

## Foreign Exchange and Foreign Currency Options Conventions

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## Preface

The Australian Financial Markets Association (AFMA) is the leading industry association promoting efficiency, integrity and professionalism in Australia's financial markets – including the capital, credit, derivatives, foreign exchange and other specialist markets.

The Australian Foreign Exchange Committee (AFXC) is a representative forum of the Australian foreign exchange market operating under the sponsorship of the Reserve Bank of Australia (RBA). For more information refer to [AFXC](#).

These Conventions represent the collaborative endeavour of AFMA and the AFXC to provide Australian foreign exchange market conventions, and should be read in conjunction with (a) [The Model Code](#), published by ACI – The Financial Markets Association, and (b) the [AFMA Code of Conduct](#). While the codes followed by foreign exchange participants around the world may differ reflecting local factors, they have in common [Codes of Best Market Practice and Shared Global Principles](#) that promote best practice. Please refer to the [AFXC website](#) for further information on this code and related principles.

## 1. Market Description

Foreign Exchange	FX Options
<p>The foreign exchange market facilitates the exchange of one currency for that of another and allows market participants to buy and sell foreign currencies. The foreign exchange market is an over-the-counter (OTC) market where participants transact with individual partners.</p> <p>Foreign exchange is a global market that operates on a worldwide, 24-hour basis, commencing on Mondays at 5am Sydney time and concluding on Fridays at 5pm New York time. Generally interbank trading is conducted electronically or via the telephone. Real time exchange rate information is readily available through information vendor screens (such as Thomson Reuters and Bloomberg) and execution systems. Delayed exchanged rate information is also freely available via the internet.</p> <p>The foreign exchange market is one of the largest financial markets in the world. It is a highly liquid market and large volumes of currency are traded on a daily basis.</p>	<p>FX Options are chiefly used to hedge currency risk or to produce income as part of a trading strategy. The predominant appeal of OTC currency options is that the option specifications can be tailored to suit individual requirements.</p> <p>A foreign currency option is a contract where the seller grants to the buyer the right (but does not impose the obligation) to buy or sell a specified amount of one currency for another, at a specified price, on or before a specified future date. The buyer pays a premium to the seller for this right.</p> <p>Foreign exchange options terminology is outlined in Appendix 1</p>

## 2. Products

Foreign Exchange	FX Options
<p><b>Spot FX transactions</b> – Purchase or sale of foreign exchange where a rate is agreed between two counterparties today for physical delivery in two business days.</p> <p><b>Forward FX Transactions</b> – Purchase or sale of foreign exchange where a rate is agreed between two counterparties today for a physical delivery at a date that is greater than two business days hence.</p> <p><b>Swap Foreign Exchange transaction:</b> – The simultaneous purchase and sale (or sale and purchase) of a spot and forward FX transaction at rates agreed between two counterparties. Usually the amounts involved are the same for one of the currencies on the spot and the forward</p>	<p>There are several types of foreign currency options. Most option transactions are based on either puts, calls or a combination of the two.</p> <ul style="list-style-type: none"><li>• <b>Put</b> – Gives the buyer the right, but not the obligation, to sell a currency at a predetermined price.</li><li>• <b>Call</b> – Gives the buyer the right, but not the obligation, to buy a currency at a predetermined price.</li><li>• <b>Straddle</b> – Buying a call and a put (long straddle) or selling a call and a put (short straddle) with the same strike price. The most common straddle is the at the money straddle, i.e. when the strike price is equivalent to the underlying asset.</li></ul>

<p>transaction. For example, a swap transaction to buy AUD 5 million against USD for spot value against selling AUD 5 million against USD for forward value</p>	<ul style="list-style-type: none"> <li>• <b>Strangle</b> – Buying a call and a put (long strangle) or selling a call and a put (short strangle) with different strike prices.</li> </ul>
<p><b>Foreign Exchange</b></p> <p>Swap transactions can also be for O/N (today against tomorrow) or T/N (tomorrow against spot) or any other two dates as agreed between the two counterparties. The difference between the spot and the forward rates is referred to as the 'forward points' or 'forward pips'.</p> <p><b>Non Deliverable Forwards (NDFs)</b> – An NDF is a cash-settled, forward contract on a thinly traded or non-convertible foreign currency. The currencies are not physically delivered; instead the contract is settled by calculating the difference between the agreed upon exchange rate and the spot rate at the time of settlement for an agreed upon notional amount of funds. One party in the agreement will make a payment to the other party on the basis of the profit or loss on the contract. NDFs are normally, but not exclusively, quoted and settled in US dollars.</p>	<p><b>FX Options</b></p> <ul style="list-style-type: none"> <li>• <b>Risk Reversal (collar)</b> – Combining a bought call and a sold put or a sold call and a bought put.</li> <li>• <b>Exotic Options</b> – Any option which has a non-standard component. The most widely used exotic option is the barrier option.</li> <li>• <b>Barrier Option</b> – An option the terms of which change in some predefined manner when an event occurs in the option currency pair in the spot market at a rate that is at or beyond a pre-specified level. Refer Appendix 2</li> </ul>

