

CHAIR'S LETTER

In the past year, the Foreign Exchange Committee has successfully met its mandate of improving the integrity and functioning of the wholesale over-the-counter foreign exchange market by responding to a number of complex challenges. These challenges stemmed from marketplace changes that were first observed about five years ago and that have evolved into major forces reshaping the conduct of foreign exchange trading. These forces include the emergence of currency as a separate asset class and the associated arrival of new market participants, significant growth in foreign exchange trading volume and liquidity, the rapid increase of new electronic trading technologies and methods, and the heightened activity in exotic derivatives and newly tradable and non-deliverable currencies. Together, these forces have produced what is essentially a new foreign exchange market.

Anticipating this transformation, the Foreign Exchange Committee has been working to apply long-standing principles to the formulation of best practice recommendations and communications regarding the new market. This market is characterized by more complex market instruments, changed counterparty roles, and new means of executing and settling trades. One key principle is that the best markets are those that are efficient, fair, and flexible, with participants who act with integrity. Markets that exhibit these characteristics not only serve their participants well, but also serve broader purposes within the global financial system and the economy. To promote and maintain an efficient and ethical market, the Committee has sought to offer guidance that balances the legitimate interests of all market participants without interfering with the market's natural evolution.

The Foreign Exchange Committee completed three major projects related to the market forces noted above, continued work on two others, and initiated work on one more.

The completed projects are:

- ❧ publication of *Foreign Exchange Prime Brokerage: Product Overview and Best Practice Recommendations* and the Master FX Give-Up Agreement,
- ❧ publication of a letter to wholesale market participants regarding retail foreign exchange, and



- ❧ publication of the new International Foreign Exchange and Currency Option Master Agreement (IFXCO) and the *2005 Barrier Option Supplement to the 1998 FX and Currency Option Definitions*.

Ongoing Committee projects that reached notable milestones are:

- ❧ publication of Malaysian ringgit non-deliverable forward (NDF) documentation and
- ❧ publication of the semiannual Survey of North American Foreign Exchange Volume.

In addition, the Committee began work on a new project addressing autodealing developments in the foreign exchange market.

The foreign exchange prime brokerage, retail foreign exchange, and autodealing projects were initiated because the Committee recognized that the elements of a foreign exchange trade are increasingly being unbundled and repackaged and that multiple links are being introduced in the distribution chain. For example, some banks may provide their clients with liquidity while “white labeling” that liquidity from another bank; other banks may provide liquidity to a retail aggregator, which then facilitates foreign exchange trading for many individual investors. A foreign exchange dealer may provide liquidity to a hedge fund, and these trades are then “given up” to the customer’s foreign exchange prime broker. Finally, some market participants may access electronic broker platforms featuring anonymous high-speed “program trading” capabilities in order to make markets in selected currency pairs in the name of their foreign exchange prime broker.

FORMULATING GUIDELINES FOR FOREIGN EXCHANGE PRIME BROKERAGE

Recognizing the dramatic growth of foreign exchange prime brokerage as well as its impact on recent market developments, the Committee established a subcommittee to explore the risks associated with the product. The subcommittee spent many months researching and analyzing the prime brokerage product; the group’s findings have been published in *Foreign Exchange Prime Brokerage: Product Overview and Best Practice Recommendations*. Released in December 2005, this document describes foreign exchange prime brokerage services and presents twenty-two new best practices intended to help market participants mitigate some of the credit, operational, and reputational risks associated with prime brokerage services. The Committee strongly believes that the implementation of these practices may help reduce the level of risk in the foreign exchange market more generally. The Committee encourages all market participants to review these best practice recommendations with the appropriate professionals in their respective organizations. Working closely with the Financial



Markets Lawyers Group, the Committee also published the first industry Master FX Give-Up Agreement for counterparties involved in foreign exchange prime brokerage transactions. This document clarifies the terms for risk allocation and the responsibilities that the give-up relationship imposes on the prime broker, executing dealers, and the prime broker's customer. By putting the participants that use this important new service offering on clearer and more uniform legal ground, these efforts should provide much greater certainty to the market.

