



THE FINANCIAL  
SERVICES  
ROUNDTABLE

November 29, 2010

Office of Financial Policy  
1500 Pennsylvania Ave., N.W.  
Washington, DC 20220

**Re: Determination of Foreign Exchange Swaps and Forwards, 75 Federal Register 66829 (October 29, 2010).**

Ladies and Gentleman:

The ABA Securities Association<sup>1</sup> (ABASA), the Institute of International Bankers<sup>2</sup> (IIB) and The Financial Services Roundtable<sup>3</sup> (the Roundtable) appreciate the opportunity to provide comments on whether an exemption for foreign exchange swaps and foreign exchange forwards is warranted under the Commodity Exchange Act (CEA). The CEA, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA), permits the Secretary of the Treasury to issue a written determination exempting foreign exchange swaps (FX Swaps), foreign exchange forwards (FX Forwards), or both, from the definition of a “swap” under the CEA. As more fully discussed below, ABASA, IIB and the Roundtable fully support the analysis and positions expressed in the November 15, 2010 comment letter filed by the Global FX division of SIFMA, AFME and ASIFMA (Global FX letter).<sup>4</sup> We strongly believe that an exemption for both FX Swaps and FX Forwards is warranted and that the Secretary should exercise his authority under DFA and exempt both from the definition of swaps under the CEA.

This issue is of vital importance to our membership. Collectively, our members are involved in approximately 95 percent of all foreign exchange transactions.<sup>5</sup> As the largest and most liquid market in the world, the FX market has a tremendous positive impact on global commerce and investment, including the funding of the US government.

The Congress, in enacting DFA, intended both to lower risks associated with derivative instruments and to bring transparency to these markets. The DFA seeks to accomplish these goals through comprehensive regulation of swap dealers and the OTC market, mandating that most derivatives be traded on either an exchange or a swap execution facility, and requiring central clearing of standardized swaps. We believe, however, that FX Swaps and FX Forwards are not the types of transactions that gave rise to the financial crisis. Indeed, as we discuss below, such transactions are already subject to systemic oversight by central banks and utilize risk reduction platforms on an international basis.

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<sup>1</sup>ABASA is a separately chartered affiliate of the American Bankers Association, representing those holding company members of the ABA that are actively engaged in capital markets, investment banking, and broker-dealer activities.

<sup>2</sup>The Institute represents internationally headquartered financial institutions from 39 countries around the world; our members include international banks that operate branches and agencies, bank subsidiaries and broker-dealer subsidiaries in the United States.

<sup>3</sup>The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer.

<sup>4</sup>Letter from the Global FX Division of SIFMA, AFME and ASIFMA to United States Department of the Treasury. November 15, 2010. (Global FX Letter).

<sup>5</sup>2010 Euromoney League Table of FX Market Share.

## DISCUSSION

As has been explained in the Global FX letter, the foreign exchange market is qualitatively different from derivatives markets. FX Swaps and FX Forwards typically are physically settled by delivery of the underlying currency, including a two-way exchange of principal agreed at the time of execution.<sup>6</sup> From this perspective, FX Swaps and FX Forwards are more similar to physically settled commodity forwards, which are excluded from the definition of “swap,” than they are to other classes of swaps.<sup>7</sup> Indeed, we believe that the term “swap” is a misnomer in the context of FX transactions, which consist either of a spot trade and a forward trade or two forward trades, one settling later than the other.

As we lay out below, the critical reforms Congress sought to impose on the derivatives market have already been accomplished in the FX market. Overlaying yet another set of regulations is unnecessary and, worse, could severely undermine the safety and efficiencies of this market.

