CHAIRMAN'S LETTER

In my fifteen years as a member of the Foreign Exchange Committee—with the last three as Chairman—I have seen many changes in the structure and operation of the foreign exchange market. The market today is not only more electronic but also considerably more intricate than it was just a few years ago. We are trading differently, and traditional trading counterparty relationships are being fundamentally altered. Adding to this mix, market instruments are more complex.

In this new environment, the path for the Committee is relatively straightforward, with two equally important obligations:

- first, to continue working vigorously to understand the new market and any implications for trading issues, including those related to ethical standards; and to address these new developments, when warranted, with best practice recommendations and market guidance, and

- second, to continue being a strong partner to other foreign exchange committees and industry groups worldwide that have similar missions. This means playing a cooperative role in initiating, supporting, and/or facilitating the sharing and adoption—on a global basis—of our industry's best practices.

During 2003, the Committee made progress incorporating the new market mechanisms and procedures in our best practice recommendations and other market guidance. I cite, in particular, the considerable efforts of our Operations Managers Working Group in updating an important market document, *Management of Operational Risk in Foreign Exchange*. We also are reexamining the Committee's guidance in light of the November 2003 arrests of forty-seven market participants for a variety of fraudulent activities.

Our continued close association with other foreign exchange committees and groups during 2003 enabled us to move forward on several vital projects. In particular, we worked closely with the London Foreign Exchange Joint Standing Committee as it spearheaded efforts to eliminate unnamed counterparty trading.

Furthermore, projects to improve documentation of non-deliverable forward contracts (NDFs) in both Asia and Latin America could not have gone forward without the interaction of the Emerging Markets Traders Association, the Singapore Foreign Exchange Market Committee, the Tokyo Foreign Exchange Market Practices Committee, and the Hong Kong Foreign Exchange and Money Market Practices Committee.

In the next section of this letter, I review in more detail the above-mentioned projects as well as a number of other efforts and events that were sponsored in 2003 by the Committee, its associated working groups, and other globally oriented groups.

Following this letter is a report on the legal-based initiatives of the Committee (page 3) and then a summary of the Committee's projects in progress for 2004 (page 7). The middle portion of this 2003 Annual Report (starting on page 9) reprints all reference materials and documents released by the Committee during the year, and the last section (starting on page 89) provides reference material on our members, meetings, and rules.

COMMITTEE PROJECTS

Eliminating Unnamed Counterparty Trading

Of the many activities that the Committee worked on this year, the efforts to eliminate unnamed counterparty trading required particularly close interaction and cooperation among a variety of foreign exchange committees and industry groups.

In unnamed counterparty trading,

- a fund manager, investment advisor, or other intermediary acts as an agent on behalf of a client,
- the client is a principal in the transaction, and
- the principal's identity is not provided to the institutional counterparty.

When an institution does not know the identity of its counterparty, the institution faces increased legal, compliance, and reputational risks. The practice also thwarts effective "know your customer" credit assessment and anti-money-laundering measures.

The London Foreign Exchange Joint Standing Committee took the lead in drafting best practice recommendations that aim to eliminate unnamed counterparty trading in the London market and revised the Non-Investment Products Code (NIPS) to indicate that unnamed trading is inconsistent with best practice. The group also set a May 2004 deadline for implementation of confidentiality terms that require advisors and other intermediaries to identify their customers to the non-trading divisions of the firms with which they are doing business. Non-trading areas include administrative, compliance, legal, and credit and risk management.

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The Foreign Exchange Committee, aware of the strong integration of the global foreign exchange market, endorsed the Joint Standing Committee's actions in a letter sent to the trading community in early January (page 67). The Committee, sensitive to the needs of all counterparties in a trade, stressed in the letter the importance of the rigorous confidentiality agreements.

As the year drew to a close, the Foreign Exchange Committee and the Singapore Foreign Exchange Market Committee discussed at their joint meeting on November 6, 2003, the efforts of the Joint Standing Committee and coauthored a letter of support for those efforts.

Improving Documentation of Asian NDFs

Efforts to improve the documentation of Asian non-deliverable forwards were made by the Foreign Exchange Committee, the Financial Markets Lawyers Group, the Singapore Foreign Exchange Market Committee, the Emerging Markets Traders Association, the Tokyo Foreign Exchange Market Practices Committee, and the Hong Kong Foreign Exchange and Money Market Practices Committee. The impetus to improve Asian NDF documentation came from several major market participants who believed that it was necessary to update the trading terms.

