October 18, 1999

Y2K: Best Practice in the Foreign Exchange Market

The Foreign Exchange Committee (sponsored by, but independent of, the Federal Reserve Bank of New York) (the "FX Committee") is today issuing this Best Practice to set forth its view of the "Best Practice" to be followed in the foreign exchange market concerning the effect of certain Y2K Events on foreign exchange contracts, options and swaps (collectively, "Transactions"). The Australian Financial Markets Association, The British Bankers' Association, the Canadian Foreign Exchange Committee, the Emerging Markets Traders Association ("EMTA"), the International Swaps and Derivatives Association, Inc. ("ISDA") and the Singapore Foreign Exchange Market Committee are joining in the issuance of this Best Practice. (These Associations and Committees, together with the FX Committee, are referred to as the "Associations.")

This Best Practice reflects extensive review and comment and, in particular, considerable work by a joint Working Group (the "Working Group") of the Financial Markets Lawyers Group and the FX Committee's Operations Managers Working Group. The Associations expect that this Best Practice will minimize the confusion associated with the failure to settle Transactions by setting forth guidelines for market participants as to how each should attempt to resolve these Y2K issues, should they arise.

The Associations believe that this Best Practice reflects commercially reasonable standards for market participants and will provide guidance to regulators and courts considering the actions of participants in the foreign exchange market. The Associations expect that, by following this Best Practice, market participants will maintain the basic economics of outstanding Transactions as originally agreed by either settling Transactions in accordance with their terms or by providing for close-out of Transactions at then current market prices.

Of course, Parties to Transactions still have the rights and remedies provided in their agreements. In particular, credit provisions and defaults unrelated to Y2K Events are not affected by this Best Practice, and any rights and remedies in respect of such credit provisions and defaults are still enforceable notwithstanding that a Y2K Event has also occurred.

The Working Group has also discussed this issue with associations of foreign exchange market participants (in addition to the Associations) outside of the U.S. The Tokyo Foreign Exchange Market Committee has, as a result of these discussions, endorsed this Best Practice, and it is hoped that others will be endorsing this Best Practice in due course.

Set forth below are background information and the terms of the Best Practice that the Associations recommend. This is followed by some general notes, and a statement as to how this Best Practice is to be used.

In this Best Practice, the term "Y2K Event" is defined as any event that results in an erroneous result caused by any computer software (a) incorrectly reading the date "01/01/00" or any day or year thereafter, (b) incorrectly identifying a date in the year 1999 or any day or year thereafter, and (c) any other computer error that is directly or indirectly related to (a) or (b) above.

Background

In March, 1999, the Working Group began considering the possible effect of Y2K on the foreign exchange market. The Working Group reviewed a number of issues pertaining to Y2K generally, and spent considerable time reviewing the specific issues which Y2K presents for the currency trading community. The Working Group also consulted with representatives of ISDA, EMTA and the Global 2000 Co-ordinating Group, who participated in this process.

The Working Group reviewed various scenarios which could arise as a result of the transition into the year 2000. The Working Group concluded that two scenarios were appropriately the subject of a Best Practice, since they are events generally outside the control of an individual market participant yet will impact many (if not all) participants involved in the settlement of a particular currency. These are the occurrence, due to a Y2K Event, of (1) the failure of a clearing bank to clear some or all Transactions, or (2) the failure of a central bank to effect transfers of its local currency. The Working Group did not believe that it was necessary or appropriate to address a scenario involving the failure of a counterparty to deliver currency as a result of a Y2K Event involving its own systems, since such failures should generally be within the control of the Party and is best left to the bilateral contractual relationship between the Parties to the Transaction.

In some cases, the Parties to a Transaction have signed a master agreement which provides remedies for nonpayment of amounts when due under the Transaction. Some of those master agreements also contain provisions that specify the rights of the Parties if performance is impossible due to events beyond the control of the Parties, or "force majeure". In some cases, Transactions between the Parties are not covered by a master agreement, and thus are covered by the applicable confirmation and by the law governing the Transaction. This Best Practice is intended to apply whether or not the Transactions between the Parties are covered by a master agreement.

The Working Group began its discussion of best practices by examining contractual provisions in the widely used forms of master agreement. Ordinarily, a failure to make a payment when due is an event of default under the industry master agreements. In an event of default, the non-defaulting Party has the right to close out all (but not less than all) Transactions with the counterparty, performing the close-out calculations specified by the master agreement (see, for example, Section 5.1 of IFEMA). While failure to make payments is normally deemed to be within the control of a Party, the force majeure provisions of the master agreement (see, for example, Section 6.1 of IFEMA) are generally designed to apply where failure to make payment is beyond the control of the Party owing payment. Where a force majeure event has occurred, generally either Party may require the close-out of affected currency obligations. Which Party does the close-out calculations depends upon whether one or both Parties is affected by the force majeure event. In sum, the remedy for non-payment, whether or not within the control of the non-paying Party, is to close out affected Transactions at their fair market value (although the scope of affected Transactions to be closed out in the event of an ordinary payment default or a force majeure event may differ dramatically).

In determining best practices, the Working Group was mindful of several important factors: First, even a clearing bank or central bank that has taken extraordinary efforts to remediate the Y2K "bug" may experience short-term problems requiring further remediation. Such remediation efforts should be of short duration. Second, the longer a Y2K Event continues without resolution, the longer its resolution is likely to take. Third, values in the capital markets change rapidly as a result of changing views of the direction of interest rates and prices of currencies, commodities and securities, as well as economic factors involving countries and market participants, and Y2K problems that last longer than a short duration may themselves have a significant effect on the market value of currencies, interest rates and commodity and security prices. Fourth, two weeks is probably a reasonable period of time in which to change clearing banks. Finally, given the sophistication of most central banks, if a central bank cannot remediate a Y2K Event in a short period of time, the likelihood of its recovering within a reasonable period of time is diminished.

