



November 15, 2010

United States Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Re: Exemption of Foreign Exchange Swaps and Forwards

Ladies and Gentlemen:

The Global FX Division (“**Global FX Division**”)* of SIFMA, AFME and ASIFMA appreciates the opportunity to share our views on the appropriateness of an exemption for foreign exchange (“**foreign exchange**” or “**FX**”) swaps and foreign exchange forwards from the definition of a “swap” under the Commodity Exchange Act (the “**CEA**”) pursuant to the authority granted to the Secretary of the Treasury (the “**Secretary**”) under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “**Dodd-Frank Act**”).¹ ** For the reasons discussed in this letter, we strongly believe that an exemption is warranted.

INTRODUCTION

The Global FX Division agrees with the Secretary’s statement made before the Senate Committee on Agriculture, Nutrition and Forestry in December of 2009:

“The FX markets are different. They are not really derivative in a sense and they don’t present the same sort of risk and there is an elaborate framework in place already to limit settlement risk. These markets actually work quite well. We have a basic obligation to do no harm, to make sure that as we reform we don’t make things worse and our judgment is because of the protection that already exists in these foreign exchange markets and because they are different from derivatives, have different risks and require different solutions, they require a different approach.”²

The Global FX Division’s position is entirely consistent with Secretary Geithner’s statement. This letter sets forth in detail the basis for our concurrence.

The Department of the Treasury has invited comment on whether an exemption is warranted, on the application of factors he is required to consider in determining whether to grant an exemption, and on ten supplemental questions in a notice and

* The Global Foreign Exchange (FX) Division was formed in cooperation with the Association for Financial Markets in Europe (AFME), the Securities Industry and Financial Markets Association (SIFMA) and the Asia Securities Industry and Financial Markets Association (ASIFMA). Its members comprise 20 global FX market participants, collectively representing more than 85% of the FX market.

** Numbered references appear as endnotes to this letter.

request for comments dated October 19, 2010. We have structured our response to Treasury's notice and request for comments into six sections. The Executive Summary sets forth the key points supporting our view that FX swaps and FX forwards should not be regulated as "swaps" under the CEA.

EXECUTIVE SUMMARY

1. The Foreign Exchange Market, Including FX Forwards and FX Swaps, Is Qualitatively Different From Derivatives Markets and Should Be Overseen by Central Banks, Including the Federal Reserve as the U.S. Central Bank.

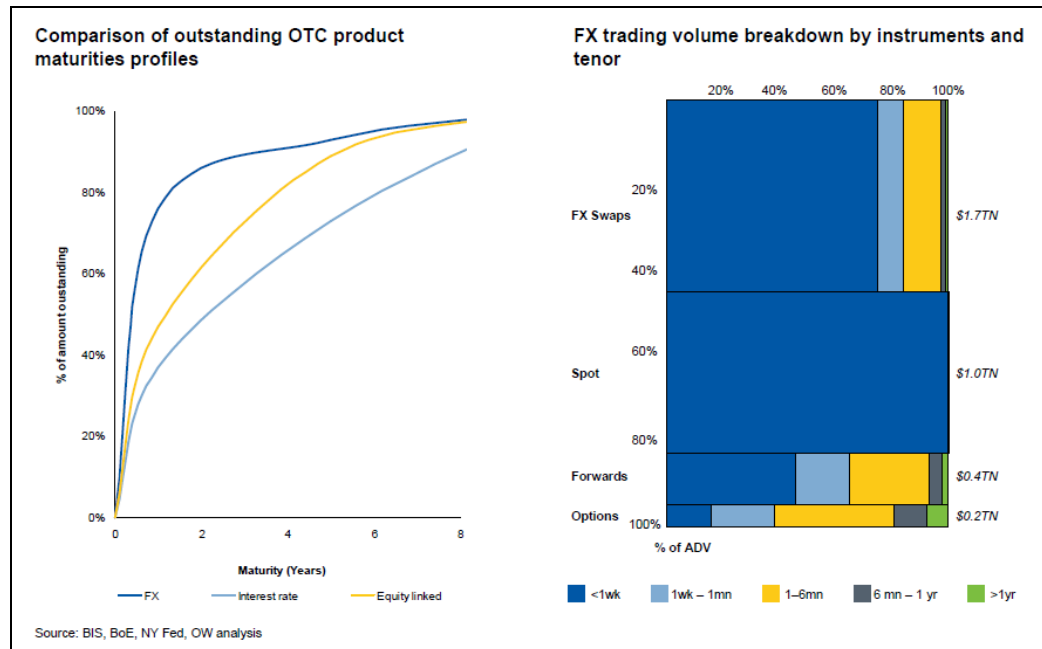
The FX market, which is the world's largest financial market, is a central component of the global payment system and should be subject to central bank supervision. FX swaps and FX forwards are not "swaps" in the traditional sense. Unlike the derivatives that will be regulated as "swaps" under the CEA, FX swaps and FX forwards are typically physically settled by delivery of the underlying currency. Like physically-settled forward contracts, they are often used to meet commercial obligations and should be excluded from the definition of "swap" under the CEA.

FX swaps and FX forwards are also too economically related to be distinguished from one another for purposes of the Secretary's determination. The term "FX swap" is a convenient naming convention for a transaction that is in fact not a swap but rather either a spot transaction plus a forward contract or two forward contracts carried out simultaneously. There is also no difference between long-dated and short-dated FX instruments that would justify oversight under two distinct regulatory regimes. The regulatory regime for foreign exchange should not be bifurcated based merely on the relative duration of an instrument.

Commodity Futures Trading Commission ("CFTC") regulation of the foreign exchange market is inadvisable. Because it is critical to a central bank's ability to carry out monetary policy, this market has long been under the purview of the Board of Governors of the Federal Reserve System (the "**Federal Reserve**") and other central banks. There are compelling macroeconomic reasons for the Federal Reserve to remain the primary supervisor of this activity in the U.S. Foreign exchange is even more important to monetary policy in the U.S. than elsewhere because of the role of the U.S. dollar as the world's principal reserve currency. Recent economic conditions in the U.S. have highlighted the need for the Federal Reserve to have maximum flexibility in effecting monetary policy. The FX market's strong operational infrastructure, developed under the supervision of the Federal Reserve in cooperation with other central banks, along with its liquid and transparent nature and the simplicity of FX products, have allowed the FX market to successfully withstand numerous market disruptions, including the financial crisis of 2008.