Representatives from the various foreign exchange committees reviewed the templates and details related to the definitions of a price-source disruption event, unscheduled holidays, reference dates, the length of waiting periods, the determination of polling methodologies and mechanisms, and the sponsorship of fallback surveys.

Members of the Financial Markets Lawyers Group and the Singapore Foreign Exchange Market Committee outlined the significant progress made on this issue at the joint meeting between the Singapore Committee and the Foreign Exchange Committee in November. The most notable developments included the construction of new polling processes and mechanisms for six Asian NDF currencies. These projects are currently in the testing phase. Remaining efforts include the completion of confirmation templates that would specify the new processes and fallback procedures.

Monitoring Market Change

Throughout 2003, the Committee monitored the continuing evolution of the foreign exchange market's structure. Clearly, e-commerce is creating efficiencies by increasing the ability of traders to handle large volumes of bids and offers at higher speeds, with less risky settlement and many fewer transaction errors. At the same time, trading margins are narrowing. Trades are being concentrated in the hands of those large institutions that can afford to keep current with state-of-the-art technology and that can offer the necessary liquidity to their counterparties.

While studying the market changes attributable to electronics, the Committee addressed some high-profile market issues in November 2003 when a scandal in the foreign exchange market related to rigged trades and other fraudulent behavior made front-page news. In a letter to the foreign exchange community (page 79), the Committee reminded market participants of its previously published best practices, particularly the guidance provided on the use of points in foreign exchange trading.

THE OPERATIONS MANAGERS WORKING GROUP PROJECTS

An important Committee subgroup, the Operations Managers Working Group, orchestrated a number of important projects during 2003.

Preparing the New Sixty Best Practices

The key project of the Operations Managers was updating *Management of Operational Risk in Foreign Exchange*, a well-regarded and now standard reference document in the foreign exchange market. The original version of this document—often referred to as the *Fifty Best Practices*—was published in 1996. The document's revision involved updating the fifty best practices to take into account all the changes in the market since 1996. Some of those changes include

- the introduction of the euro,
- the consolidation of markets,
- the start up of CLS operations,
- the increased use of outsourcing,
- the evolution and growth of e-commerce, and
- the use of derivatives and emerging market currencies as dominant market instruments.

The 1996 document was expanded to include all these new developments and is now known as the *Sixty Best Practices*. In addition to addressing the above-mentioned topics, the new version includes a separate discussion of pre-trade preparation and documentation, more emphasis on crisis situations outside trading organizations, and a new section on NDFs. The Operations Managers rolled out the new document with a half-day seminar on June 6, 2003, at the Federal Reserve Bank of New York that was attended by market participants from a variety of institutions. The document is printed in this report (starting on page 11).

Commenting on the Basel II Accord

The Operations Managers Working Group is aware of the importance of operational issues and risks in the performance of financial institutions and has addressed these concerns effectively over its nine-year history. Recently, the working group has been monitoring the Bank for International Settlements' initiatives relating to operational risk, particularly the New Basel Capital Accord, also known as Basel II.

In July, the Operations Managers sent a letter (page 81) to the Bank for International Settlements commenting on the Basel II proposals. In the letter, the working group recognized that the identification of operational risk is a lengthy and difficult task. Furthermore, mitigation of operational risk is a complex endeavor that requires significant supervisory resources as well as the active participation and cooperation of all global financial institutions. The working group will continue to monitor the Basel process and local regulatory implementation efforts and—given its own long-term commitment to operational concerns in the foreign exchange market—will offer suggestions and support when warranted.

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Other projects of the Operations Managers Working Group in 2003 included efforts to encourage the institutional use of the Master Agreement Addendum for non-deliverable forwards. The group supported the addition of fixing dates on NDF to the SWIFT MT300 electronic confirmation. More information on this addendum is found on the Committee's website at <www.newyork-fed.org/fxc>.

THE CHIEF DEALERS WORKING GROUP

During 2003, the Chief Dealers Working Group addressed the need to conduct more frequent surveys of foreign exchange turnover, including gathering information from U.S. market participants. Currently, there is tremendous dependence on the triennial survey from the Bank for International Settlements. The notable drawback to the survey is its infrequency—trends and patterns are difficult to analyze when data are available only every three years. In pursuing a more frequent survey, the Chief Dealers Working Group will be coordinating efforts with other institutions and groups, including:

- the Bank of Canada, which calculates a daily turnover survey of its national banks,
- the London Foreign Exchange Joint Standing Committee, which is also working on its own frequent London-based survey, and
- the Emerging Markets Traders Association, which currently provides market volume surveys on more specialized instruments such as non-deliverable forwards.

