# CHAIRMAN'S LETTER

*Recent transgressions in financial markets have underscored the fact that one can hardly overstate the importance of reputation in a market economy. To be sure, a market economy requires a structure of formal rules . . . but rules cannot substitute for character.*

On April 16, 2004, Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System, delivered these comments in a speech entitled "Capitalizing Reputation" before the Financial Markets Conference of the Federal Reserve Bank of Atlanta. His words carried particular resonance for the global foreign exchange industry, which faced two back-to-back scandals in late 2003 and early 2004: the arrests related to Operation Wooden Nickel and the foreign exchange losses announced by the National Australia Bank. Recognizing the need for integrity and sound practice in market operations, the Foreign Exchange Committee completed a range of strategic initiatives in 2004 that were designed to enhance the orderly and responsible functioning of the market and provide critical guidance to members of the foreign exchange community.

Underlying the Committee's initiatives were three broad goals:

- To consider carefully the implications of the new product offerings and service models that are increasingly prevalent in the foreign exchange market. Included in this review were white labeling, retail aggregation, and the rapid proliferation of electronic trading methods, each of which is altering traditional relationships in the market and raising new ethical issues.

- To review vigorously and update as appropriate our three principal best practice documents, *Guidelines for Foreign Exchange Trading Activities, Management of Operational Risk in Foreign Exchange,* and *Foreign Exchange Transaction Processing: Execution-to-Settlement Recommendations for Nondealer Participants*.

- To enhance dramatically the Committee's communications with the global foreign exchange community of dealers, end-users, central banks, and other foreign exchange committees and industry groups.

Although some issues confronting the Committee in 2004 were directly related to the scandals, most were driven by our members' recognition that, over the past few years, the foreign exchange market has rapidly evolved into a new market, with changed counterparty roles, new means of executing and settling trades, and more complex

market instruments. This new market requires careful deliberation and guidance, communicated broadly by market leaders. It is my hope and expectation that the world's largest market will adjust to the changes and adopt revised conventions so that the foreign exchange market will continue to function in a trustworthy and sustainable manner for the benefit of the entire industry.

During 2004, the Committee's close association with other foreign exchange committees and groups enabled us to complete a number of key projects. In particular, a multiyear effort to bring significant improvements to non-deliverable foreign exchange transactions in six Asian currencies was successfully concluded through close collaboration with the Singapore Foreign Exchange Market Committee and EMTA. The Committee also collaborated with the Foreign Exchange Joint Standing Committee, chaired by the Bank of England, in developing semiannual foreign exchange volume surveys for the months of April and October. The first survey of the U.K. and North American markets was conducted during October 2004. Over time, these new surveys will provide market participants with more frequent updates on developments and trends in aggregate activity levels.

Collaboration was also key to the Committee's efforts to develop guidance regarding the practice of trading foreign exchange on an unnamed basis. In 2004, the Committee and the Singapore Foreign Exchange Market Committee issued a joint statement highlighting the risks of unnamed counterparty trading. In addition, the Committee and the Foreign Exchange Joint Standing Committee both introduced changes regarding the practice of dealing with unnamed counterparties to the *Guidelines for Foreign Exchange Trading Activities* and the London Code of Conduct for Non-investment Products (NIPs Code), respectively.

In the sections of this letter that follow, I review all of these projects in more detail and discuss as well some other important efforts. The final section highlights initiatives that will carry over into the Committee's work in 2005 and identifies some new issues ripe for review and consideration.

## COMMITTEE PROJECTS

### Considering the Implications of White Labeling, Prime Brokerage, and the Retail/Wholesale Interface

Innovation in the foreign exchange market is not new, but rarely have we witnessed as many interlinked and profound changes as we have in the past few years. Indeed, I am certain that in the coming years we will look back on the past two years and recognize that we have experienced a watershed transition toward a new foreign exchange market. Not surprisingly, technology played a key role in this period. Electronic trading networks and their associated downstream and upstream order management and aggregation technologies created the improved work flows often hoped for but never before possible. Almost all end-users surely benefited from these changes, and many dealers did as well.

What new technology made possible was quickly combined with new product offerings as dealer firms jostled for market share. These new products included enhanced credit access via prime brokerage and electronic distribution via white-label trading platforms. The dramatically expanded role of the Continuous Linked Services (CLS) Bank in settling foreign exchange transactions also helped transform market mechanisms. New market entrants provided innovative services such as multibank portals and retail end-user market access.