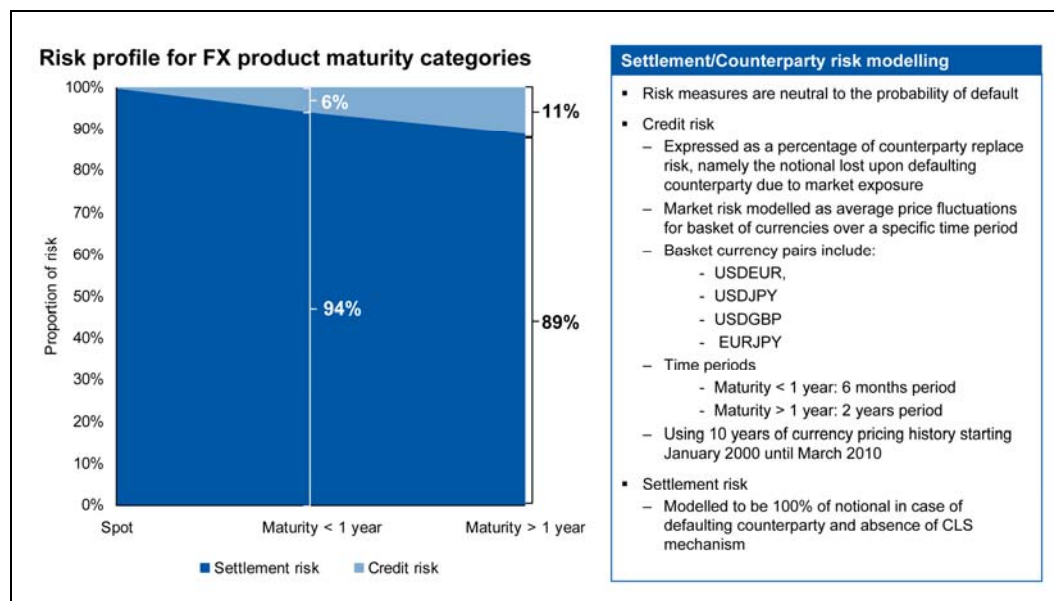
Unlike over-the-counter ("**OTC**") derivatives that will be regulated as swaps, FX swaps and FX forwards are overwhelmingly short-term instruments. The chart that follows on the left contrasts the short maturity profile of outstanding FX instruments with those of interest rate and equity derivatives. The 16% of outstanding FX contracts with maturities longer than 2 years contrasts with more than 55% of interest rate derivatives

and 40% of equity derivatives with maturities longer than two years. Of daily traded volume in 2007, more than 98% of FX forwards and 99% of FX swaps were of maturities of less than a year, as illustrated in the chart that follows on the right.³



2. The FX Market Is a Global Payment System with a Well-Developed Settlement System That Has Effectively Mitigated Systemic Risk.

Settlement risk dwarfs all other risks in the FX market. The graph below, based on Oliver Wyman analysis, illustrates that settlement risk comprises 94% of the estimated maximum loss exposure in a transaction involving foreign exchange instruments with a maturity of 6 months and 89% for instruments with a maturity of 2 years.



Following extensive study of systemic risk, central banks and FX dealers went to considerable lengths to address this risk, ultimately leading to the creation of CLS Bank as a global settlement bank. CLS Bank's settlement system today eliminates virtually *all* settlement risk to CLS Bank participants. CLS Bank settles almost 90% of all inter-dealer FX trades. Efforts to extend the reach of CLS Bank are under way, with broad support from FX dealers and central banks around the globe. Efforts to introduce a central counterparty ("**CCP**") model could distract from current industry plans to increase usage of CLS Bank, or worse, cause participants to cease using CLS Bank for cost or operational reasons, thereby increasing settlement risk.

To address the remaining mark-to-market credit risk, credit support annexes ("**CSAs**") are heavily used and relied on in the FX market and are a particularly effective risk mitigation tool. Initial analysis by the Global FX Division estimates that 85% of the mark-to-market credit risk for FX swaps and FX forwards is effectively covered by CSAs. Even for 2-year instruments, only 1.65% of the credit risk of loss in FX instruments is not covered by CSAs (with 0.9% not covered by CSAs for instruments with maturities of 6 months). Mandatory clearing for FX swaps and FX forwards would therefore deliver almost no incremental credit risk mitigation. We believe that the significant operational risk and costs to the global payment system of implementing mandatory clearing far exceed the benefits of mitigation for the small residual unsecured credit risk of FX swaps and FX forwards.

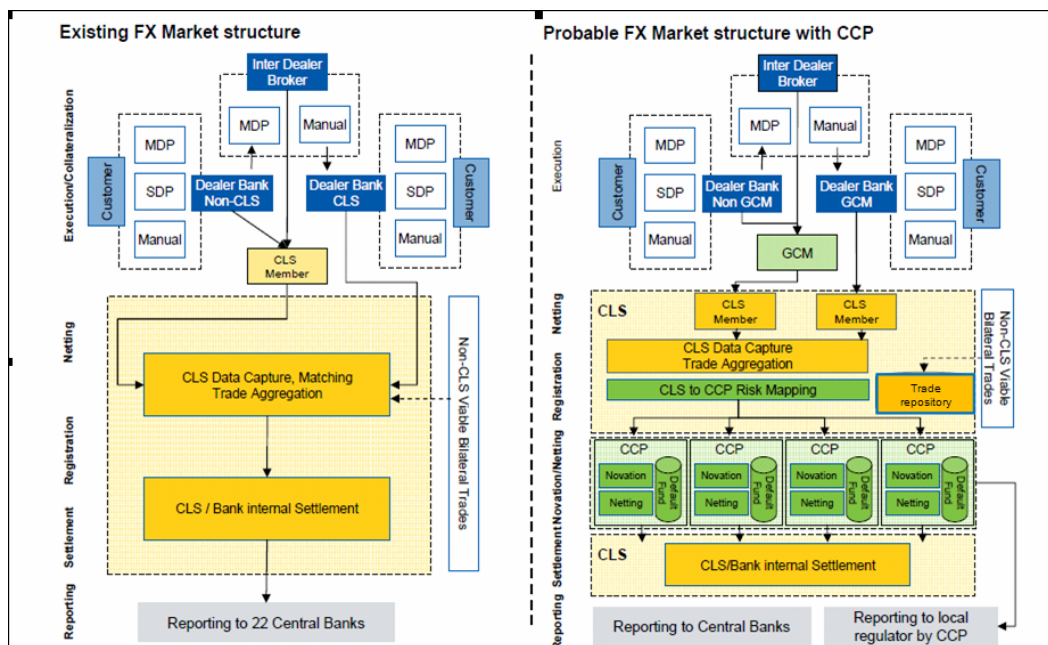
3. Imposing Mandatory Trading and Clearing on the FX Market Would Increase Systemic Risk and Threaten Financial Stability.