IMPORTANT EVENTS IN 2003

The Committee's Twenty-Fifth Anniversary

On October 2, 2003, the Foreign Exchange Committee marked its twenty-fifth anniversary with a reception and dinner. About sixty-five members attended the event at the Federal Reserve Bank of New York, including several members from the original Committee roster of 1978-79 and members from the current Committee. The event renewed and strengthened the camaraderie among the current and former leaders within the foreign exchange community. The guest speaker was John Taylor, Under Secretary of the Treasury for International Affairs. His presentation to the group is reprinted here, beginning on page 83.

The Joint Meeting with the Singapore Foreign Exchange Market Committee

The Committee's first joint meeting with the Singapore Foreign Exchange Market Committee was in November 1997 in Singapore. Since that meeting, the two groups have met every November, alternating locations between New York and Singapore. By planning a meeting to be held toward the end of the year, the two committees keep each other updated throughout the year on their projects and begin work to coordinate the agenda several months before the event.

This past year, on November 6, the Singapore Committee came to New York and presented the New York Committee with a thorough analysis of China's economy and a progress report on the Asian NDF project. The President and Chief Executive Officer of the CLS Bank, Joseph DeFeo, discussed the bank's recent progress and its outlook for 2004. The two committees will meet in Singapore for the eighth consecutive joint meeting in November 2004.

The First Global Operations Managers Meeting

On September 17 and 18, the Operations Managers Working Group hosted the first Global Operations Managers Meeting at the Federal Reserve Bank of New York. Approximately sixty members from operations subgroups of the London Foreign Exchange Joint Standing Committee, the European Central Bank Committee, the Canadian Foreign Exchange Committee, and the Tokyo Foreign Exchange Market Practices Committee attended the two-day meeting. Many of these committees had only recently set up operations managers subgroups and were able, through interaction at this meeting, to find help and support for their initial efforts.

The main objectives of the meeting were to introduce groups and participants to one other, improve interaction among the various global groups, encourage project coordination, improve the quality of efforts, and avoid duplication. The meeting included

- discussion of crisis contingency measures, including comments from institutions that dealt with the outbreak of SARS (severe acute respiratory syndrome),
- panels on prime brokerage, straight-through processing, and the future of the foreign exchange business, and
- updates on regulatory change and the impact of the derivatives market on operations.

Eugene Ludwig of the Promontory Financial Group gave a memorable luncheon presentation in which he provided insight into the Group's *Report to the Boards of Allied Irish Banks, p.l.c., Allfirst Financial Inc., and Allfirst Bank Concerning Currency Trading Losses*, a document issued on March 12, 2002. The meeting concluded with a tour of the gold vault at the Federal Reserve Bank of New York.

LOOKING AHEAD

As of the end of 2003, I am stepping down both as Chairman of the Foreign Exchange Committee and as a Committee member. I have served as a member since 1989—the longest tenure on record. After all these years, I leave reluctantly but with the hope that other industry leaders will take steps to participate actively in the efforts of this distinguished and dedicated group and its related working groups. I know that I join many present and former Committee members who say that their participation in the Committee was a special time—a highlight of their career in the foreign exchange market.

I am confident that current members, including the new members who started in January 2004, will continue the tradition of service that we have established. The hope is that all members stay alert to new trends and market directions and are intuitive and creative in suggesting issues for Committee action. In addition, senior officials in the market are encouraged to support the Committee's efforts and to participate in projects that help the Committee to both understand the new market and respond appropriately with the necessary next steps, including formulating best practices.

I know from experience that our most successful projects—whether it be our efforts to understand settlement risk or our work in providing guidance to the market in the form of best practices—resulted from extremely hard work and the strong endorsement and support of all our Committee members. I also know that the Committee will only be successful in guiding our unregulated market if our members take ownership of the projects and act as sponsors within their own organization, as well as within the entire foreign exchange community.

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It is particularly important for Committee members to take ownership of our projects as the market grapples with the ongoing development of doing business electronically. Having broad participation in all of its projects will help the Foreign Exchange Committee establish and maintain a strong public image—a boon to the Committee as it tries to offer guidance to market participants.

I firmly believe that as the year 2004 progresses, our Committee and similar groups around the globe will make great strides toward helping market participants understand and adapt to the new electronic age. The use of electronic trading platforms, new trading relationships, and the proliferation of complex trading instruments raise issues that affect every facet of the market. By working together and being attentive and creative, foreign exchange committees and industry groups worldwide will have the tools needed to facilitate a strong, vibrant, and self-regulated foreign exchange market.

David Puth