### 3. Dealing

#### 3.1 Methods of Dealing

Foreign Exchange	FX Options
<ul style="list-style-type: none"> <li>• Brokers via telephone.</li> <li>• Interbank bank to bank deals over Reuters</li> <li>• Through single bank chat portals over Bloomberg and Reuters Messenger</li> <li>• other electronic platforms as authorised by counterparties</li> </ul>	<ul style="list-style-type: none"> <li>• Brokers via telephone.</li> <li>• Interbank bank to bank deals over Reuters</li> <li>• Through single bank chat portals over Bloomberg and Reuters Messenger</li> <li>• other electronic platforms as authorised by counterparties</li> </ul>

#### 3.2 Electronic and Internet Dealing

Foreign Exchange	FX Options
<ul style="list-style-type: none"> <li>• Through broker portals with the interbank community</li> <li>• Through single bank platforms</li> <li>• Via multi bank platforms such as FXCM and Bloomberg.</li> </ul>	<ul style="list-style-type: none"> <li>• Through broker portals with the interbank community</li> <li>• Through single bank platforms</li> <li>• Via multi bank platforms such as FXCM and Bloomberg.</li> </ul>

#### 3.3 Business Days

Foreign Exchange and FX Options
<p>A business day is defined as a day that is a good business day in each of the centres applicable to the currencies being transacted, i.e. for an AUD-USD trade; a business day is only good if the payment systems are open in Sydney and New York. A Sydney business day may be defined as a day on which banks in the state of New South Wales (NSW) are generally open for business, or a day other than one on which banks in NSW are obliged or permitted to close, excluding Saturday and Sunday.</p> <p>Essentially, Sydney business days are weekdays (Monday to Friday) other than NSW public holidays.</p>

### 3.4 Standard Transaction Size (market parcel)

Foreign Exchange	FX Options
Unless specified or bilaterally agreed prior to dealing: Transactions with an AUD Leg – AUD 5 million Other currency pairs: USD 5 million	Unless specified or bilaterally agreed prior to dealing, the standard amount for contracts against AUD is AUD 30 million: In the case of a straddle it is AUD 15 million on each leg.

### 3.5 Two Way Pricing

Foreign Exchange	FX Options
Two-way pricing is predominantly on an interbank reciprocal basis; More generally counterparties will indicate their side.	Two way pricing is generally undertaken only on a bilateral reciprocal basis between counterparties which have previously agreed to do so and is dependent upon market conditions.

### 3.6 Quotation and Dealing

Foreign Exchange	FX Options
<p><b>Deals at non market rates</b> should generally be avoided as such practices may result in concealment of a profit or loss in the perpetration of a fraud or the giving of an unauthorised extension of credit. Where however the use of non-current market rates may be necessary (as in swaps market or in certain transactions with corporate clients) they should be entered into with the prior express permission of senior management, who should ensure that proper controls are in place for the monitoring and reporting of such transactions to avoid the above mentioned problems. Cash flow implications should be taken into account in the pricing.</p> <p><b>Dealing after normal local hours</b>, particularly from premises other than banks' dealing rooms, should only be undertaken with the prior permission of management, who should issue guidelines to their staff on the extent of such dealing (including names of persons authorised to deal) and arrangements for the prompt recording and confirmation of such deals.</p> <p>The terms under which <b>stop loss orders</b> are accepted should be explicitly identified and agreed between the parties concerned and be within any management criteria on such orders. Any dealer handling such an order must have adequate lines of communication with the counterparty for use in the event of an extreme price/rate movement or other unusual situation.</p>	<ul style="list-style-type: none"> <li>• <b>Style</b> – To be European unless otherwise stated.</li> <li>• <b>Exchange of Delta</b> – Unless otherwise specified all Volatility trades will include the exchange of delta. Once the contract specifications are agreed to, the interbank market standard is now to exchange the delta at the forward date and rate which eliminates any dispute over premium calculations.</li> <li>• <b>Live Price</b> – A request for an option quotation where there is no delta hedge exchange. Quoted in premium NOT in volatility.</li> <li>• <b>Strike</b> – For an A.T.M. straddle volatility trade the strike is that which makes the straddle as close as can be agreed to delta neutral. If a contract with any other strike is required this would need to be stated when asking for the volatility price.</li> <li>• The strike price should be rounded to four decimal places and should be a multiple of five, e.g. 0.0005 – 0.0010.</li> <li>• <b>Determinations of Dealing Dates</b> – The straight dealing date is determined as: <ul style="list-style-type: none"> <li>• The first date preceding the equivalent forward date (as dealt in the forward foreign exchange market) that will give settlement on the forward date, if it is exercised on the expiration date.</li> <li>• An exception to straight dealing dates is the 1 week date and multiples thereof (2 week, 3 week etc). These will be multiples of 7 days regardless of whether these expiry dates fall on a non-business day for the currency involved.</li> </ul> </li> <li>• <b>Setting a Forward Rate</b> – As soon as a volatility price is dealt on, a forward price should be agreed as soon as possible thereafter for calculation of premium. This should be at the current market rate. In addition most interbank trades are now priced with premium paid at delivery which removes an additional point on conjecture as a pricing parameter.</li> <li>• <b>Rounding the Option Price</b> – In the case of AUD-USD contracts, to ensure prices can be agreed as easily as possible interbank participants will accept a price</li> </ul>

