

■ CHAIR'S LETTER

"May you live in interesting times . . .": This maxim—often described as the English translation of an ancient Chinese proverb—is the first of three invocations of increasing severity. The events of the past year have certainly galvanized the attention of those in the global markets and have become a focus for the discussions of my colleagues on the Foreign Exchange Committee. As I write this letter, I believe we are still in the early stages of significant changes to the financial landscape.

The Committee began the year by looking at the evolution of the foreign exchange industry, with an emphasis on developments in transparency, best execution, and electronic trading. Working groups examined retail foreign exchange, the influence of technology on market practices, and the effect of proposed regulatory change in the United Kingdom (the Markets in Financial Instruments Directive, or MiFID). In addition, the Committee discussed broadening its perspective by soliciting buy-side input and began a study of issues arising out of the intersection of multiple trading platforms, dark pools of liquidity, and path-dependent options.

By midyear, it became obvious that many of these topics overlapped—technology affected market structure, and the fastest growing components of the foreign exchange market, that is, retail foreign exchange and high-frequency machine-to-machine trading, appeared to be nontraditional. This observation led to discussions of prime brokerage and the desire for more granular data on volume growth by target market segment. The Committee maintains an active dialogue with the Operations Managers Working Group as well as with foreign exchange committees around the world and their sponsoring central banks as it attempts to develop timelier and more accurate trend analysis.

The seismic disruptions to the global financial markets beginning in the summer of 2007 and persisting through the second half of the year focused the Committee's work on market function, liquidity, systemic risk, and risk management. Despite the ruptures observed elsewhere, the foreign exchange market appears to have served all of its various constituents well, while processing record volumes in an environment of constant reevaluation of risk premia. That being said, we realize that we are in the midst of fundamental changes to the structure of the global financial markets. The Committee continues to anticipate, analyze, and react to these events.

The challenges posed by credit, leverage, and liquidity, along with conspicuous failures in risk management, compelled the Committee to accelerate its review of trading guidelines and best practices. As such, an updated version of the *Guidelines for Foreign Exchange Trading Activities* was published on the Foreign Exchange Committee's website in May 2008. As technology, business conditions, and business models evolve, the Committee will continue to update this document, as we believe it lays a foundation for the advanced management practices that stabilize the foreign exchange market.

The "Works in Progress" section of this report highlights some of the current concerns of the Committee. While the foreign exchange market has functioned well in the face of unprecedented turbulence, the financial services industry will likely be permanently altered. Some of the observed resiliency of the foreign exchange market no doubt reflects its adaptability. This adaptability, in turn, is derived from the commitment of public as well as private sector participants to embrace change through the lens of market integrity.

I am grateful to my colleagues who serve on this advisory committee to the Federal Reserve Bank of New York for their dedication, professionalism, candor, and concern that transcends parochial interest. The Committee will continue to assess the effect of events on market structure, market discipline, market liquidity, and business practices. We expected 2008 to be no less "interesting" than 2007; thus far, the year seems to be meeting our expectations.

The other maxims in the aforementioned Chinese trilogy are:

May you come to the attention of those in authority

and

May you find what you are looking for.

Rich Mahoney