ISDA®

International Swaps and Derivatives Association, Inc.
360 Madison Avenue, 16th Floor
New York, NY 10017
United States of America
Telephone: 1 (212) 901-6000
Facsimile: 1 (212) 901-6001
email: isda@isda.org
website: www.isda.org

November 23, 2010

Office of Financial Institutions Policy
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Submitted via regulations.gov

Re: Notice and Request for Comments - Determinations of Foreign Exchange Swaps and Forwards (75 Fed. Reg. 66829)

Ladies and Gentlemen:

The International Swaps and Derivatives Association, Inc. ("ISDA")[1] is writing in response to the Department of the Treasury's Notice and Request for Comments - Determinations of Foreign Exchange Swaps and Forwards, specifically whether "foreign exchange swaps" and "foreign exchange forwards" should be exempted from the definition of "swap" under the Commodity Exchange Act ("CEA") as amended by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). For the reasons outlined in detail below, ISDA strongly believes that Treasury should exercise its authority to exempt foreign exchange swaps ("FX Swaps") and foreign exchange forwards ("FX Forwards") from the definition and related regulation of swaps.

Specifically, ISDA is concerned that clearing and execution requirements related to the failure to exempt such transactions would, among other things:

- significantly increase the cost and difficulty of hedging currency risk, leading to greater credit, settlement and market risk for companies and investors;

[1] ISDA was chartered in 1985 and has over 830 member institutions from 57 countries on six continents. Our members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the risks inherent in their core economic activities. Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business through documentation that is the recognized standard throughout the global market, legal opinions that facilitate enforceability of agreements, the development of sound risk management practices, and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives.

- increase systemic risk and threaten overall U.S. financial stability; and
- lower overall liquidity and market transparency.

We approach this topic by setting out some general remarks on the FX market and the requirements of Dodd-Frank with respect to the exemption, then describe the differences between FX Swaps and FX Forwards and other classes of swaps. Following these descriptions, we examine the risks that regulating these transactions as "swaps" would entail, which lead to the conclusion that an exemption is necessary. We then highlight some of the features of the current regulatory environment for the FX market, and conclude by explaining why we believe an exemption would not allow FX Swaps and FX Forwards to be used to evade otherwise applicable regulatory requirements under Dodd-Frank.

We commend to you the November 15th letter submitted by the Global FX Division of SIFMA, AFME, and ASIFMA on this issues. In addition, ISDA respectfully submits the following comments regarding the Notice and Request for Comments - Determinations of Foreign Exchange Swaps and Forwards.

Introduction

For hundreds of years, the foreign exchange market has operated as the largest and most liquid financial market in the world. For much of this period, foreign exchange trading has been an integral part of the business activities of regulated commercial banks. As economic activity has become increasingly global in nature, the importance of the deep and liquid over-the-counter FX market has continued to grow. Notably, the FX market has withstood many market disruptions throughout its long history, from the rise and fall of governments to the more contemporary currency crises in the 1990s and the financial crisis of the last several years.

Corporations participate in the FX market to:

- export goods abroad;
- repatriate earnings from foreign operations;
- effect payments to non-local suppliers and service providers;
- invest in plant, equipment and businesses abroad; and
- hedge investment exposure and income.

Investors participate in the FX market to:

- repatriate earnings;
- ensure adequate liquidity to meet obligations to pension owners, 401k owners and other investors;
- settle the purchase of foreign assets, which allows foreign investors to readily purchase U.S. assets;
- hedge the currency risk in foreign assets;
- offset sovereign risk; and
- take currency views to manage portfolio risk and return.

The FX market has historically been an over-the-counter market in which dealers have designed and offered a wide range of products to meet the currency and risk management needs of the market's participants. The global nature of the FX market and the many varied reasons for FX trades has created the need for customized products to manage risks effectively. As a result, the ability of FX dealers to tailor products to meet the specific needs of individual participants has become essential for these corporations and investors to manage their risks most effectively and conduct their ongoing commercial business most efficiently.

The FX market is inherently global. However, the United States is particularly impacted by this market, as approximately 85% of all FX trades are estimated to involve the U.S. Dollar. Accordingly, it is critical that any regulation of the foreign exchange market be carefully considered as the liquidity and efficiency of the market for the U.S. Dollar significantly affects the global FX market.

Requirements of the Legislation

Dodd-Frank creates a new regulatory regime for swaps. FX Swaps and FX Forwards are a carefully-defined special class of transactions that are included within the definition of "swap" under Dodd-Frank, unless the Secretary of the Treasury (the "Secretary") makes a written determination that FX Swaps and/or FX Forwards should not be regulated as swaps and are not structured to evade Dodd-Frank.

Among other things, classification of FX Swaps and FX Forwards as swaps would subject many FX transactions to clearing and execution requirements under the CEA, which, as outlined in more detail below, would have significant adverse effects on the market for these transactions.