Including FX swaps and FX forwards as "swaps" under the CEA would impose a mandatory central clearing and exchange or swap execution facility ("**SEF**") trading regime for FX, regulated by the CFTC. These requirements could introduce significant new risks into the FX market. Because the FX market is an integral part of the global payment system, the failure of an FX CCP could be catastrophic, with destabilizing effects on foreign exchange and the global economy as a whole. Mandatory exchange trading is also inappropriate for a market that functions as an integral component of the global payment system, in which financial instruments are specifically designed (particularly as to tenors) to match the commercial needs of market participants.

85% of FX transactions involve the U.S. dollar, yet only 18% of FX transactions occur within U.S. borders. U.S.-mandated clearing and trading requirements would likely drive the U.S.'s 18% of FX market share further offshore, reducing the Federal Reserve's ability to exercise effective oversight of the FX market. Given the importance of the FX market to the U.S. economy, this would be an undesirable result.

Mandatory clearing would present unique difficulties and complexities. It would introduce the danger of concentration risk, creating a potential single point of failure where none exists today, simply to address limited residual credit risk exposure. Such a change could not be implemented successfully without significant cooperation and consensus among the central banks responsible for all the world's major currencies. Before embracing mandatory clearing and trading requirements for the FX market, central banks are likely to require significant evidence that it can be implemented without imposing greater risk upon the financial system and would want to understand how a CCP model would interact with CLS Bank.

Probable CCP structures like that illustrated below would add additional layers of complexity, cost and concentration risk.



4. Central Banks Actively Oversee and Are the Appropriate Primary Regulators of the FX Market.

Due to the central role of FX in monetary policy and macro-economic stability, oversight of the FX markets has fallen squarely within the mandate of central banks. Central banks, particularly the Federal Reserve, actively oversee the FX market, supervising compliance of industry “best practices” through safety and soundness reviews and regulation of banks, including CLS Bank. CLS Bank is an Edge corporation, established under a special charter and regulated by the Federal Reserve under a program of ongoing supervision. CLS Bank’s activities are also subject to a cooperative oversight arrangement of a consortium of 22 central banks whose currencies are settled in CLS Bank. This oversight arrangement is administered by the Federal Reserve. Banking regulations provide capital-based incentives for banks to cause their counterparties to become CLS Bank participants. Subjecting this market to regulation by the CFTC, an agency that has no mandate to regulate banks, would be inconsistent with this universal approach of central bank regulation of the FX market.

5. The Federal Reserve Has Authority to Regulate “Systemically Important” Payment Activities and Designated Activities by Financial Institutions Under Title VIII of the Dodd-Frank Act.

Title VIII of the Dodd-Frank Act provides the Federal Reserve with the authority to craft appropriate regulations for financial market utilities such as systemically important payment, clearing and settlement systems. This authority could be used by the Federal Reserve to increase its regulation or oversight of CLS Bank. Title VIII also permits the Federal Reserve to prescribe risk management standards governing the conduct of designated activities by financial institutions. This authority permits the Federal Reserve and other prudential regulators to impose appropriate standards on financial institutions

to address risks in the foreign exchange markets. The Title VIII authority permits regulators to tailor regulations to address any specific concerns in the FX market, rather than imposing all of the Title VII requirements on a market that is distinctly different from the derivatives markets.

6. Regulators Have Ample Tools to Address Any Potential Abuses of the Exemption to Evade Otherwise Applicable Regulatory Requirements.

The CFTC has authority under Section 721 of the Dodd-Frank Act to modify the definition of “swap” to include transactions that are structured to evade Title VII, which is a sufficient tool to ensure that an exemption of FX forwards and FX swaps will not serve as a vehicle for non-compliance with Title VII.

It is difficult to foresee, even in the absence of a rule-making by the CFTC, how other swaps could be financially reengineered to become FX forwards and FX swaps. FX swaps and FX forwards are straightforward instruments that do not reference any asset class other than FX and do not include any variable or periodic payments. They are typically physically settled. All of their cash flows are determined at the inception of the trade and thus there are no contingent outcomes.

Finally, it is important to note that an exemption of FX swaps and FX forwards from the definition of “swap” in Title VII of the Dodd-Frank Act will not exempt those products from other requirements of Title VII, including the requirement to report transactions to a swap data repository or the CFTC and certain business conduct standards and anti-manipulation provisions. An exemption also will have no impact on the provisions of the Dodd-Frank Act or the Food, Conservation and Energy Act of 2008 that expanded the CFTC’s authority with respect to retail FX transactions.

DISCUSSION

1. The Foreign Exchange Market, Including FX Forwards and FX Swaps, Is Qualitatively Different From Derivatives Markets and Should Be Overseen by Central Banks, Including the Federal Reserve as the U.S. Central Bank.

1.1 The FX market is a critical source of liquidity and funding for market participants and is a significant part of the global payment system.

FX products are the critical medium of exchange used by all cross-border payment systems globally. FX swaps and FX forwards are not “swaps” in the traditional sense and are distinctly different from the derivatives that will be regulated by the CFTC as “swaps”. Treating FX swaps and FX forwards as “swaps” under the CEA is inadvisable.

In addition to being the world’s largest financial market, the foreign exchange market underpins other financial markets and the global economy generally. Institutions rely heavily on foreign exchange settlements to fund their commercial and other payment obligations. The Committee on Payment and Settlement Systems (“**CPSS**”) of the Bank for International Settlements (“**BIS**”) estimates that foreign exchange settlements account for between 50% and 90% of the daily turnover value in key domestic payment systems.⁴

FX swaps have for many years been the most efficient short-term funding vehicle worldwide, and FX forwards provide an efficient payment mechanism. Unlike other “swaps” that are subject to Title VII of the Dodd-Frank Act, FX forwards and FX swaps are typically physically settled by delivery of the underlying currency. FX forwards and FX swaps are more similar to physically-settled commodity forwards than to “swaps” that are required to be cleared under Title VII. Physically settled commodity forwards are often used to meet commercial obligations and are excluded from the definition of “swap” under Section 1a(47)(B)(ii) of the CEA.

