace as a whole. Without further clarification of what a "wide-scale, regional disruption" implies, the Committee questions whether a four-hour window provides sufficient recovery time.

In order to clarify the assumptions underlying the proposed guidelines, the Committee would recommend, 1) a full description of what a "wide-scale, regional disruption" implies, and 2) an outline of what infrastructure and market systems are assumed to be functional or nonfunctional in such instances.

In addition, the proposal prescribes that "core utilities" and financial institutions reconfigure their contingency plans simultaneously. However, the proposal is ambiguous about what facilities are considered core utilities and how preparedness will be measured and monitored. The Committee recommends that regulators consider proposing a two-stage process that concentrates first on core utilities and second on financial firms. A two-stage process would provide greater certainty about the appropriate criteria and the technical requirements necessary to develop contingency arrangements for various financial market participants. In addition, the Committee recommends that the final contingency guidelines include:

1) A list of which utilities qualify as "core clearing and settlement organizations." (Does the proposal imply, for instance, that market participants can assume that settlement systems such as continuous linked settlement (CLS), payment systems such as Fedwire, and secure messaging systems such as SWIFT are all core utilities?)

2) A description of how the preparedness of these utilities will be measured that assumes that not all of them are regulated. Financial firms understandably seek a high level of confidence that such utilities would be

proven to be available during a "wide-scale, regional disruption" before they invest in contingency operations that rely on those utilities.

SCOPE OF CONTINGENCY OPERATIONS

The Committee is concerned that the proposal requires technology that is not currently available or widely used. For example, syncretistic mirroring, which is necessary for 100 percent data replication, is limited to 100 kilometers of optic wire line. Consequently, uninterrupted replication of all trade data by current technology cannot span the 200- to 300-mile distance implied in the proposal for backup facilities. The Committee recommends that contingency standards should be based on available technology, because if standards are set unreasonably high they become a disincentive for firms in pursuing commercial business and may compromise fair market access.

CLARIFY THE OPERATIONAL FOCUS

The Committee seeks further clarification of which operational functions fall within the scope of the guidelines. While we surmise that the proposal is directed at back-office operations for payment and settlement, there remains some ambiguity as to whether the guidelines also include front-office operations.

CLARIFY FIRM THRESHOLDS

The proposal is somewhat unclear about how a firm should determine whether it is subject to the proposed standards. We are particularly concerned about firms whose business activity vacillates near threshold levels. How would these firms determine whether they would be subject to the proposed standards or not, and in what cases? For determining applicability of the new standards, the Committee recommends that dollar-value thresholds would be more objective than market-share thresholds. Firms note that dollar settlement levels are simple to determine, while measures of market share can be somewhat subjective.

CLARIFY CONTINGENCY OPERATIONS LOCATIONS

While the proposal emphasizes that contingency operations should rely on a separate labor pool and infrastructure grid, the Committee seeks additional clarity about the locations suggested for contingency operations. The Committee recommends, however, that each firm should have the discretion to determine the appropriate mileage between its usual and its contingency operations centers based on the infrastructure and labor demographics of its location.

CLARIFY "MATERIAL BUSINESS"

The proposal advocates that firms strive to process and settle "material business" within four hours of a disruption event. The proposal at times implies that the term material business suggests prioritized large obligations only. At other times it suggests that normal activities are included in material business. The difference between the two definitions has significant implications for the technology necessary to maintain parallel or delayed-information backups. Further clarification of the definition of material business would offer necessary guidance on the scope of contingency arrangements.

CLARIFY THE SCOPE OF FOREIGN EXCHANGE SETTLEMENT

The proposal is unclear whether foreign exchange participants would be required to meet end-of-day funding and collateral requirements for U.S. dollar trades only, or for all other currency trades as well. The difference between the two pools greatly affects the scope of operations that would fall within the proposed requirements.

CLARIFY REGULATORY DISTINCTIONS

The proposal suggests that the Federal Reserve System, the SEC, and the OCC may interpret the final contingency guidelines differently with regard to their respective regulated entities. The Committee recommends that each regulatory body clearly communicate its regulatory expectations in tandem with the release of the final guidelines.

GLOBAL REGULATORY REQUIREMENTS

The Committee is concerned that standards that incur higher operational costs could put U.S.-based institutions at a disadvantage against firms regulated by non-U.S.-based regulatory bodies. In addition, such standards could compromise a firm's ability to comply with requirements by other regulators. The Committee recommends that regulators carefully review the conflicting requirements of regulatory bodies in other jurisdictions, particularly those in Asia and Europe.

IMPLEMENTATION TIMETABLE

The Committee recognizes that the timetable for implementation of these guidelines could take several years, and therefore recommends that the final standards acknowledge that planning and implementation may require that much time. In addition, it is notable that the proposed standards would require that day-to-day operations for settlement and clearing be radically reconstructed, which could impose significant operational costs and planning needs.

In conclusion, the Foreign Exchange Committee commends the efforts of the Federal Reserve System, the OCC, and the SEC to harmonize guidance on contingency planning in the U.S. financial sector. We welcome any questions or comments you may have regarding our recommendations.

Sincerely,

David Puth
Chairman
Foreign Exchange Committee