	<p>rounded to the nearest quarter point, e.g. 0.002525 or 0.002550.</p> <ul style="list-style-type: none"> <li>Where the premium is quoted as a percentage of the base amount (i.e. per cent of AUD in the case of an AUD cross contract, interbank participants will accept a price rounded to the nearest four decimal places rounded to multiples of 25, e.g. 1.0025% or 1.0075%.</li> </ul>
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### 3.7 Settlement Rate or Index

Foreign Exchange	FX Options
Not Applicable	Strike rate

### 3.8 Premium Payment Date(s)

Foreign Exchange	FX Options
Not applicable	<p>Market standard is forward premium settlement, and in such instances the premium is payable on the spot date on expiry.</p> <p>In instances where spot premium settlement is nominated, then premium is payable value spot on the transaction date.</p>

### 3.9 Expiry Conventions

Foreign Exchange	FX Options
Not Applicable	<p>Options may expire on a weekday that is not a good business day, however can only be settled on a good business day.</p> <p>Standard expiry times for G10 currency pairs should be 10am NY time. 3pm Tokyo expiry time is also traded for pairs including JPY, AUD and NZD.</p> <p>Local corporates in Australia may also deal for a 10am or 3pm Sydney expiry time. In NZ corporates usually deal for a 3pm Wellington expiry time.</p> <p>For Emerging market pairs these are traded exclusively for a local cut-off time. NDOs are traded against a prior specified fix.</p>

### 3.10 Broker Conventions

Foreign Exchange	FX Options
<p><b>Passing Names</b> – Where a FX Spot or FX Swap price has been hit (dealt) through a broker the broker will pass the name of the potential counterparty to the price maker as soon as possible. These deals are binding subject to credit checks.</p> <p><b>Quiet Trade</b> – When two counterparties elect to deal through the regular broking market neither party can expect the trade not to be reported to the general market. However, in the case of deals larger than standard market parcels it is up to the counterparties to decide whether the total amount of the trade is reported. NDF transactions</p>	<p><b>Passing Names</b> – Where a volatility price has been hit (dealt) through a broker the broker will pass the name of the potential counterparty as soon as possible. These deals are binding subject to credit checks. Additionally some US names can only deal 'On-SEF' or 'Off-SEF' and in these cases the broker should make any counterparties aware of this prior to transaction.</p> <p><b>Quiet Trade</b> – When two counterparties elect to deal through the regular broking market neither party can expect the trade not to be reported to the general market. However, in the case of deals larger than standard market parcels it is up to the counterparties to decide whether the</p>

executed On-SEF are required to have the size of the deal reported.	total amount of the trade is reported. If the deal is traded On-SEF the size of the deal must always be reported.
<b><i>Misquote</i></b> – Should an obviously incorrect price be quoted the onus is on the price taker to reconfirm the price from the price maker before transacting.	<b><i>Misquote</i></b> – Should an obviously incorrect price be quoted the onus is on the price taker to reconfirm the price from the price maker before transacting.

### 3.11 Confidentiality

#### Foreign Exchange and FX Options

Refer: ACI Model Code, Chapter One, – Confidentiality

### 3.12 Credit

#### Foreign Exchange and FX Options

The ability to deal is subject to credit limits. Dealers should advise the counterparty if they unable to deal because of credit limits. The quoting of a price to the counterparty indicates to that counterparty that credit lines are in place up to the dealing amount that was requested or the generally accepted market dealing parcel if no dealing amount has been stated.

### 3.13 Exercise of Options

Foreign Exchange	FX Options
Not Applicable	<p>It is acknowledged that exercise must be made on or before the expiry time set for the particular contract but it is good market practice to accept a late exercise of a contract which, at expiry time, has a reasonable degree of intrinsic value.</p> <p>An option contract with at least 1% intrinsic value is considered automatically exercisable although the market convention is usually to confirm the exercise with the counterparty even under these conditions.</p> <p>In the event of the strike being close to the spot level at the time of expiry, options can be exercised either in whole or in part. However, when partial amounts are exercised these should be in even amounts.</p> <p>Expiry time for options in this trading zone should be referenced against the time page on Reuters.</p> <p>Where exercise is being confirmed it is good market practice to confirm also the flows and value dates involved.</p>

## 4 Confirmations: Post-Trade Standards and Practices

Refer Appendix 3 for general information on Continuous Linked Settlement (CLS) and payments netting arrangements