CLARIFYING ROLES AND RISKS IN RETAIL FOREIGN EXCHANGE

Retail foreign exchange trading has grown rapidly in recent years as individuals seeking to generate returns for their investment portfolios have acquired greater market access through new trading technologies and business models. These technologies and

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business models have made it possible for price discovery, liquidity, execution, confirmation, and reporting services to be delivered in real, or near real, time. Moreover, in the foreign exchange distribution channel, transaction services that were historically bundled together and offered by a single provider have now been broken out into their components, with specialized entities providing the individual services. Examples of this segmentation include retail aggregators

that act as portals for retail investors trading foreign exchange on a margin basis and "white labeling," whereby banks or e-commerce platforms allow their customers to trade at prices quoted by a third-party bank.

These innovations separate wholesale foreign exchange dealers from retail end users, a development that may complicate the dealers' execution of their responsibilities. Such responsibilities include typical know-your-customer and anti-money-laundering obligations and compliance with statutory and supervisory guidance. Of particular concern is a dealer's exposure to reputational risk if the dealer is linked to a chain of transactions that result in dissatisfaction or litigation or both. In response to the apparent blurring of the demarcation between the wholesale and retail segments of the foreign exchange market, the Committee prepared a market letter dealing with retail foreign exchange trading and wholesale market participants. In the document, the Committee calls for good legal documentation and stresses the importance of understanding know-your-customer obligations and contractual relationships. The Committee also notes that while reputational risk is not new to the foreign exchange market, recent developments



related to retail foreign exchange may be increasing this type of risk for market participants. Accompanying this market letter is a detailed appendix containing descriptions of retail aggregation, white labeling, and a legal framework for understanding the retail-wholesale boundary in the foreign exchange market.

EXAMINING AUTODEALING DEVELOPMENTS IN THE FOREIGN EXCHANGE MARKET

During 2005, the Committee's Chief Dealers Working Group voiced concerns that unprofessional trading behavior might be increasing with the advent of autodealer technologies, particularly in conjunction with the element of anonymity afforded by electronic foreign exchange prime brokerage services. Some market participants are worried that an increase in unprofessional trading behavior might undermine the reputation and confidence of the market and constrain the ability of the market to self-regulate. The Committee has formed a subcommittee to review and analyze these concerns and consider what, if any, action the Committee should take.

OTHER NOTEWORTHY ACCOMPLISHMENTS

In other work, the Committee has addressed developments heightening the complexity of the foreign exchange market, including the overall increase in trading volumes. While the Committee began its semiannual market volume survey only in October 2004, analysis of data from the October 2004 and April 2005 surveys confirms what major market participants already know to be true—that currency market volumes are up dramatically. The use of almost all traditional market instruments has increased, and growth has also occurred in the more complex products such as currency option contracts. To strengthen the legal framework for all market participants, the Committee published the International Foreign Exchange and Currency Option Master Agreement (IFXCO) and the *2005 Barrier Option Supplement to the 1998 FX and Currency Option Definitions*. The Committee also published Malaysian ringgit non-deliverable forward documentation, which adds to work on Asian currency NDFs begun in recent years. Each of these three publications is designed to help market participants speak a common language so that the terminology means the same to all concerned. Indeed, standardized agreements make the conduct of business much simpler for everyone and contribute to the legal certainty of agreements for all market participants.

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2006 AND BEYOND

The Foreign Exchange Committee has no enforcement authority; rather, its role is to deepen understanding of the foreign exchange market, foster improvements in the quality of foreign exchange risk management, investigate topics of interest to market participants, and develop best practice recommendations for distribution to market participants and their management. In accordance with this mandate, the Committee has an important role to play in enhancing the reputation of the foreign exchange market. Consequently, the Committee will continue to reach out to new market participants to make them aware of its work over the past twenty-eight years.

For the wholesale over-the-counter currency markets to function smoothly, all participants must share responsibility for maintaining the highest professional standards of conduct and ethics. Thus, the Committee and its counterparts around the world will continue to pursue ambitious initiatives. Certainly, the changes to the market noted in this letter have precipitated much of the work undertaken by the Committee in recent years. These forces are expected to continue to shape market activity in 2006 and beyond. Unquestionably, market innovations will continue to alter the terrain for agreements and conventions. By anticipating and preparing for new trends, the Committee will continue to take a proactive approach. Its members are committed to examining new issues and working collaboratively to craft guidance that serves the market and its participants well. This dedication will certainly help the Committee to build on its predecessors' accomplishments and to achieve its mandate going forward.

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