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During 2004, the Committee moved beyond monitoring these changes to the foreign exchange market and began considering their ramifications. Below I summarize some of the issues raised by foreign exchange white labeling, prime brokerage, and retail aggregation.

The white labeling of electronic foreign exchange services allows the “outsourcing” of foreign exchange pricing to large liquidity providers. Under a white-label arrangement, a bank (the “white-label bank”) uses an e-commerce platform to allow its customers to trade at prices quoted by a third-party bank (the “liquidity provider”). The product allows the white-label bank to transfer market risk to the liquidity provider while earning a profit margin for the continued provision of credit services and account-coverage services to its customers. With this innovation, both the white-label bank and the liquidity provider are able to focus on providing those services in which they have a comparative advantage. Among other issues, the Committee discussed whether a dealer offering another dealer white-label services has some responsibility for “know your customer” (KYC) controls.

Foreign exchange prime brokerage allows clients to source liquidity from a variety of banks while maintaining a credit relationship, placing collateral, and settling with a single entity. The primary legal agreements are between the customer and the prime broker, and between the prime broker and the executing dealer. In such a structure, questions naturally arise regarding KYC responsibilities: Which dealer has responsibility for determining the suitability of a customer’s transactions? Does the executing broker have KYC responsibility to determine other elements of appropriate customer due diligence duties, or do these reside entirely with the prime broker? These issues take on larger dimensions with the growth of foreign exchange as a source of absolute return, the increase in pooled-fund vehicles trading foreign exchange actively, and the rise of individuals trading foreign exchange—all developments that have been made possible through the availability of electronic platforms.

Clearly the increase in the trading of foreign exchange by individual investors brings forward essential customer due diligence questions. For example, do dealers that trade with retail foreign exchange aggregators assume any responsibility by means of their own KYC duties for those of the retail aggregator?

Although the Committee has not reached definitive best practice conclusions about the range of issues raised by foreign exchange white labeling, prime brokerage, or the retail/wholesale interface, we have developed three principles that will assist us in establishing any new guidance going forward. First, the best way to mitigate the risks raised by new products is to provide for clear contractual documentation that reflects the parties' expectations and allocates the risk and responsibilities between the parties. Second, supervisory guidance is clear that dealers, in order to protect themselves, must take into account the types of counterparties with which they deal and the overall context of the dealing relationship. Third, each new product must be analyzed with respect to the particular issues that it raises and the risks that it poses to the dealing institution.

During 2005, the Committee will carefully weigh the benefits of offering specific best practice guidance on the issues raised by the new market, but in the interim, we encourage market practitioners to use these three principles in reviewing each new product.

### Eliminating the Use of Broker Points

In November 2003, federal authorities charged a large number of individuals working in New York-area foreign exchange trading firms with criminal behavior, including an alleged "points for cash scheme." We established a Points Subcommittee to assess potential changes or amplifications to Committee guidance regarding the use of broker points. While the Committee has for many years strongly discouraged the use of points or points-type compensation between individuals or firms, the Points Subcommittee revised the *Guidelines for Foreign Exchange Trading Activities* to address points and their use explicitly. The document now states that "the use of points is not an appropriate means of trade dispute resolution, and for some counterparties in some jurisdictions the use of points may be contrary to regulatory or supervisory guidance." I hope that this unambiguous language will put an end to this unsound practice, and I thank the subcommittee for arriving at a solution that best serves all market participants.



### Eliminating Unnamed Counterparty Trading

In unnamed trading, an investment advisor engages a dealer to execute a foreign exchange trade with a client of the advisor whose identity is not revealed to the dealer. In 2001, the Committee began considering the risks associated with trading foreign exchange on an unnamed basis. The Committee determined that such practices constrain dealers' ability to assess the creditworthiness of their counterparties and to comply with KYC and anti-money-laundering rules and regulations. In addition, Committee members concluded that unnamed trading exposes dealers to significant legal, credit, compliance, and reputational risks and heightens the risk of fraud.

During 2002 and 2003, the Committee worked with the Foreign Exchange Joint Standing Committee, the Singapore Foreign Exchange Market Committee, the Tokyo Foreign Exchange Market Committee, the U.S.-based Financial Services Forum, and the Financial Markets Lawyers Group to encourage procedures that would effectively eliminate the practice. Specifically, a recommendation was made that investment advisor intermediaries put in place procedures that provide for the disclosure of client names to the credit and legal staffs of their clients' dealer counterparties. Foreign exchange dealers were also urged to establish procedures to guarantee that the identity of intermediaries' clients remains strictly confidential and is not released to their trading staff.