Foreign Exchange										FX Options																																																											
Refer Chapter 11 the <a href="#">ACI Model Code</a>										Refer Chapter 11 the <a href="#">ACI Model Code</a>																																																											
<table border="1"> <thead> <tr> <th>Type of deal</th> <th colspan="9">Method</th> </tr> <tr> <th></th> <th>Reuters</th> <th>EBS</th> <th>SWIFT<sup>2</sup></th> <th>CLS</th> <th>Austraclear</th> <th>Fax<sup>1</sup></th> <th>Letter</th> <th>Phone<sup>3</sup></th> <th>Internet (email/manual)<sup>1</sup></th> </tr> </thead> <tbody> <tr> <td>FX</td> <td>P</td> <td>P</td> <td>S</td> <td>S</td> <td>S</td> <td>S</td> <td>S</td> <td>P/S</td> <td>S</td> </tr> <tr> <td>FX MM</td> <td>P</td> <td>P</td> <td>S</td> <td></td> <td></td> <td>S</td> <td>S</td> <td>P/S</td> <td>S</td> </tr> <tr> <td>FX Options</td> <td>P</td> <td>P</td> <td>S</td> <td></td> <td></td> <td>S</td> <td>S</td> <td>P/S</td> <td>S</td> </tr> </tbody> </table>										Type of deal	Method										Reuters	EBS	SWIFT <sup>2</sup>	CLS	Austraclear	Fax <sup>1</sup>	Letter	Phone <sup>3</sup>	Internet (email/manual) <sup>1</sup>	FX	P	P	S	S	S	S	S	P/S	S	FX MM	P	P	S			S	S	P/S	S	FX Options	P	P	S			S	S	P/S	S	<p>Timing</p> <p>All transactions must be confirmed either electronically or in writing by both parties as soon as possible but no later than midday on the business day following the day on which the transaction was executed.</p>									
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<p>P = Primary Confirmation  S = Secondary Confirmation</p> <p>1 Parties can confirm by fax, telex or the internet only if they have previously agreed expressly on this method and preferably hold a letter of indemnity or (in the case of internet portals) have entered into a bilateral user agreement.</p> <p>2 Appropriate SWIFT message type (MT 300 Series) must be used.</p> <p>3 If a confirmation has been received directly from a counterparty/client within one hour of trade, a secondary telephone confirmation is not required.</p>										<p>MT 305 is best practice for confirming vanilla options; exotics options are typically confirmed via fax but where possible SWIFT MT306 should be utilised.</p>																																																											
<p><b>Reuters</b></p> <p>Automatic printout of the deal is provided, representing a primary confirmation of the transaction.</p>										<p><b>Terminology</b></p> <p>Operations personnel of either party to a deal may initiate a telephone confirmation if no confirmation has been received one hour after the transaction. Both operations offices must have the dealing ticket at the time. If the office receiving the call does not have the dealing ticket, it must obtain it and inform the other office of the status of the deal within 30 minutes of the original call.</p>																																																											
<p><b>Electronic Broking System (EBS)</b></p> <p>Automatic printout of the deal is provided, representing primary confirmation of a transaction.</p>										<p>Recommended language is:</p> <p>"A [name in full] buys an AUD put USD call from B [name in full], face value AUD 10,000,000, strike 0.5500 expiry 2 September 2005, cut-off time 3 p.m. Tokyo, European style. A [name in full] will pay B [name in full] a premium of USD 207,000.00, value 4 April 2005.</p>																																																											
<p><b>CLS</b></p> <p>CLS endorsed best practice is for member banks not to require a SWIFT MT 300 for deals which are being settled through CLS. In effect, the entry of settlement details into the CLS system doubles as a secondary confirmation. Whilst this is considered best practice, an MT 300 should be provided if the counterparty requests it.</p>										<p>a) method of dealing (telephone or broker's name)  b) payment — SSI or full details of alternative  c) reference number  d) name of caller "</p>																																																											
<p><b>ASX Austraclear</b></p> <p>FXConfirm allows banks and their customers to receive and despatch electronic foreign exchange confirmations for spot and forward transactions.</p> <p>Under the acknowledged confirmation method, the bank's SWIFT confirmation is delivered on line to the corporate counterparty, which agrees/rejects the confirmation via the ASX Austraclear system FINTRACS. An appropriate SWIFT message is delivered back via FINTRACS to the bank for processing via its internal matching system.</p> <p>Under the matched confirmations method, both the bank and the corporate deliver a confirmation to the ASX Austraclear system via the means of their choice (SWIFT/Electronic file upload/manual input). The ASX Austraclear system attempts to match the confirmation pair and generates the resulting message to both parties.</p>																																																																					
<p><b>Letter</b></p>																																																																					

Letters can be used as a secondary form of confirmation of transactions.

#### **Phone**

Recorded conversations preserve the step-by-step details of a deal. They are used primarily for primary confirmation of onshore/onshore transactions.

#### **Internet based Portals**

This form of confirmation should be covered by a bilateral indemnity or user agreement. Internet portal confirmations are generally governed by specific software requirements and policies/procedures of the financial institution providing the service.

#### **Non Deliverable Forwards**

In December 2006 the [NY] Foreign Exchange Committee (FXC), EMTA, Inc. (EMTA) and the Foreign Exchange Joint Standing Committee (FX JSC) released the Master Confirmation Agreement for Non-Deliverable Forward FX Transactions. The FXC announcement contains links to the Agreement, Practice Notes and Addendum. The Agreement is designed to be incorporated into an ISDA Master Agreement.