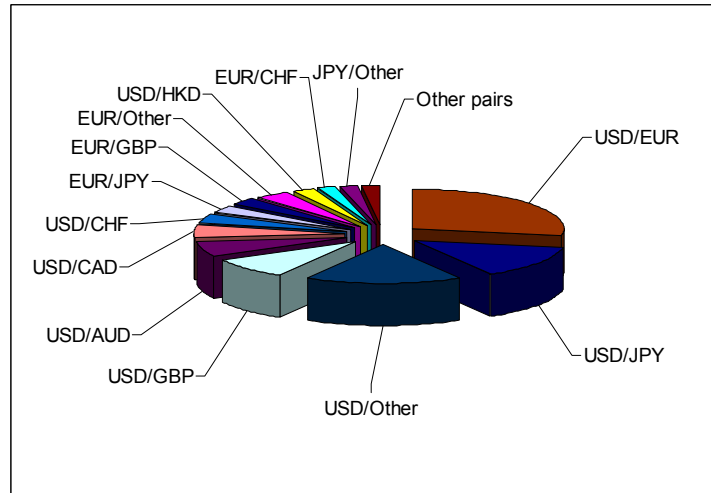
1.2 FX is a critical tool in effecting monetary policy.

The foreign exchange market is critical to a central bank’s ability to carry out monetary policy. Dollar exchange rates are one channel through which U.S. monetary policy affects the U.S. economy. Interest rate movements directly influence exchange rates. Changes in exchange rates, in turn, impact demand for exports, which affects output in the U.S., international competitiveness and the composition of the U.S. gross domestic product. Similarly, exchange rates affect the dollar-price of imports, which in turn affect inflation. Maintaining maximum sustainable growth and price stability are the Federal Reserve’s monetary policy objectives. Recent economic conditions in the U.S. have highlighted the need for the Federal Reserve to have maximum flexibility in effecting monetary policy.

In the United States, foreign exchange is even more central to monetary policy than in many countries due to the highly international investor base for U.S. Treasury bonds and the role of the U.S. dollar as the world’s principal reserve currency. Approximately 85% of foreign exchange trades involve the U.S. dollar,⁵ and more than 60% of foreign exchange reserves are held in U.S. dollars or U.S. dollar-denominated assets.⁶ More international contracts are denominated in U.S. dollars than in any other currency,⁷ and during economic turmoil investors tend to buy U.S. Treasury bonds. The resulting demand for U.S. dollars reduces borrowing costs for U.S. corporations, individuals and the U.S. Treasury, and reduces foreign exchange risk for U.S. corporations, as it increases liquidity in the market for U.S. dollars.

The following chart illustrates as of April 2010 the overwhelming extent to which FX transactions involve the US dollar.⁸

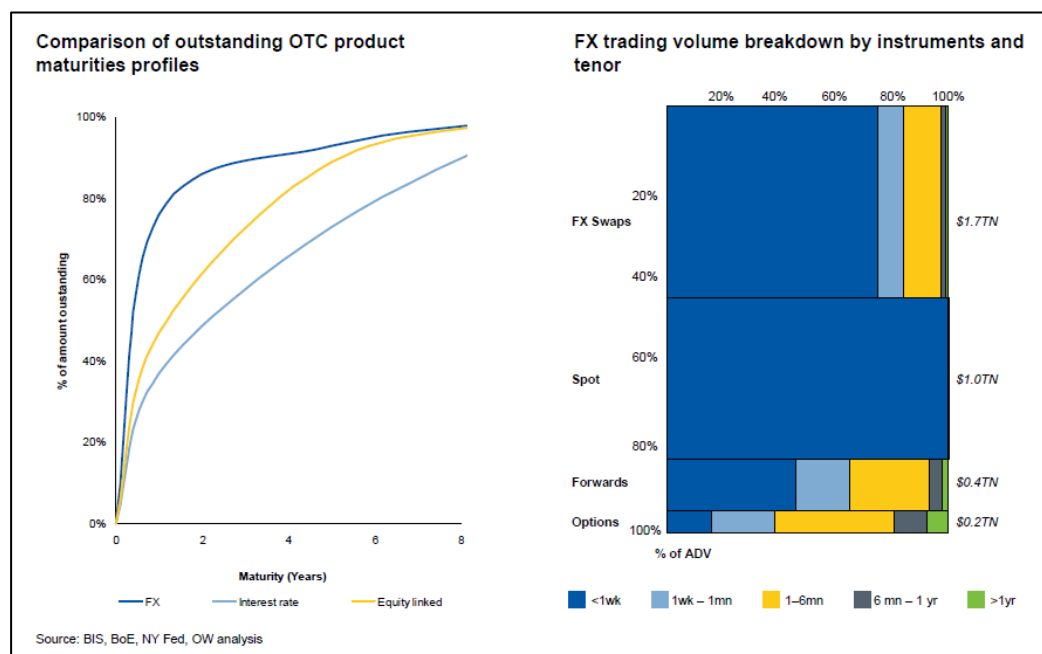
Value of FX Transactions by Currency Pair



1.3 The FX market is short-dated, collateralized, liquid and transparent.

1.3.1 FX transactions are overwhelmingly short-dated.

Unlike OTC derivatives that will be regulated as swaps, FX swaps and FX forwards are overwhelmingly short-term instruments. The chart below on the left contrasts the short maturity profile of outstanding FX instruments with those of interest rate and equity derivatives. The 16% of outstanding FX contracts with maturities longer than 2 years contrasts with more than 55% of interest rate derivatives and 40% of equity derivatives with maturities longer than two years. Of daily traded volume, more than 98% of FX forwards and 99% of FX swaps in 2007 were of maturities of less than a year, as illustrated in the chart below on the right.⁹



The foreign exchange market is very liquid. Since most foreign exchange contracts have short maturities, the foreign exchange rate is unlikely to change significantly between the inception and maturity of most foreign exchange contracts. As a result, the in-the-money portion of the trade tends to be small relative to the principal value, which means the maximum possible loss for foreign exchange transactions consists overwhelmingly of settlement risk, which is largely eliminated through the settlement mechanics employed by CLS Bank.

For FX forwards and FX swaps with a maturity of less than one year, only 6% of the maximum risk of loss is mark-to-market credit risk.¹⁰ Because of their short duration and physical settlement, FX forwards and FX swaps stand in sharp contrast to most other swaps, for which counterparty risk is comprised almost exclusively of credit risk on the mark-to-market value of the swap. Credit risk is the risk that CCPs are primarily designed to address.