Qualitative Differences Between FX Swaps and FX Forwards and Other Classes of Swaps

There are a number of qualitative differences between FX Swaps and FX Forwards and other classes of swaps under the CEA that have important implications in considering whether the clearing and trading requirements under Dodd-Frank should apply. We set out below some of the key qualitative differences.

Special considerations for the FX market generally

The FX market provides the medium for exchange of currencies used by payment systems globally, and is therefore a critical source of liquidity and funding for market participants and the wider global financial system. FX Swaps and FX Forwards make up a large proportion of this critical market, having been estimated to constitute more than 50% of FX market transactions by volume.

In addition, the FX market is an important channel through which U.S. monetary policy affects the U.S. economy. Changes in U.S. dollar interest rates directly influence exchange rates, which impact supply demand for U.S. exports. In the U.S., foreign exchange plays a particularly important role in monetary policy due to the U.S. dollar's status as the world's principal reserve currency and the highly international investor base for U.S. Treasury bonds. International contracts are commonly denominated in U.S. dollars and approximately 85% of FX transactions involve the U.S. dollar. The resulting demand for U.S. dollars reduces borrowing costs for U.S. corporations, individuals and the U.S. Treasury, and reduces FX risk for U.S. corporations, as it increases liquidity in the market for U.S. dollars.

The FX market is transparent and efficient, benefitting from a large number of different participants and trading facilities, including electronic platforms, which have resulted in a high degree of price transparency. End-users have access to real time prices quickly through up to date prices on electronic platforms posted by multiple participants. The FX market has led other markets over the past decade in converting to electronic trading platforms where feasible.

Risks in the FX market

The primary risk in the FX market generally, including FX Swaps and FX Forwards, is settlement risk, which is the risk that one party to an FX transaction delivers the currency it sold but does not receive the currency it bought. While counterparty credit risk, market risk and operational risk are present and should be managed appropriately, they are a much smaller concern than settlement risk. FX Swaps and FX Forwards are on the whole shorter dated transactions compared to other classes of swaps, leading to relatively stable prices during the life of these transactions, and the underlying FX market is highly liquid. As a result, counterparty credit risk and market risk are both relatively lower for FX Swaps and FX Forwards. This is a significant difference between FX Forwards and FX Swaps and other classes of swaps under the CEA.

The industry, in conjunction with regulators, has taken several steps to manage the risks that exist for FX transactions. Settlement risk has been addressed through the creation of CLS Bank, whose continuous linked settlement service eliminates settlement risk for parties settling through CLS Bank. CLS Bank now settles a large portion of FX transactions, including more than 85% of inter-bank FX transactions. What counterparty credit risk does exist is largely mitigated through the use of collateral arrangements, which are particularly effective for FX transactions due to the highly-liquid nature of the FX market. Operational risk has been reduced through the promulgation by industry groups (under the auspices of banking regulators) of best practices and promotion of the use of standardized documentation, as well as the use of electronic booking and confirmation systems.

Structure of FX Swaps and FX Forwards

Unlike most other products within the definition of “swap” under Dodd-Frank, FX Swaps and FX Forwards are typically physically settled by delivery of the underlying currency, including a two-way exchange of principal agreed at the time of execution, i.e. the amount of currency being bought is delivered in exchange for the amount of currency being sold. 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 other classes of swaps.

Notwithstanding these differences between the structure of FX Swaps and FX Forwards and other classes of swaps, the contractual documentation for FX Swaps and FX Forwards may be based on the ISDA Master Agreement, in which case it will be related to other classes of swaps. However this should not be taken to indicate that FX Swaps and FX Forwards are similar to other transactions documented under the ISDA Master Agreement. One of the key benefits of using an ISDA Master Agreement is the robust close-out netting mechanism the document contains. By bringing FX Swaps and FX Forwards within the scope of the close-out netting provided by the

ISDA Master Agreement, the parties further reduce any remaining credit risk. It is the practical desire to reduce credit risk to the minimum possible (with consequent regulatory capital benefits for regulated entities) that has guided documentation in this area, rather than any considerations of whether FX Swaps and FX Forwards are similar to other classes of swaps.

Risks of Regulating FX Swaps and FX Forwards as "Swaps"

When compared to other classes of "swap" under the CEA, the unique considerations applicable to the FX market generally, and to FX Swaps and FX Forwards in particular, mean that there are serious risks of regulating FX Swaps and FX Forwards as swaps, in particular subjecting them to the clearing and execution requirements.

In the FX market, a requirement for parties to clear through a CCP would introduce significant new risks. Because of the importance of a stable and liquid FX market to the global economy, a CCP for FX transactions would pose unique and significant systemic risk, as its failure would deprive market participants of the ability to obtain currency necessary to make payments. The global nature of the FX market would make it particularly challenging to operate a CCP, due to the need to access currencies from different jurisdictions in different time zones and the practical necessity of cooperating with central banks around the globe. The CCP would also need to address settlement risk (the key risk for FX transactions), which would likely require use of the existing CLS Bank mechanisms.