**FX Dealers and the FX Market Already Are Subject to Comprehensive Regulation.** While DFA requires regulation of many swap dealers that were previously unregulated, the FX market and FX dealers already have been subject to significant regulatory oversight by central banks. In the US and in international markets, the potential for systemic risk is carefully monitored by central banks through capital adequacy requirements and safety and soundness reviews. The Foreign Exchange Committee, an independent body sponsored by the Federal Reserve Bank of New York and composed of representatives from institutions participating in the foreign exchange market, produces and regularly updates its report on Guidelines for Foreign Exchange Trading Activities (the Guidelines). The Guidelines are designed to foster the healthy functioning and development of the foreign exchange market in the United States and to provide important assistance to participants in the markets regarding how to manage risk. The Federal Reserve and the Office of the Comptroller of the Currency (OCC) monitor compliance with the Guidelines as part of their safety and soundness review of banks. We believe that this knowledgeable and significant supervision of market participants materially distinguishes the FX Swap and FX Forward markets from the OTC derivatives markets. As a corollary, we do not believe that the capital and prudential requirements imposed by DFA and the CEA on Swap Dealers or Major Swap participants will add any material element of safety and soundness to FX market participants.

Moreover, the Continuous Linked Settlement Bank (CLS Bank), which serves as the principal settlement vehicle for foreign exchange, is subject to regulation by the Federal Reserve Board, which has established a cooperative arrangement for oversight of CLS Bank with the other central banks whose currencies are settled in CLS Bank. The Federal Reserve provides regular reports to central banks and regulators on transactions in the FX market.<sup>8</sup> Because the FX markets are critical to the

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<sup>6</sup> While not physically settled, non-deliverable forward contracts (NDFs) are functionally identical to FX forwards but, due to currency controls in certain foreign jurisdictions, e.g., Brazil, China and India, the subject currencies cannot be physically delivered. Instead, NDFs settle in cash, based on the difference between a price agreed upon at the inception of the contract and the spot price for the currency determined one or two days before the date of settlement. NDFs are highly liquid and transparent, with high standards for documentation and execution, and can, like FX forwards, be settled through the Continuous Linked Settlement system (CLS).

<sup>7</sup> We strongly agree with the analysis in the Global FX letter that there is no valid reason to distinguish FX Swaps and FX Forwards as they are too economically related to be distinguishable. Likewise, there is no difference between long-dated and short-dated FX Swaps and FX Forwards that would justify subjecting them to two different regulatory schemes. Global FX Letter at 1.4.

<sup>8</sup> See Protocol for the Cooperative Oversight Arrangement for CLS ([http://www.federalreserve.gov/paymentsystems/cls\\_protocol.htm](http://www.federalreserve.gov/paymentsystems/cls_protocol.htm)).

ability of central banks to carry out monetary policy, there are compelling macroeconomic reasons for the Federal Reserve, not the CFTC, to remain the primary supervisor of FX activity in the US.

**The FX Market is Transparent and Efficient.** Unlike OTC derivatives FX Swaps and FX Forwards are overwhelmingly short-term instruments that trade in a very liquid market.<sup>9</sup> The foreign exchange market led other markets over the past decade in converting to electronic trading platforms, which brought significant improvements in price transparency, liquidity and efficiency. End-users have access to real time prices quickly through up-to-date prices on electronic platforms posted by multiple participants. This has contributed to narrow spreads and deep liquidity. Moreover, the proliferation of multi-dealer and single-dealer electronic communications networks in the foreign exchange market provides a high degree of operational resiliency coupled with a lack of concentration of systemic risk.

The foreign exchange market, with its strong operational infrastructure has already withstood numerous disruptions. Notably, the foreign exchange market continued to function well throughout the 2008 financial crisis. Market participants were “able to execute trades and manage their currency exposure on an uninterrupted, twenty-four hour basis in a relatively liquid market” and had enough confidence in the payment system to continue executing foreign exchange transactions.<sup>10</sup>

**The FX Market Is a Global Payment System with a Well-Developed Settlement System that Effectively Mitigates Systemic Risk.** It is well understood that settlement risk is the greatest systemic risk in the FX market.<sup>11</sup> Settlement risk is the risk that one party to an FX transaction delivers the currency it sold but does not receive the currency it bought. In recognition of this issue, regulators and major financial institutions developed the CLS settlement system. CLS is a simultaneous exchange—“payment vs. payment”—of each of the two legs of an FX transaction, which eliminates settlement risk for parties settling through CLS Bank. CLS Bank now settles more than 85% of interbank FX transactions. To address the remaining mark-to-market credit risk, master netting agreements with associated credit support annexes (CSAs) and other forms of security agreements are heavily used and relied on in the FX market.