1.3.2 The vast majority of mark-to-market exposure is related to counterparties that are covered by CSAs.

Standard International Swaps and Derivatives Association (“ISDA”) documentation, including CSAs, is widely used in the foreign exchange market to mitigate credit risk. The deep liquidity and excellent price transparency of the FX market allows for a high level of confidence that initial margin levels will cover losses on FX swaps and FX forwards. Market participants can also reliably determine the net amount of their exposure and the appropriate amount of mark-to-market collateral because the FX market is a highly liquid market in which prices are widely available 24 hours a day. Upon a default, the deep liquidity in the FX market means that the non-defaulting party can generally replace the transaction quickly and easily. Due to these characteristics of the FX market, existing bilateral agreements have been successful in mitigating counterparty credit risk exposures following the default of large FX counterparties, such as Lehman Brothers in 2008.¹¹

The only portion of the foreign exchange market where trades generally are unsecured is where transactions are effected with corporates. Corporates use FX transactions to hedge business risks and do not generally have excess capital to use for CCP margining purposes. Regardless of whether the Secretary determines to exempt FX swaps and FX forwards from the definition of “swap”, many of those contracts would likely come within the commercial end-user exemption to mandatory clearing under Section 2(h)(7) of the CEA. Regulating FX forwards and swaps under Title VII would therefore not result in mandatory clearing for the portion of the market that is most often unsecured.

A CCP for FX forwards and FX swaps would deliver almost no incremental credit risk mitigation because most of that risk has been covered by CSAs. The Global FX Division has undertaken indicative analysis of dealers accounting for approximately 66% of the market (by reference to Euromoney league tables). This analysis indicates that approximately 85% or more of mark-to-market exposure in 2010 relates to counterparties (excluding corporates) for which CSAs have been put in place.¹²

To put this CSA coverage in context, as illustrated in the table below, using the 6-month instruments’ potential mark-to-market risk of 6%, we estimate the total remaining uncovered risk for less-than-one-year instruments to be only 0.9%. Similarly, assuming the 2-year potential mark-to-market risk of 11% for FX forwards and FX swaps with maturities greater than a year, we estimate the total remaining uncovered risk for greater-than-one-year instruments to be 1.65%.¹³

FX Market Volume Profile and Uncovered Credit Exposure

	< 1yr Tenor	> 1 yr Tenor
Risk Profile:		
Credit / Counterparty Risk	6.00%	11.00%
Settlement Exposure %	94.00%	89.00%
CSA Usage @ 85%	5.10%	9.35%
Uncovered Credit Exposure	0.90%	1.65%

An FX CCP could undermine the significant gains that have been made in addressing the overwhelming percentage of risk that constitutes settlement risk. An FX CCP would only address default risk in the range of between 0.9% and 1.65% that currently constitutes mark-to-market credit risk for counterparties not using CSAs.

1.3.3 The FX market is transparent and efficient.

The proliferation of multi-dealer and single-dealer electronic communications networks in the foreign exchange market leads to a high degree of systemic redundancy and resiliency. In the event that one trading system fails, market participants can easily route their trades to another electronic communication network (“ECN”).

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. Prices are widely available in the FX market, contributing to its narrow spreads and deep liquidity. Currently 89% of foreign exchange spot transactions, 72% of foreign exchange forwards and 41% of foreign exchange swaps use automated transaction processing.¹⁴ In addition, more than 95% of the foreign exchange transactions between dealers are processed via straight-through processing, meaning they are processed electronically without any human input, and trades are normally confirmed within 15 minutes.¹⁵ These robust infrastructure advancements have significantly strengthened the integrity of the marketplace from a systemic risk standpoint.

1.4 There is no valid reason to distinguish FX swaps from FX forwards, nor is there any compelling reason to distinguish long-dated from short-dated instruments.

The Global FX Division sees no valid reason to distinguish the two types of instruments when making the determination to exempt FX swaps and FX forwards from the definition of “swap” under the CEA. As an economic matter, FX swaps and FX forwards are too economically related to be distinguishable. The use of the term “FX swap” is a convenient naming convention for a transaction that is in fact not a swap but rather either a spot transaction plus a forward contract or two forward contracts carried out simultaneously. As a practical matter, the fact that FX swaps are funding vehicles and FX forwards are payment vehicles is also a distinction without a difference. Likewise, there is no difference between long-dated and short-dated FX swaps and FX forwards that would justify oversight under two distinct regulatory regimes. The regulatory regime for foreign exchange should not be bifurcated based merely on the relative duration of an instrument.

If two different regulatory regimes were to apply, the cost of using different tenors of FX swaps or FX forwards might well differ. For example, longer-dated instruments might be subject to clearing costs and others not. Spreads are so tight in the FX market that small differences in cost can be expected to affect market behavior. Transactions would be expected to migrate either to the less costly form of the transaction, and where that cannot be accomplished domestically, transactions will likely migrate overseas.

1.5 The FX market has a proven track record of withstanding widespread market disruptions.

The liquid, transparent nature of the foreign exchange market, its strong operational infrastructure and the simplicity of foreign exchange products have allowed the foreign exchange market to withstand numerous disruptions, including the currency

crises of the 1990s, the bursting of the tech-stock bubble in 2000-2001 and various large bankruptcies. Most recently, the financial crisis in 2008 provided a significant test of the foreign exchange market's ability to withstand major disruptions and continue operating in a safe and sound manner. The Foreign Exchange Committee ("**Foreign Exchange Committee**") of the Federal Reserve Bank of New York ("**FRBNY**") found in November 2009 that:

The market functioned well [during the financial crisis], despite strains seen in international funding and credit markets, and enabled participants to measure and mitigate risk dynamically in a global marketplace. During this time, transaction costs were elevated, owing to the volatility and spillover from U.S. dollar funding challenges. However, systemic risk mitigants built into the OTC FX market structure over the years proved successful in providing a liquid and continuous market despite the volatility, defaults, and disruptions of [2008 and 2009].¹⁶

Similarly, The Bank of England Foreign Exchange Joint Standing Committee ("**FXJSC**") found that the foreign exchange market's sophisticated settlement system, together with its well-established code of best practices and high degree of transparency and liquidity, allowed the foreign exchange market 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.¹⁷ The FXJSC also found that during the financial crisis of 2008, close-out netting was particularly effective in the foreign exchange market because the simple structure of foreign exchange transactions and the deep liquidity of the spot market made FX instruments easy to value and thus to net against one another.¹⁸