In early 2004, the Committee and the Singapore Foreign Exchange Market Committee issued a joint letter to underscore the importance of eliminating the risks to the financial system posed by unnamed trading, and—to the extent the practice exists in other over-the-counter markets—to urge other industry groups associated with these markets to discourage the practice. The Committee also amended the *Guidelines for Foreign Exchange Trading Activities* to address the issue specifically. On June 1, 2004, the revised Code of Conduct for Non-investment Products went into effect in the United Kingdom, in essence banning the practice of unnamed trading there. The NIPs Code is a reference source used for regulatory review of financial institutions and investment managers in the United Kingdom.

### Enhancing Committee Communications

Over the past twenty-six years, the Foreign Exchange Committee has communicated its guidance, comments, and concerns through announcements, special reports, letters, the annual report, and special events. While this approach met the needs of the market in the past, it has become clear that we can better serve the global foreign exchange market by adopting a more comprehensive and efficient communications strategy that will reach the broad range of foreign exchange market participants. Our revised communications goals include raising awareness of the Committee and its mandate, promoting the understanding and implementation of best practices, and ensuring smooth market functioning in the face of contingency events.

In 2004, the reestablished Communications Subcommittee undertook several improvements to the group's communications efforts. To start, the Committee's website (<www.newyorkfed.org/fxc>) underwent a dramatic redesign. The new site, launched in January 2005, features more comprehensive content and a clearer, more up-to-date format. The organization of the site has also been improved, enabling visitors to use a variety of approaches to find the information they need. New functionalities have been added to the site, such as site bookmarking, URL forwarding, site search, and subscription to e-mail alerts.

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Our mailing list is also being upgraded to improve the breadth and depth of the Committee's outreach efforts. Various industry contact lists have been added in recent months, and Committee member institutions have provided full contact information for the heads of various regional and product trading desks and for managers in compliance/audit, risk management, operations, and executive divisions.

## Improving Documentation of Asian Non-deliverable Foreign Exchange Transactions

For a number of years, the Committee, in partnership with EMTA and the Singapore Foreign Exchange Market Committee, has worked to promote standardized trading documentation for non-deliverable foreign exchange transactions. In 2004, we published updated documentation for six Asian currencies: the Chinese renminbi, the Indonesian rupiah, the Indian rupee, the Korean won, the Philippine peso, and the Taiwanese dollar. This initiative continued our earlier efforts to improve documentation for non-deliverable foreign exchange transactions used for various Latin American currencies. The revised documentation will enhance efficient settlements in the event of a long-term disruption in a local market. In addition, new and amended rate source definitions were published for Annex A of the *1998 FX and Currency Option Definitions* for the six currencies.

The Committee and our cosponsors encourage the market to adopt the 2004 templates and are committed to supporting further efforts to improve documentation that will promote an efficient and orderly market.



## OPERATIONS MANAGERS WORKING GROUP PROJECTS

### Reviewing and Updating *Management of Operational Risk in Foreign Exchange*, or the *Sixty Best Practices*

In light of the available information concerning foreign exchange trading issues experienced at the National Australia Bank in 2001-03, the Operations Managers Working Group recommended revisions to the *Management of Operational Risk in Foreign Exchange*. During the Working Group's review of this document, the Committee concluded that firms' adherence to the *Sixty Best Practices* should reduce the possibility of their suffering weaknesses like those reportedly found at the National Australia Bank. At the same time, the Committee determined that additional guidance addressing foreign exchange derivatives would be helpful.

In particular, the Committee noted that the sale of deep-in-the-money options warrants special attention and specific procedures applicable to sales and trading staff. Procedures should ensure an appropriate level of review—if necessary, by senior trading management or risk management outside the sales and trading area—to guard against potential legal, reputational, and other risks. In addition, the Committee recommended that foreign exchange options portfolios be revalued to reflect the shape of the volatility curve, or the "smile effect." The new guidance can be found on pages 95-99.

### Reviewing and Updating *Foreign Exchange Transaction Processing: Execution-to-Settlement Recommendations for Nondealer Participants*

The Operations Managers Working Group, in association with the Committee, published an updated version of *Foreign Exchange Transaction Processing: Execution-to-Settlement Recommendations for Nondealer Participants*. The revised document focuses on the requirements of nondealer participants with moderate foreign exchange activities and addresses the entire foreign exchange transaction process, including pre-trade preparation/documentation and trade execution and capture. Moreover, the 2004 update takes into account market developments and practices that have evolved since the paper's original publication in 1999, including the proliferation of electronic trading platforms, the surge in foreign exchange derivatives trading, the outsourcing of back office functions, and heightened attention to crisis management and contingency planning.