The cosponsors expect the Master Confirmation will offer market participants adopting it a legal framework for highly efficient confirmation processes for NDF Transactions.

## **4.1 Deal Confirmation Deadlines**

### **Foreign Exchange and FX Options**

All transactions must be confirmed within two hours of the transaction. This conforms to minimum CLS and AFMA standards. However, for transactions between two counterparties domiciled in Australia, best practice is for counterparties to send confirmations to each other within one hour of the transaction being executed and for these confirmations to be matched within two hours.

## **4.2 Post-Exercise Confirmation of Foreign Exchange Options**

### **Foreign Exchange Options**

If an FX option is exercised, the resulting FX deal must be confirmed in accordance with these rules on the date of exercise.

## **4.3 Standard Procedures for Confirmations**

### **Foreign Exchange and FX Options**

**Reuters** – The hard copy printout of the Reuters screen (or electronic receipt into a matching system) is accepted as firm evidence of details of the deal.

**EBS** – The hard copy printout of the EBS deal (or electronic receipt into a matching system) is accepted as firm evidence of details of the deal.

**SWIFT** – Hard copy printout of the SWIFT message (or receipt into a matching system) is accepted as firm evidence of the details of the deal.

**CLS** – Appearance of the transaction in “settlements due” listing for relevant day is accepted as firm evidence of the details of the deal.

**ASX Austraclear** – Hard copy printout of the FINTRACS message (or listing in online report) is accepted as firm evidence of the details of the deal. FINTRACS provides hourly status reports of confirmed/ unconfirmed deals via the TRANSENQ screen

**Internet** – Because this will normally be a proprietary system, the form of confirmation will be determined by the policy, procedures and requirements of the financial institution providing the system and possibly by limitations of the software in use.

**Telephone** – Financial Institution counterparty:

Operations personnel of either party to a deal may initiate a telephone confirmation if no confirmation has been received one hour after the transaction. Both operations offices must have the dealing ticket at the time. If the office receiving the call does not have the dealing ticket, it must obtain it and inform the other office of the status of the deal within 30 minutes of the original call.

With the introduction of continuous linked settlement (CLS), care needs to be taken with settlement instructions.

Format to be used over telephone by the caller (organisation A):

- Organisation name (it is imperative that the full legal name of each organisation be used, e.g. "Westpac Banking Corporation Limited, Sydney Office" — not just "Westpac")
- Broker's name (if deal is executed through a broker, e.g. "dealt by Tullett Prebon")
- Details of confirmation, which may include:
  - client/counterparty
  - trade date
  - settlement/value date
  - buy/sell
  - organisation name
  - amount
  - currency/commodity/security
  - rate/price/yield
  - full settlement instructions
- Method of deal (telephone or broker's name)
- Payment (SSI or full details of alternative)
- Reference number
- Name of caller

Format to be used over telephone by the receiver (organisation B):

- Details of deal from B's viewpoint
- Reference number
- Name of person confirming

**Telephone** – Other counterparties:

If the financial institution has not received confirmation of the deal after one hour by facsimile, telex or internet, its operations staff should initiate a telephone confirmation.

Failure to receive a corporate confirmation could result in:

- Incorrect name
- Incorrect SSI
- Unwanted currency positions
- Failed settlement

The financial institution has a responsibility to ensure that deal confirmation is completed. Special care should be taken as corporates may be netting off against new trades for value same day.

**Fax Confirmations** – to be used where telephone not available:

Include type of deal, reference number, details of deal, method of deal and payment instructions. For example:

FX Confirmation – Ref 23456

A [name in full] buys GBP1,000,000 and sells USD1,501,500 at 1.15015, value 5 April 2005, from B [name in full].

Method dealt: telephone

Payment: SSI to apply.

**Late Trading**

Deals that cannot be confirmed on the deal day because of late trading must be confirmed as soon as possible and no later than 10.00 am on the following business day.

If confirmation of full details of a trade cannot be made, at least its existence should be verified.

## 5. Foreign Exchange Options Settlement and Premium Payment

### 5.1. Foreign Exchange Options Physical Settlements

#### Foreign Exchange Options

Settlement of all contracts both deliverable and non-deliverable will be on the spot date on expiry unless negotiated otherwise at the time of trade.

### 5.2. Foreign Exchange Options Premiums Payments

#### Foreign Exchange Options

Convention for interbank premium currencies is based on a hierarchy as Follows:

USD, EUR, GBP, AUD, NZD, CAD, CHF, JPY

For example:

Premium currency for contracts against the USD, including AUD-USD and NZD-USD, should be USD unless otherwise specified.

All premiums are payable value date spot on expiry or spot on the day of transaction.

FX option premium settlements can be effected as a single settlement class or can be included in FX transaction netting, as mutually agreed by both parties.

