Works in Progress for 2006

A confluence of new products, participants, and technology is blurring the conventional distinctions that have long characterized the foreign exchange market. Fundamental relationships among all participants in the market are being tested and transformed, with significant implications for market structure and potentially for market functioning. In 2005, the Committee focused on identifying the risks associated with the evolution of the foreign exchange market, publishing a letter on issues related to intermediated distribution arrangements in the retail foreign exchange market and issuing documentation and best practice recommendations regarding foreign exchange prime brokerage. Looking ahead, the Committee will continue to work with the industry to ensure that emerging risks are properly identified, measured, and managed in order to promote the continued smooth functioning of the market.

UPDATING TRADING GUIDANCE

As the foreign exchange industry continues to evolve, the Committee recognizes the value of revising its guidance to address emerging issues. As reflected in the Bank for International Settlements' *Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity 2004*, trading in foreign currency options has surged in recent years, increasing 95 percent between 2001 and 2004. At the same time, foreign exchange losses such as those announced by National Australia Bank early in 2004 underscore the challenges of trading in these more complex instruments.

In this context, in 2004, the Committee updated its *Management of Operational Risk in Foreign Exchange* to address more fully issues associated with foreign exchange derivatives. In 2005, the Committee, the International Swaps and Derivatives Association, Inc. (ISDA), and EMTA, Inc. (EMTA) published common reference terms for a variety of barrier and binary options to improve the efficiency of the documentation process, reduce confirmation and settlement risk, and enhance legal certainty for all market participants. Looking ahead to 2006, the Committee plans to review and revise the *Guidelines for Foreign Exchange Trading Activities* to better reflect developments in this increasingly important market segment.

AUTODEALING

Advances in information technology have facilitated the increased activity of newer participants and a proliferation of products in the foreign exchange market. The homogenous nature of the basic spot foreign exchange product and the size of the market contributed to the adoption of the electronic trading model in foreign exchange. This

model was first manifested in the interdealer market, in which electronic broking systems became the primary means of interbank trading. According to the Committee's *October 2005 Survey of North American Foreign Exchange Volume*, approximately half of all trades between dealers are now executed via electronic broking or dealing systems. This move toward electronic trading has been followed in the dealer-to-customer arena, with Internet-based single- and multibank portals continuing to gain traction. The same survey reveals that between 20 and 25 percent of all trades between customers and dealers occur electronically.

More recently, the role of automation has developed and expanded with the introduction of autodealing, with the industry moving beyond manual traders that execute with one another via electronic communication networks to computers that now trade directly with other computers via automated program trading. In 2006, the Committee and the Chief Dealers Working Group will explore potential liquidity and pricing issues related to autodealing.

NON-DELIVERABLE FOREIGN EXCHANGE PRODUCTS

Over the past two years, the Committee, the Singapore Foreign Exchange Market Committee, and EMTA, acting as cosponsors, have published updated documentation for non-deliverable foreign exchange transactions for seven Asian currencies in order to reduce documentation and settlement risk and facilitate improved efficiency in the non-deliverable foreign exchange market. In 2006, the Committee will coordinate further with EMTA in the development of market standards for non-deliverable transactions in emerging market currencies. In addition, the Committee is in the process of updating its Master Agreement Addendum for the confirmation of non-deliverable forwards to reflect the template terms introduced since its publication in 2003. More generally, the Committee will continue to support EMTA's efforts to provide standardized terms for non-deliverable foreign exchange agreements, particularly as they relate to the settlement of these transactions in the event of unexpected local market disruptions.

CLS BANK

As the Continuous Linked Settlement (CLS) Bank enters its third year of operation, the Committee will continue to focus on specialized issues involving CLS Bank and its integration within the marketplace. In 2006, the Committee, together with the Financial Markets Lawyers Group and the Operations Managers Working Group, will coordinate with CLS Bank as it introduces new services such as non-deliverable forward and option premium settlement.

EFFORTS OF THE WORKING GROUPS

The Chief Dealers Working Group, in close association with London's Foreign Exchange Joint Standing Committee, will continue its efforts to publish the semiannual Survey of North American Foreign Exchange Volume. The group will also assist the Committee in its initiative to update the *Guidelines to Foreign Exchange Trading Activities* to better reflect best practices in foreign exchange derivatives trading and to examine the pricing and liquidity implications of autodealing.

The agenda of the Operations Managers Working Group includes

- continuing efforts to address, in coordination with the Financial Markets Lawyers Group, ISDA, and EMTA, industry challenges in matching and exchanging documentation for exotic option transactions;

- exploring the changing nature of the confirmation process and the implications of advances in automation and technology and, if appropriate, updating the Committee's guidance on managing operational risk in foreign exchange; and

- updating the format and terms and encouraging further progress in the institutional implementation of the Master Agreement Addendum for the confirmation of non-deliverable forwards, first published in January 2003.