The Associations are hopeful that this Best Practice will promote legal certainty and reduce confusion in the market, and believe that this Best Practice generally reflects the realities of the market as well as the requirements of applicable law.

Y2K Best Practice

Scenario 1 – Clearing Bank Fails to Clear

This scenario covers the case where, due to a Y2K Event, a clearing bank fails to clear for one of the Parties (the "Affected Party") to a Transaction. In such event, the recommended Best Practice for Transactions between those Parties is as follows:

1. After the failure to clear, there is a three Business Day waiting period (the "Waiting Period") to arrange a settlement or to determine whether the issue has resolved itself with no further action being necessary. If a payment under a Transaction is due during the Waiting Period, the due date for that payment is deferred for three Business Days (so that, if the Y2K Event is cured, all deferred Transactions do not settle on the same date).

2. If the Y2K Event is not cured by the close of business on the last Business Day of the Waiting Period, the other Party (the "non-Affected Party") has the right (but not the obligation) to liquidate any or all Affected Transactions between those Parties that would have settled during the Waiting Period and that would settle within the Interim Liquidation Period. "Interim Liquidation Period" means the shorter of (a) ten Business Days commencing on the First Business Day after the end of the Waiting Period, and (b) the period through (and including) the Sunset Date.

3. If the Y2K Event is not cured by the close of business on the last Business Day of the Interim Liquidation Period, a non-Affected Party has the right (but not the obligation) to liquidate any or all Affected Transactions between those Parties.

Scenario 2 – Central Bank Fails to Transfer Currency

This scenario covers the case where, due to a Y2K Event, a central bank fails to effect transfers of its local currency, whether or not that failure to pay involved the Parties to the Transaction as to which this Best Practice is being invoked. In such event, the recommended Best Practice is as follows:

1. After the failure of a central bank to settle a payment in its local currency, there is a three Business Day Waiting Period for all Transactions in that currency to determine whether the central bank resumes transfers of its currency. If a payment under a Transaction is due during the Waiting Period, the due date for that payment is deferred for three Business Days (so that, if the Y2K Event is cured, all deferred Transactions do not settle on the same date).

2. If the Y2K Event is not cured by the close of business on the last Business Day of the Waiting Period, either Party has the right (but not the obligation) to liquidate any or all Affected Transactions between those Parties.

General Notes to Best Practice:

1. Sunset Date. This Best Practice ends with respect to events occurring after January 31, 2000. It is expected that all relevant events will have manifested themselves by that date, and the Associations do not want this Best Practice to remain in effect and potentially be applied (or arguably applied) to unintended factual situations.

2. Business Day & Close of Business. For this purpose, Business Day would include days which, but for the Y2K Event, would have been Business Days. Close of business is 5:00 p.m., local time in the principal Financial Center for the currency in respect of which the Y2K Event has occurred.

3. Application of Best Practice. Scenario 2 applies when a central bank fails to effect transfers of its local currency, whether or not the failure has affected a Transaction involving the Party who wishes to invoke this Best Practice and its counterparty in that Transaction. This Best Practice is, in part, predicated on the doctrine of anticipatory breach of contract. Market participants may wish to consult with their own counsel as to the applicability to their own Transactions of this Best Practice in general and, in particular, the doctrine of anticipatory breach of contract or similar doctrines and rights (such as the right to demand adequate assurance of performance).

4. Compensation for Payments Deferred During the Waiting Period. Compensation for this deferral shall be at then current market rates as determined in a commercially reasonable manner by the non-Affected Party (in the case of Scenario 1) or the Parties (in the case of Scenario 2).

5. No Obligation to Liquidate. This Best Practice would, to the extent noted above, grant the right to liquidate Affected Transactions, but the non-Affected Party (in the case of Scenario 1) or the Parties (in the case of Scenario 2) could always determine not to do so.

6. Liquidation of Less Than All Affected Transactions. The non-Affected Party (in the case of Scenario 1) and the Parties (in the case of Scenario 2) could elect to liquidate less than all Transactions. However, in the case of Scenario 1 where only the non-Affected Party has the right to liquidate, that Party is expected to have a commercially reasonable basis to distinguish between those Affected Transactions it has determined to liquidate and those which it has determined not to liquidate (such as, by way of example and without limitation, by maturity, type of Transaction or perceived credit or market exposure).

7. Payments Under Affected Transaction. Once a currency is not deliverable due to a Y2K Event, the other currency under those Transactions need not be delivered. The Parties will rely on their existing contractual rights if a Party has paid the other currency under those Transactions.

8. Force Majeure Events. If an event is both a Y2K Event and a force majeure event under any Agreement issued by the FX Committee or ISDA, the Associations intend that, until the Sunset Date, that event be treated as a Y2K Event and, after the Sunset Date, as a force majeure event.

9. Affected Transactions. Affected Transactions include any Transaction involving the receipt or delivery of payment in a currency in respect of which the respective Y2K Event has occurred, including, without limitation, non-deliverable Transactions which settle in that currency.

Use of this Best Practice

The Associations recognize that each market participant retains the freedom to include or exclude particular provisions from some or all of its master agreements or other agreements and to negotiate whatever terms it deems appropriate with each of its counterparts. However, Transactions are generally entered into under New York, English or Japanese law, all of which imply a covenant of good faith and fair dealing. The Associations are releasing this Best Practice in order to provide guidance as market participants try to comply with their obligations of good faith, by setting forth commercially reasonable standards and trade practices for these specific Y2K Events.

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The Associations are presenting this Best Practice to the foreign exchange market with the hope and expectation that it will reflect and help strengthen fair dealing in such market and facilitate the maintenance of an orderly market during times of crisis.