## 6. Foreign Exchange Options SEF Contracts

Refer Appendix 4 for background information

#### Foreign Exchange and Foreign Exchange Options

The following rules apply if dealing with a US registered entity or via a US broking house:

1. Non-deliverable forwards (NDF) and foreign exchange options are to be reported when dealing with a US registered entity or through a US broking house;
2. Associated delta hedges are not reported, except in circumstances where the delta hedge is transacted as an NDF.

## Appendix 1 – Foreign Exchange Options Terminology

*At The Money Forward* – An ATMF option has a strike price equal to the price of the underlying asset. It has no intrinsic value but will have time value.

*At The Money Spot* – An ATMS option has a strike price equal to the SPOT price of the underlying asset. It has intrinsic value and time value.

*Delta Neutral Straddle* – An DNS option has a strike price where the delta and strike of the put option is the same as that of the call. The strike will be close to but may not be the same as the ATMF strike. This is the convention for all market traded 'At-the-money' strikes out to 1 year in G10 pairs.

*Delta Hedging* – Involves taking an offsetting position in the underlying instrument equivalent to the option face value multiplied by its current delta in percent.

*Delta* – The change in the price of an option for a given percentage change in the price of the underlying instrument.

*Expiry Date* – Also known as the maturity date. If an option is not exercised by the expiry time on this date it becomes worthless and expires. An American option can be exercised on any date up to and including the expiry date for delivery value spot on exercise. European options have a fixed delivery date and are exercised on the expiry date.

*Face Value* – The quantity of the base currency to be exchanged under the option contract.

*In-the-money* – An in the money option has intrinsic value as well as time value, ie. the option has value if it were to be exercised immediately.

*Misquote* – Should an obviously incorrect price be quoted. The onus is on the price taker to reconfirm the price from the price maker before transacting.

*Out-of-the-money* – An out of the money option has no intrinsic value but may have time value.

*Premium* – The cost of purchasing an option contract. The premium is made up of two components:

- *Intrinsic value* – the value derived if the option were to be exercised immediately, ie. the difference between the price of the underlying forward and the strike price for a call option and visa versa for a put option.
- *Time value* – the extra value (over intrinsic) of optionality until the expiry date. Time value declines as the option approaches its expiry date (theta).

*Strike Price (Exercise Price)* – The price or rate at which the option contract can be exercised.

*Underlying Instrument* – A currency option is an option on a foreign exchange contract. Therefore, the underlying instrument is a foreign exchange spot contract to exchange the underlying currencies value spot on the expiry date of the option.

*Volatility* – Is a statistical means of measuring the changes in price of the underlying instrument, expressed as an annualised percentage. There are two types of volatility:

- *Implied volatility* – is an estimate of future volatility.
- *Historical volatility* – a measure of historical movements in the underlying asset.

## Appendix 2 – Foreign Exchange Barrier Options

- *Barrier Options* – Barrier options are complex instruments with unusual risks. Barrier options are options the terms of which change in some predefined manner when a barrier event occurs. A barrier event is a transaction in the relevant currency pair occurring in the spot market at a rate that is at or beyond a certain pre specified level (generically called the barrier price).

There are many specific types of barrier options including the knock out option, the double knock out option, the knock in option, the lock out option, the double lock out option, the lock in option, the step payment option and others.

- *Barrier Determination Agent* – Parties to a barrier option are expected to nominate a barrier determination agent (BDA), which will generally be either the buyer or the seller. Unless otherwise determined the BDA will be the market marker, ie. the party which provided the price quotation for the option. The BDA for each option must be designated in the confirmation. It is the responsibility of the BDA to determine whether a barrier event has occurred.
- *Barrier Event* – Problems can arise when the criteria used for determining barrier events are not transparent. The following conventions should be followed in relation to determining if a barrier event has occurred.
  - a) The transaction must occur at a rate that is at or beyond the barrier price.
  - b) A barrier event must be an actual transaction in the foreign exchange markets. A transaction determined to be a barrier event can take place between:
    - two independent counterparties through the brokers market;
    - the BDA and an independent counterparty through the brokers market; or
    - the BDA and an independent counterparty dealing direct.

Quotations, whether firm or indicative, obtained from a foreign exchange broker or dealer or a quotation screen or other information source which does not provide evidence of an actual transaction, are not acceptable evidence that a barrier has been breached.

- *Illiquid Currency Pair* – In the case of a barrier option in an illiquid currency pair A/B (ie. a pair in which spot transactions are few and irregular) the BDA may determine whether a barrier event has occurred by observing a transaction in the currency pair meeting all the criteria above, or alternatively by observing two spot transactions, one in which currency A is traded against a third currency C, and the other in which C is traded against B, and calculating from these the implied rate of exchange for A/B.

Such spot transactions must be reasonably close together in time and meet all the above criteria (except a).