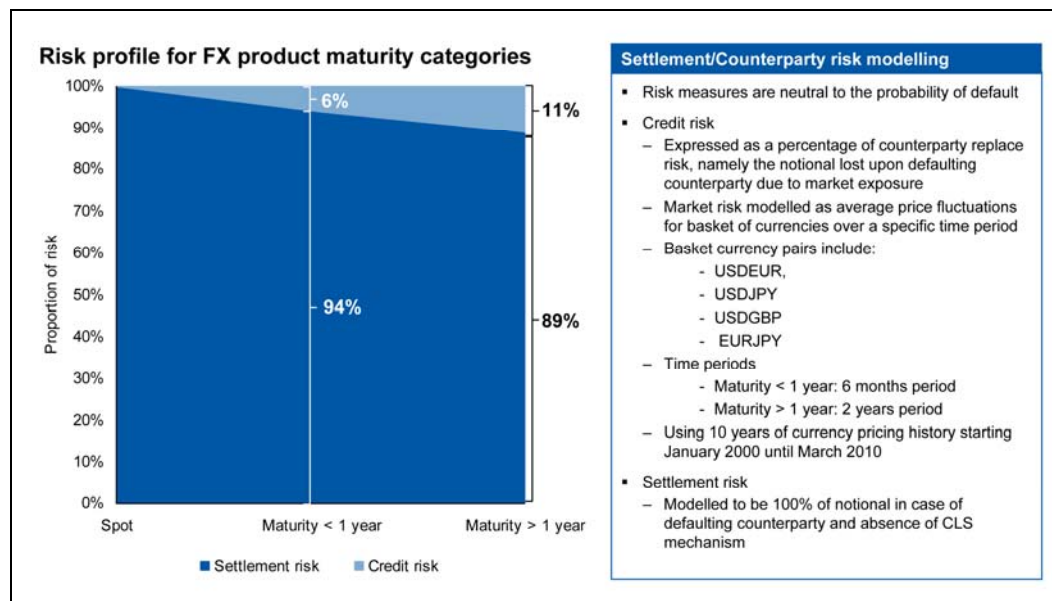
2. The FX Market Is a Global Payment System with a Well-Developed Settlement System That Has Effectively Mitigated Systemic Risk.

2.1 Central banks studied systemic risk in the FX market extensively, finding that settlement risk dwarfs all other risks.

The infamous Bankhaus Herstatt episode of 1974 focused central banks and other market participants on foreign exchange 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. Central banks, through the BIS, extensively studied settlement risk in the foreign exchange markets and spurred efforts toward industry-wide risk-mitigation efforts.

A study of the CPSS found that while replacement risk (the risk of needing to replace an unsettled trade after a counterparty default, which is also called credit risk), market risk and operational risk should all be managed appropriately by foreign exchange market participants, they are "dwarfed by the size of foreign exchange settlement exposures."¹⁹ According to a more recent study, settlement risk comprises 94% of the maximum loss exposure in a trade for foreign exchange instruments with maturity of less

than one year, and 89% for instruments with maturity of greater than a year.²⁰ The chart below illustrates the break-down of the maximum risk of loss between mark-to-market credit risk and settlement risk for foreign exchange contracts of different maturities.²¹



2.2 Central banks' and FX dealers' considerable efforts to address settlement risk led to the creation of CLS Bank.

Beginning in the mid-1990s, central banks became increasingly concerned that the high level of risk caused by existing settlement practices, coupled with an unexpected event or failure, could trigger a serious disruption of the global FX market and financial system liquidity. In 1996, the BIS recommended that industry groups develop a multi-currency service to protect against the loss of principal in FX settlements. A study by a group of major financial institutions resulted in the continuous linked settlement concept (CLS). CLS is a simultaneous exchange — “payment vs. payment” — of each of the two legs of an FX transaction, which eliminates settlement risk. This led to the formation in 1997 of CLS Bank, which by 1998 had 61 major financial institutions as shareholders and had acquired and consolidated the two existing providers of FX netting and clearing services. CLS Bank was established as an Edge corporation in November 1999 following approval by the Federal Reserve.

2.3 CLS Bank now eliminates settlement risk in a large part of the FX market, including almost 90% of inter-dealer trades.

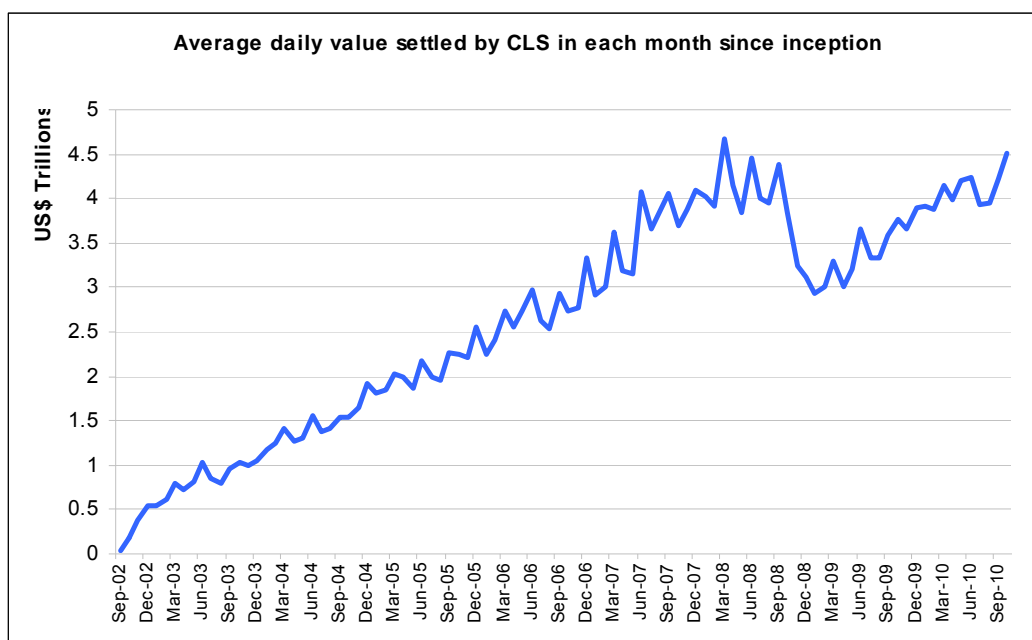
The efforts of central banks to raise awareness of settlement risk and to improve banks' self-monitoring of settlement risk have been remarkably successful. According to the 2008 CPSS Progress Report, 92% of institutions surveyed subject foreign exchange settlement exposures to credit management controls (e.g., credit limits) equivalent to the controls they apply to other similar exposures, and 80% apply the same weight to foreign exchange settlement exposures as to other similar exposures.²²

According to CPSS's calculations in the 2008 CPSS Progress Report, “if the obligations settled by CLS had instead been settled via other available methods,

settlement exposures would have been on average almost two to three times higher than reported.”²³ CLS Bank has had zero settlement failures since it was created.