If FX Swaps and FX Forwards are included within the definition of a “swap,” and all parties to such transactions are subject to a clearing requirement, significant additional costs would be imposed on market participants. For example, technology start-ups or emerging growth companies that depend on international markets for manufacturing or sales will incur considerable additional costs in managing their foreign currency exposures. These companies are extremely sensitive to currency risk and to any increase in costs; they may not be able or willing to replicate their FX Swaps or Forwards with centralized exchange traded positions. As a result, these companies may choose to avoid the added expense by not hedging their currency risk. The result would increase instability and inefficiency for emerging growth companies with possible negative repercussions for future job growth in the US.

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<sup>9</sup>See generally, Global FX letter at Section 1.3.

<sup>10</sup>New York Federal Reserve Foreign Exchange Committee. Overview of the OTC Foreign Exchange Market: 2009. November 9, 2009. Pp. 1-4.

<sup>11</sup> While counterparty credit risk, market risk and operational risk are present and must be managed, they are a much smaller concern than settlement risk as FX Swaps and FX Forwards are on the whole shorter dated instruments compared to other classes of swaps, and the underlying FX market is highly liquid with relatively stable prices. See Bank for International Settlements Committee on Payment and Settlement Systems. Central Bank Payment and Settlement Services with Respect to Cross-Border and Multi-Currency Transaction. September 1993. Section 2.3.p.2.

In addition, clearing and exchange trading requirements have the effect of standardizing transactions. While standardization is already available in FX markets, it frequently is not used because it does not provide sufficient flexibility for end-users to hedge specific risks. The costs associated with central clearing, coupled with the need for bespoke transactions, with respect to the FX Swap and FX Forward markets may increase risk by discouraging appropriate hedging and may bring little to no benefit, since the existing regulatory regime and infrastructure provide for transparency and efficient risk mitigation.

Imposing a mandatory clearing and exchange trading requirement on the FX market would require dismantling or detracting from the existing infrastructure that has effectively addressed systemic risk in the globally interconnected payment and foreign exchange systems. The New York Federal Reserve Foreign Exchange Committee found in its Overview of the OTC Foreign Exchange Market in 2009 that “[absent . . . consideration of [the] key characteristics of the foreign exchange market, the potential for negative unintended consequences of any efforts to improve market resiliency is quite large.”<sup>12</sup> We share the concerns raised by the Global FX Division regarding the introduction of a mandatory clearing and exchange trading regime in the FX market. At a bare minimum, we believe that no efforts to impose such a regime should be considered without a clear understanding and evaluation of the impact of a central clearing platform model on the FX markets *and* evidence that such a regime can be implemented without causing more harm than good to sovereign currencies and existing settlement and risk mitigation processes.

## CONCLUSION

Today’s foreign exchange markets operate with high levels of transparency and executional efficiency; with greatly reduced counterparty and systemic risk; and have performed extremely well throughout the recent market crisis. Including foreign exchange swaps and forwards within the scope of the CEA would be highly disruptive to global financial markets and detrimental to corporate and investment management end users. We urge the Secretary to exempt FX Swaps and FX Forwards from the coverage of the CEA.

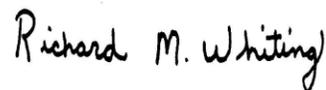
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<sup>12</sup>New York Federal Reserve Foreign Exchange Committee. Overview of the OTC Foreign Exchange Market: 2009. November 9, 2009. Page 7.