- *Disputes* – The BDA is required to inform the other party as soon as possible of the occurrence of a barrier event. If there is a dispute over the determination of a barrier event, the BDA must be able to furnish evidence of the observed spot transaction(s). Transactions that the BDA does not observe and could not observe from sources regularly available to it in the ordinary course of its business cannot be the basis for barrier event determination.
- *Specific Orders* – A barrier event does not require the execution of an order placed by the seller or the buyer of the option at the barrier price or any other specific order.
- *Confirmations* – The initial spot rate is a term which should be included in barrier options confirmations, since it is helpful for potential dispute resolution and risk management purposes. The initial spot rate means the spot rate at the time a barrier options is entered into.
- *Disclosure Statement* – Users of barrier options may wish to consider whether it would be appropriate to disclose to its counterparty that its ordinary course foreign exchange transactions and its activities in hedging or de-hedging its position under a barrier option may increase the probability that a barrier event will occur.
- *Good Faith* – All option counterparties are expected to act honestly and in good faith. Use of disclosure statements does not justify foreign exchange transactions that are undertaken to manipulate the spot exchange rate and not as part of bona fide good-faith foreign exchange transactions, hedging or de-hedging.

## Appendix 3 – Continuous Linked Settlement and Payments Netting Arrangements

CLS Settlement is the market standard for FX settlement and is the industry's response to continuing regulatory concern about the settlement and systemic risk associated with the growth in FX trading. Settlement risk is the risk that one party to an FX transaction pays out the currency it sold but does not receive the currency it bought.

The settlement service went live in September 2002 settling seven currencies for 39 Member banks. Seven years later the service settles seventeen currencies for 59 Member banks and over 5,000 other participants. Direct participants or Members are also shareholders in CLS Group and have an account at CLS Bank, an Edge Act bank based in NY.

The service eliminates settlement risk using a unique combination of payment versus payment in "central bank funds", multilateral payment netting supported by a comprehensive, standardised operating and legal framework. The service is delivered by a resilient infrastructure that complies with the Federal Reserve Bank standards for critical infrastructures under its oversight. The key attributes are as follows:

- Matches settlement instructions, on average within 30 minutes after trade execution;
- Eliminates FX settlement risk by settling both sides of each trade simultaneously, PvP. In the event of failure by one party to the trade, the principal is immediately returned to the other party;
- Settles seventeen currencies that account for 94% of daily traded value (*BIS Triennial FX Survey 2007*);
- Multilaterally nets the cash obligations between all Members for each value date. Currently this process achieves a netting efficiency of 97%, or for every \$1 trillion settled, the members have to fund \$30 billion in the respective currencies settled;
- Settles payment instructions related to trades executed in five main instruments:
  - FX spot
  - FX forwards
  - FX option exercises
  - FX swaps
  - Non deliverable forwards

CLS Bank does not guarantee the settlement or become counterparty to any transaction. The FX trade obligations remain with the trading parties. The service risk model is designed to assure protection against the loss of principal value by any one party to an FX trade.

Members input transactions into the CLS system and hold a direct account with CLS Bank. User members input transactions but do not have a direct account with CLS Bank and thus are sponsored by a Settlement Member for their payments. Third party participants do not have direct access to CLS and therefore must use a Settlement Member who submits transactions and processes payments on their behalf.

There were seven CLS launch currencies (AUD, CAD, CHF, EUR, GBP, JPY and USD). A further ten currencies (SEK, NOK, DKK, SGD, HKD, NZD, KRW, ZAR, MXN and ILS) have since been added.

The CLS Non-Deliverable Forward (NDF) Settlement Service has been live since November 2007, providing settlement risk elimination and operational risk reduction for Members and Third Parties.

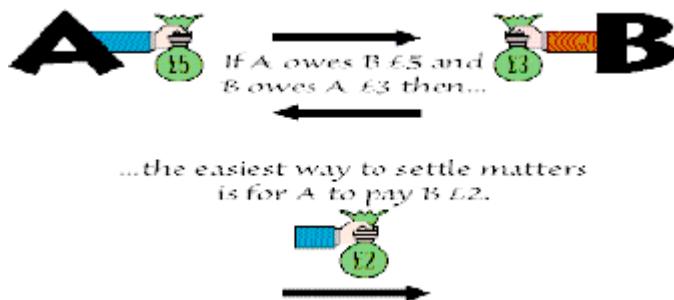
CLS has also partnered with The Depository Trust & Clearing Corporation (DTCC) to provide an automated settlement service for cash flows relating OTC credit derivatives contracts. This links DTCC Deriv/SERV's Trade Information Warehouse to the CLS settlement service. The service started operation in mid-2007 with settlements between the primary dealers in the warehouse; this has more recently expanded to include buy-side firms.

The Reserve Bank of Australia has introduced extended operational hours for the RTGS system to accommodate CLS settlements.

CLS has established protocols published and administered by CLS Bank International. The purpose of these Protocols is to offer market participants an efficient way to address issues relating to standards and/or best practices surrounding post-trade processes where related instructions are submitted to the CLS System for Settlement services in CLS Bank. Full details are available on the website; [www.cls-group.com](http://www.cls-group.com).

### **Payments Netting (non-CLS transactions)**

I owe you £5 but you owe me £3. If I give you £2, we're quits -- the concept of netting in a nutshell.



Payments netting is an arrangement in which opposite payments are matched. This usually occurs where there are opposite obligations in the same currency, between the same parties, and involving the same risk management product or different products on a common date.

