THE FOREIGN EXCHANGE COMMITTEE
33 LIBERTY STREET, 9TH FLOOR
NEW YORK, NEW YORK 10045

November 5, 2004

Dear Market Participant,

I am writing to announce some recent changes to *Management of Operational Risk in Foreign Exchange,* or the *"Sixty Best Practices*." The Foreign Exchange Committee ("the Committee") regularly reviews these practices, which were first published in 1996 and updated in 2003, to ensure that they remain relevant and address topical issues. To that end, the Committee recently reassessed the *Sixty Best Practices* in light of the public information related to FX trading issues experienced at National Australia Bank ("NAB") in 2001-2003.

From this review, the Committee concluded that adherence to the *Sixty Best Practices* should reduce the possibility of a firm suffering weaknesses like those allegedly found at NAB. At the same time, the Committee determined that the *Sixty Best Practices* could benefit from some revisions, specifically the introduction of additional guidance addressing FX derivatives.

In particular, the Committee notes 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 emphasizes that an FX options portfolio is not effectively marked to market unless the valuation reflects the shape of the volatility curve. Further, the Committee recommends that positions should wherever possible be revalued reflecting the "smile effect." For the complete outline of the revisions, please see the attached note.

On behalf of the Committee, I encourage you to review the *Sixty Best Practices* with the relevant departments within your organization and, where appropriate, incorporate the recommendations to your firm's internal policies and procedures. As the industry evolves, the Committee will continue to review the *Sixty Best Practices* and its other market guidance and will address as needed other practices that could adversely affect the integrity of the foreign exchange market.

The revised *Sixty Best Practices* are now available on the Committee's website at www.newyorkfed.org/fxc, where you can also find more information about the Committee, its recent initiatives, and other published documents.

Mark Snyder
Chairman
Foreign Exchange Committee

2004 Changes to the *Management of Operational Risk in Foreign Exchange*

In 1996, the Foreign Exchange Committee published its first version of ***Management of Operational Risk in Foreign Exchange,*** or the "***Sixty Best Practices***." As the industry evolves and trading processes change, the Committee periodically updates this paper. In 2004, the changes indicated below have been introduced into the ***Sixty Best Practices***. The most recent version of the ***Sixty Best Practices*** can always be found on the Foreign Exchange Committee's public website: www.newyorkfed.org/fxc.

Best Practice no. 12: Closely Monitor Off-Market and Deep-in-the-Money Transactions

- Amend the first paragraph to state: All dealer institutions that permit requests for Historical Rate Roll-overs (HRRs) should have written procedures to guide their use and should detail the added controls required in the trading and reporting of off-market transactions. Operational responsibilities should be clearly defined in regard to monitoring, reporting, and special confirmations, if any are needed. Such special confirmations may be necessary to identify the market forward rate in effect when the HRR was executed. ***The sale of deep-in-the-money options warrants special attention and specific procedures applicable to sales and trading staff (and, if necessary, senior management).***

- Add a final paragraph to read: ***The sale of deep-in-the-money options warrants special attention and specific procedures applicable to sales and trading staff (and, if necessary, senior management). There may be legitimate reasons for the sale of such options—for example, the "sell back" of an option or the implied delta within a separate derivatives product. However, it should also be recognized that the sale of deep-in-the-money options can be used to exploit weaknesses in a counterparty's revaluation or accounting process that could create erroneous results. 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.***

Best Practice no. 41: Conduct Daily Position and P&L Reconciliation

- Revise the final sentence of the second paragraph to read: Because a discrepancy in P&L between Sales & Trading and Operations can indicate a difference in positions or market parameters (that is, rates or prices) all differences should be ***reported, investigated, and resolved in a timely manner.***

Best Practice no. 42: Conduct Daily Position Valuation

- Amend the fourth paragraph to read: Illiquid markets present additional risk to a bank because illiquid instruments are infrequently traded, making them difficult to price. Often, it is hard for a bank to obtain market quotes, thereby preventing timely and consistent position monitoring. P&L may be distorted and risk may not be properly managed. In such instances, a bank should seek to obtain quotes from other counterparties active in the market. Management should be aware of these procedures so that they may effectively manage and evaluate illiquid market positions. These procedures allow a bank to mark to market its positions and to evaluate associated risks. ***All market participants should be aware that an FX option portfolio is not effectively marked to market unless the valuation reflects the shape of the volatility curve. With consideration given to the size of the portfolio and daily activity, positions should wherever possible be revalued reflecting the "smile effect" when the firm wishes to mark to market. Where appropriate, firms should reserve against liquidity and pricing risk.***

Best Practice no. 43: Review Trade Prices for Off-Market Rates

- Revise the first paragraph to state: Trade prices for ***both internal and external*** trades should be independently reviewed to ensure reasonableness within the market prices that existed on the trade date.

Best Practice no. 52: Ensure Proper Model Signoff and Implementation

- Amend the first paragraph to read: Quantitative models often support FX trading activities. As a result, their implementation and management should be a coordinated effort among the various FX business lines. Model implementation and maintenance should ensure that all FX business lines (Sales & Trading, Operations, financial control, risk control, technology, audit, and others) approve, support, and understand the model purpose and capabilities, as well as the roles and responsibilities of each business line. Further, to maintain appropriate segregation of duties, ***model validation***, model technical development, and data input and output reporting should ***all*** be performed independently from Sales & Trading.

Best Practice no. 54: Establish Strong Independent Audit/Risk Control Groups

- Revise the first paragraph to state: Market participants should have sophisticated and independent audit/risk control groups. It is recommended that market participants perform rigorous self-assessments and publish regular reporting of such to management, the business line, and audit/risk control groups. ***Firms should implement policies and procedures that enable employees to raise concerns anonymously.***