CLS Bank now settles a large portion of foreign exchange transactions, including 87.7% of inter-bank foreign exchange trades,²⁴ which are the transactions most relevant to systemic risk, and 48.5% of foreign exchange trades booked in the United States.²⁵

The following chart illustrates the growth in trades settled by CLS Bank from 2002 to 2010.²⁶ The reduction in transactions settled by CLS Bank around September 2008 appears consistent with the reduction in financial activity generally during the 2008 financial crisis.

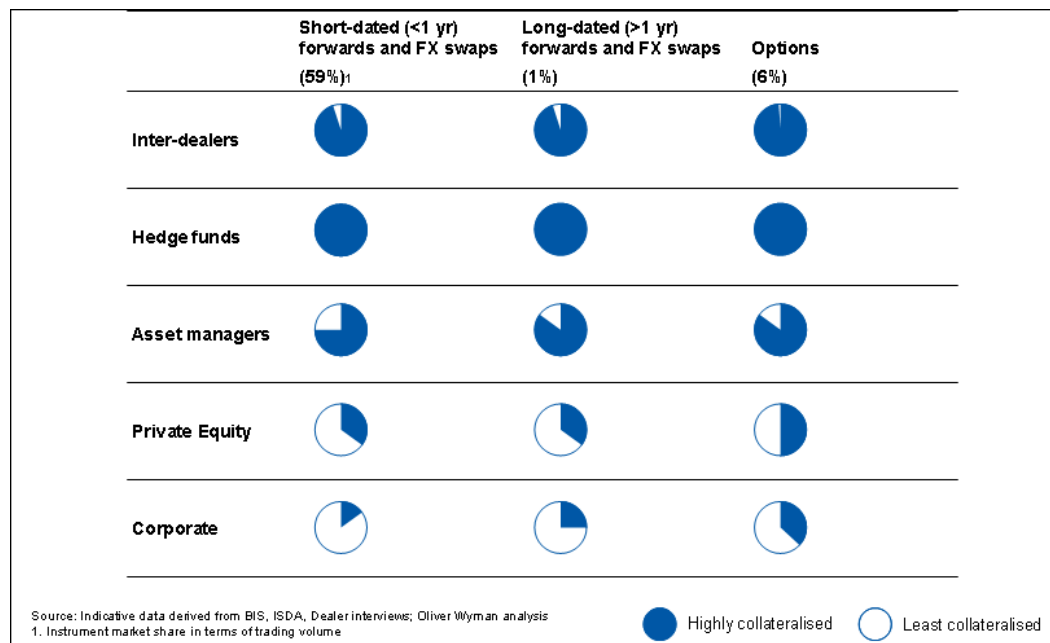


2.4 FX market participants have committed to further strengthen the FX market's operational infrastructure, with broad support from FX dealers and central banks.

Beginning in October 2008, the Foreign Exchange and Currency Derivatives Major Dealers²⁷ have made a series of commitments to a group of regulators, including the FRBNY and the United Kingdom's Financial Services Authority ("FSA"), to improve the operational infrastructure of the FX market.²⁸ These include increasing the use of CLS Bank, establishing a novation protocol and working with buy-side institutions.

According to interviews by the BIS,²⁹ the vast majority of CLS Bank-eligible trades between CLS Bank users are settled through CLS Bank. CLS Bank has added a number of new settlement members since the financial crisis that began in 2008 and is continuing its efforts to expand the products that CLS Bank can settle, in particular same-day transactions. The banks on the Foreign Exchange Committee and the FXJSC, as well as CLS Bank, have expressed support for efforts to add more currencies, settlement sessions and participants to CLS Bank.

Since 2008, FX dealers have also worked to mitigate mark-to-market credit risk by expanding use of CSAs, and are committed to increased usage of CSAs. The chart below illustrates the usage of CSAs by counterparty type.



2.5 The FX industry is taking steps to enhance the industry infrastructure with a trade repository.

There is currently no trade repository for FX swap data, although CLS Bank reports market data both publicly and to regulators. FX dealers recognize the benefit of further increasing transparency to regulators through a swap data repository and are firmly committed to assisting regulators in this regard. The FX dealers, supported by buy side participants, have been proactively engaging with regulators and potential suppliers of swap data repository services to determine how best to implement the swap data repository requirement under the Dodd-Frank Act. Following recent meetings with the CFTC, European Commission and FSA, the Global FX Division expects shortly to issue a request for indications of interest from potential vendors to create a central FX trade repository.

3. Imposing Mandatory Trading and Clearing on the FX Market Would Increase Systemic Risk and Threaten Financial Stability.

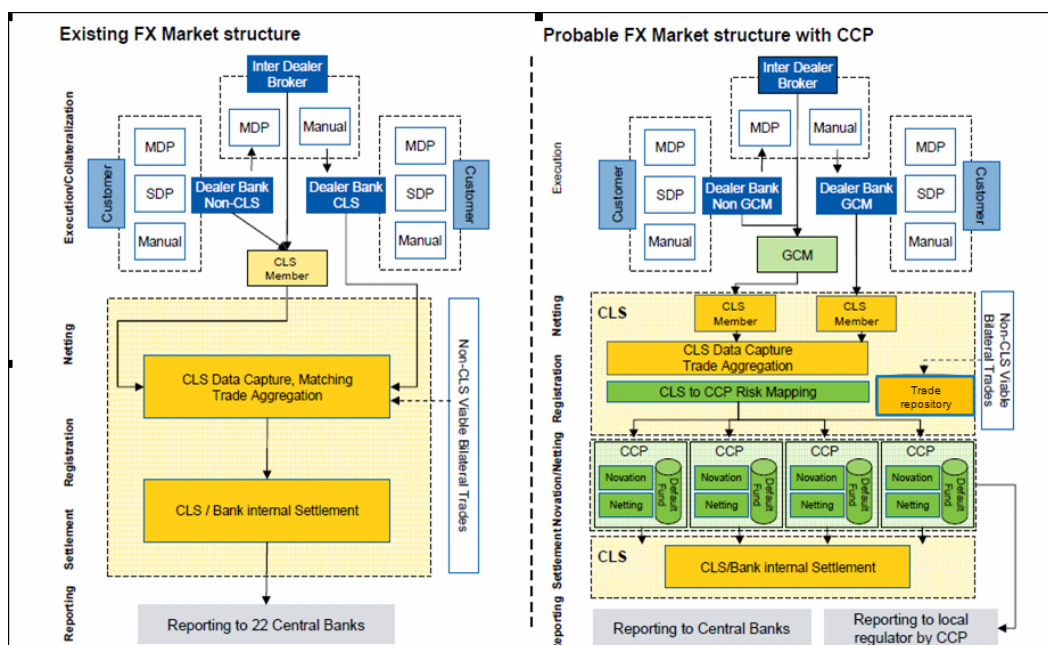
The Foreign Exchange Committee found in its Overview of the OTC Foreign Exchange Market in 2009 that “[a]bsent ... consideration of [the] key characteristics of the foreign exchange market, the potential for negative unintended consequences of any efforts to improve market resiliency is quite large.”³⁰ Indeed, we believe that efforts to introduce a CCP model could either detract from current industry plans to increase usage of CLS Bank, or worse, cause participants to cease using CLS Bank for cost or operational reasons, thereby increasing settlement risk.