On the due (value) date, the amounts due for payment between the parties are netted off and only the difference is paid by one of the parties to the other.

Payments netting results in a simple set-off at the time of payment without altering the contractual rights of the parties under the contract. Payments netting reduces settlement risk.

### **Netting Arrangements**

CLS is the principal system for netting payments.

If a counterparty (generally a corporate client) wishes to net off maturing transactions on an ongoing basis, the bank must be notified with adequate time for the first netting to be effected. All payments related to subsequent deals with the bank will be netted against payments for deals maturing on the same day.

Deals transacted for same-day value which are to be included in netting together with maturing deals are to be advised accordingly to the bank (optional in the agreement).

Customers wishing to net-off transactions on an ad hoc basis should notify the bank as earlier as possible on the day netting is to take place, ideally by 9:30am.

### **Netting Procedure**

The bank will contact the counterparty by 9:30am on value date and confirm the currencies and amounts to be remitted by either party.

### **Payments Netting Confirmations**

On completion of the telephone confirmation, the bank will transmit a facsimile summary of deals netted on the day. Each facsimile will detail the individual deals maturing on the day which constituted the net result. The customer is required to provide similar confirmation on the day to the bank, or acknowledge the confirmation provided by the bank by signing and returning a copy by facsimile.

Alternatively, the bank may confirm the trades through its online system to the customer.

### **Confirmation Discrepancies**

The customer should notify the bank by telephone immediately if a discrepancy is identified in a payments netting confirmation.

## Payments Netting Documentation

### Bilateral Payments Netting Agreement

Note: This agreement does not cover transactions processed under continuous link settlement (CLS).

This agreement outlines the procedures in relation to bilateral payments netting for non-CLS deals between [Party A – Counterparty] and [Party B – Bank]. *(This paragraph can be tailored to include all deal types or specific deal types, as mutually agreed)*

Payments and receipts in [currencies to be included] in settlement of foreign exchange deals are to be netted.

“Value today” foreign exchange deals, money market deals and derivative product trades are to be excluded. (optional clause – include as appropriate)

The bank agrees to contact the other party on a recorded telephone line [before 9:30am Sydney time]<sup>1</sup> on value date to agree net settlement currency amounts.

Formal confirmation showing a summary of deals netted and amounts payable/receivable will be sent by fax (or other electronic means) by the bank to the counterparty. Acknowledgment by return is required. This may be by signing and returning the original facsimile or through a proprietary system.

If a net settlement amount cannot be agreed, each party shall attempt promptly and in good faith to resolve the dispute. If such a dispute is not resolved, the individual deals will be settled individually and no netting will be undertaken for that particular currency.

Each party agrees to provide five working days notice of any intention to withdraw from this agreement.

Contact Numbers

Party A: Telephone \_\_\_\_\_ Fax \_\_\_\_\_

Party B: Telephone \_\_\_\_\_ Fax \_\_\_\_\_

This agreement will commence: \_\_\_\_\_

Signed for and on behalf of:

[Name of Party A] [Name of Party B]

\_\_\_\_\_  
Signed

\_\_\_\_\_  
Signed

\_\_\_\_\_  
Name

\_\_\_\_\_  
Name

\_\_\_\_\_  
Date

\_\_\_\_\_  
Date

1 Specifying a particular cut off time is optional.

## Appendix 4 – Foreign Exchange Options SEF Contracts

### Background

Recent changes have affected how FX options are transacted with US entities.

The Commodity Futures Trading Commission (CFTC) published its Core Principles and Other Requirements for Swap Execution Facilities (“SEF rules”) in May 2013. SEF rules came into effect from 2 October 2013. The rules implement provisions enacted by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).

SEF rules describe the process for an entity to register (with the CFTC) and operate an over-the-counter (OTC) swaps trading facility.

The CFTC mandate that certain swap transactions are executed on a registered facility in accordance with SEF rules. The consequence is that entities who are captured by CFTC regulations (often referred to as “US Persons”) must execute these transactions on a SEF.

### Who is impacted by SEF Rules?

SEF rules target both swap execution facilities and US Persons alike.

### Swap Execution Facilities

The CFTC mandate that swap execution facilities (“SEFs”) must register with the CFTC to operate as a regulated entity if the facility offers a multilateral trading platform. The CFTC define a multilateral platform as a platform where *“more than one market participant has the ability to execute or trade swaps with more than one other market participant”* (SEF rules, May 2013).

This definition precludes single-dealer platforms from having to comply with SEF rules. Furthermore, direct bilateral trading between two parties does not meet the definition of a SEF, for example trading via email, chat, and direct phone contact.

As of February 2014 the CFTC website listed 23 multilateral platforms as temporarily registered to operate a SEF, or are pending temporary registration

### Which Swap Products are impacted by SEF Rules?

- FX Non-Deliverable Forwards;
- FX Currency Options;

When dealing with a US registered entity or via a US broking house, FX Options need to be reported but not the associated delta hedge unless this is transacted as an NDF.