Central clearing would also impose significant additional costs on market participants as a result of clearing fees. When faced with these increased costs and hedging difficulties many companies and investors may not hedge their FX risk, leaving them exposed to the significant financial risk of adverse movements in FX rates. The ultimate result of the inclusion of FX as swaps may be to increase, rather than decrease, risk in the global FX market.

ISDA recognizes that central clearing of transactions is intended to reduce credit risk, and there is cost associated with this. However, due to the relatively lesser importance of counterparty credit risk for FX Swaps and FX Forwards, the benefits of using a CCP for these transactions compared to other classes of swap are significantly reduced, particularly when the current use of effective bilateral collateral arrangements is taken into account.

Requiring parties to execute FX Swaps and FX Forwards on an exchange or swap execution facility ("<u>SEF</u>") would negatively impact market participants' ability to use the FX markets to access the funding needed to facilitate international trade and investment. For contracts to be tradeable on an exchange or SEF, standardization will be required, implying a reduction in market participants' ability to customize FX Swaps and FX Forwards to meet their foreign currency needs. This will increase those participants' exposure to foreign currency risks, with a concomitant increase in default risk by those participants in meeting their domestic or foreign currency obligations. Because the FX markets are already liquid and transparent, there are no benefits to be obtained to offset this increase in risk.

In summary, the increase in risk that would result from imposition of a CCP for FX transactions, as well as the incremental risk that would result from a decrease in currency risk-hedging activity due to increased costs of central clearing or reduced flexibility of exchange trading, would increase systemic risk and threaten overall U.S. financial stability, without offering any benefit to the market or the broader economy. The decrease in volume of FX activity will also reduce liquidity and ultimately the pricing transparency that a liquid market provides.

Current Supervision and Regulation of the FX Market

The majority of FX trading is conducted through banks that are subject to consolidated supervision by the relevant banking regulator and, thus, are generally subject to capital and other prudential requirements that apply to all activities, including FX transactions. We believe that these requirements are materially comparable to the capital and prudential requirements that will apply under Dodd-Frank and the CEA to parties to other classes of swaps under the CEA and provide adequate supervision for the FX market.

In addition, CLS Bank, the principal settlement vehicle for foreign exchange, is subject to regulation by the Federal Reserve Board, which cooperates oversight of CLS with the other global central banks whose currencies are settled in CLS and provides regular reports to central banks and regulators on transactions in the FX market. CLS currently settles 17 major currencies, with the addition of further currencies anticipated, and settles payments arising from a broad range of FX products, including spot, deliverable and non-deliverable forwards, swaps, and the exercise of options. Major dealers in the FX and currency derivatives markets have made commitments to a group of regulators, including the Federal Reserve Bank of New York and the United Kingdom's Financial Services Authority ("FSA"), to increase the use of CLS. Importantly, CLS continued to function without interruption throughout the financial crisis of the past several years; notably during the week of the Lehman Brothers bankruptcy, CLS settled a record $25.5 trillion, and all settlement and pay-out processing occurred without incident.

Separately, the industry has worked diligently with the banking regulators to develop best practices and to promote the use of standardized documents, including increasing the use of collateral documentation to further minimize counterparty credit risk.[2] ISDA's own efforts in producing standard documentation are coordinated with the Foreign Exchange Committee and EMTA (formerly known as the Emerging Markets Traders Association).

Very Limited Scope for Potential Abuses of the Exemption

The statutory requirement that the Secretary consider the use of a potential exemption of FX Swaps and FX Forwards from the definition of "swap" to evade otherwise applicable regulatory requirements should be considered in the wider context of Dodd-Frank, which provides the Commodity Futures Trading Commission the authority to define "swap" to include transactions structured to evade the requirements of Title VII of Dodd-Frank and also requires FX Swaps and FX Forwards to be reported to a swap data repository or the CFTC. Dodd-Frank therefore provides the CFTC with the means to identify transactions that might be structured using FX Swaps or FX Forwards to evade the requirements of Title VII and the power to regulate such transactions as swaps. As a result, an exemption of FX Swaps and FX Forwards from the definition of "swap"

[2] See the Foreign Exchange Committee, which is sponsored by the Federal Reserve Bank of New York and which includes representatives of major financial institutions engaged in foreign currency trading in the United States. Aware of the strong integration of the global foreign exchange market, the Foreign Exchange Committee is also an active partner to other foreign exchange committees and industry associations worldwide.

would not allow those transactions to be used to evade otherwise applicable regulatory requirements under Dodd-Frank.

In addition, the definitions of FX Swap and FX Forward in Dodd-Frank were carefully drafted to include only transactions that "solely" involve exchanges of currency. This precludes the possibility of decomposing or restructuring more complicated transactions that would otherwise be "swaps" under Dodd-Frank into FX Swaps or FX Forwards. We therefore believe there is little potential for using these transactions to avoid regulatory requirements.

* * *

ISDA appreciates the ability to provide its comments on the notice and request for comments and looks forward to working with Treasury as you continue the rulemaking process. Please feel free to contact me or ISDA's staff at your convenience.

Sincerely,

Robert G. Pickel

Robert Pickel
Executive Vice Chairman