## CHIEF DEALERS WORKING GROUP PROJECT

### Establishing a Semiannual Foreign Exchange Volume Survey

Foreign exchange market participants have long relied upon the Bank for International Settlements' Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity for comprehensive global information regarding changes in aggregate market volumes, shifts in end-user demand, and trends in the geographic distribution of business. However, one of the characteristics of a vibrant market is the ready availability of frequent information on market volume. With this in mind, the Chief Dealers Working Group recommended that the Committee establish a semiannual foreign exchange survey of the North American market. More timely information on the size and structure of foreign exchange activity will enable participants to measure and effectively manage the risks associated with high trade volume in a rapidly evolving industry. Moreover, the increased frequency of available data should assist all market participants in their business planning and foster a deeper understanding of trends and patterns that are important to the smooth functioning of the market.

In conjunction with the United Kingdom's Foreign Exchange Joint Standing Committee, the Committee decided to conduct surveys of major market participants in the U.K. and North American markets every April and October. The results of the inaugural North American survey for October 2004 are included in this report and are also available on our website (<www.newyorkfed.org/fxc>). I am confident that market participants will quickly find the survey an invaluable source of information. I commend the Chief Dealers Working Group and the operations managers of participating dealers for their dedication in seeing this initiative through to implementation.

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## 2005 AND BEYOND

When I look back on my first year as chairman of the Foreign Exchange Committee, I am encouraged that we accomplished so much. This is a credit to the membership. The Committee members are uniquely qualified to serve because of their expertise, their many years of leadership experience, and the value they each place on contributing to the work of the Committee and the foreign exchange industry as a whole.

A number of initiatives launched by the Committee membership in 2004 or before will carry over into the work of the Committee in 2005.

In 2005, the Committee plans to review and revise the *Guidelines for Foreign Exchange Trading Activities* to better reflect developments in foreign currency options trading.

According to the Bank for International Settlements' 2004 Triennial Survey, options trading has grown 95 percent since 2001. The growth in this market segment has raised a number of issues: Difficulties such as those announced by the National Australia Bank early last year underscore the challenges of engaging in these more complex instruments. In this context, the Committee recently updated its *Management of Operational Risk in Foreign Exchange* to address more fully issues associated with foreign exchange derivatives.

Also in 2005, the Committee, the Singapore Foreign Exchange Market Committee, and EMTA, acting as cosponsors, expect to expand the currencies included under the new non-deliverable foreign exchange transaction architecture, beginning with the Malaysian ringgit. The group has also discussed initiatives to promote understanding and implementation of the new documentation, raising the possibility of a conference in Asia this year. More generally, the Committee will continue to support the efforts of EMTA to standardize non-deliverable foreign exchange transaction agreements, particularly as those agreements relate to the principles for settling these transactions when unexpected local market disruptions occur.

The Operations Managers Working Group, in association with the Committee, published an updated version of *Foreign Exchange Transaction Processing: Execution-to-Settlement Recommendations for Nondealer Participants* in 2004. In 2005, the Committee intends to offer a number of symposia to discuss the recommendations with market participants.

The Committee also plans to examine specific distribution channels, such as white labeling and retail aggregation, to determine whether market guidance on these types of products and services is required.

I expect that the Committee will also focus on a number of new questions in 2005. Given the increase in proprietary trading, potential exists for ethical conflicts within dealers' trading rooms when the interests of customers compete with those of units closely affiliated with the dealer. Another issue for consideration involves the value of best practice guidance specific to foreign exchange prime brokers. Finally, we will examine the impact of high-volume electronic trading on traditional control methods for exchange rate error minimization and liquidity management contingencies.

In summary, the Committee in 2005 will surely address ethical as well as technical issues as it strives to meet its objectives of enhancing knowledge of the foreign exchange markets, improving the quality of risk management in these markets, and developing recommendations on specific practices for market participants and their management. In closing his speech before the Financial Markets Conference last year, Chairman Greenspan underscored the importance of the sound and principled conduct of market operations: "I hope and anticipate that trust and integrity again will be amply rewarded in the marketplace as they were in earlier generations. There is no better antidote for the business and financial transgressions of recent years."

*Mark Snyder*