3.1 Mandatory clearing would introduce more points of failure in an already highly interdependent, interconnected system.

Settlement of FX transactions involves extensive interconnectedness across payment and foreign exchange systems, which is illustrated by the relationships that CLS Bank has with central banks to facilitate the funding process that supports the payment-vs-payment settlement process across CLS.³¹

A central clearing regime by necessity would be either global or accomplished through a network of local CCPs. A global CCP for a market the size of the FX market would pose significant systemic risk. Local CCPs would fragment the market and reduce liquidity through the dispersal of trades, positions and collateral across many jurisdictions. As the BIS pointed out in its “Report on Netting Systems”, if local CCPs were linked in order to maximize netting benefits, a liquidity problem at one CCP could impact the entire system.³²

The diagrams below illustrate the increased operational complexity and interdependencies that one or more CCPs would likely introduce into the FX market.³³ Any CCP should have the same degree of operational robustness and oversight currently afforded to CLS Bank.



3.1.1 *Introducing CCPs concentrates credit risk. Because the FX market is an integral part of the global payments system, the failure of an FX CCP would likely be catastrophic.*

Introducing a CCP into the FX market means that credit risk that would otherwise be dispersed among multiple institutions would be concentrated in the CCP. In the case of the failure of a CCP that clears foreign exchange, clearing members would be unable to access the currency they need to meet other payment obligations. The repercussions would immediately spread globally. Because of the central role of foreign exchange in the global economy, the failure of a significant foreign exchange CCP would be uniquely devastating. Given that the U.S. dollar is involved in approximately 85% of foreign exchange transactions, the failure of any foreign exchange CCP, whether domestic or foreign, would likely have a disproportionate impact on the U.S. dollar.

3.1.2 *Mandatory clearing could exacerbate market dislocations and have a direct impact on the ability of central banks to carry out monetary policy.*

Even without failure of a CCP, CCP risk mitigation techniques could disrupt the foreign exchange market. During a market dislocation, CCP demands for margin could cause unique problems in the foreign exchange market since at any given time there is reduced liquidity in some currencies due to time zone differences. A CCP will often increase margin requirements in response to market volatility, which induces borrowing by banks (potentially from central banks), thus subtracting liquidity from the financial system, and restricting central banks' ability to effect monetary policy. Any disruptions in the foreign exchange market could lead to increased volatility in U.S. dollar exchange rates and to funding issues for the U.S. Treasury and U.S. businesses. In the case of severe volatility, the Federal Reserve would likely need to intervene in the foreign exchange market.

The imposition of CCPs could also affect the procedures that central banks use in effecting monetary policy, such as the timing of open market operations and central bank lending. Banks' need for liquidity to meet margin calls also could affect demand for central bank balances.³⁴ Any rules and restrictions imposed by CCPs could negatively affect depository institutions' access to currency, which in turn would determine how heavily depository institutions rely on central bank liquidity facilities to meet their liquidity needs. Issues may also arise with respect to the need of the banks for overnight liquidity to satisfy CCP margin calls.³⁵

More generally, a foreign exchange CCP would increase international interdependencies, and shift control over liquidity and demand for central bank balances and government debt from the central banks to the CCP. As a result, an FX CCP could impair the monetary forecasting capabilities of the central banks, make it more difficult for them to effect targeted interest rates³⁶ and reduce the ability of central banks to independently address any liquidity problems or market dislocations relating to their home currencies.³⁷

Mandatory clearing, as well as mandatory exchange or SEF trading in the U.S., would also likely drive the FX market further offshore, reducing the Federal Reserve's ability to exercise effective oversight of the market. Regardless of where FX transactions take place, the FX market has significant U.S. impacts, encompassing, among other things, the U.S. Treasury's and U.S. businesses' funding costs, import and export prices and inflation.

3.2 Effecting a mandatory clearing regime for FX transactions would present unique difficulties, be extremely complex and impose unnecessary and material risk.

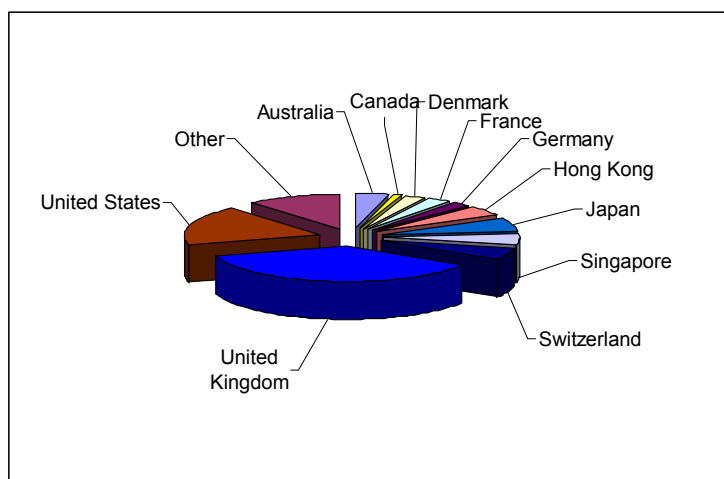
3.2.1 The global, 24-hour nature of the foreign exchange market requires global cooperation in clearing and settlement.

The inherently global, 24-hour-a-day nature of the foreign exchange market, as well as the involvement of many central banks, makes it difficult to achieve central clearing in the U.S. in the manner contemplated by the Dodd-Frank Act for derivatives markets. Because every FX transaction involving the U.S. dollar also involves a foreign currency, clearing and settling U.S. dollar FX transactions requires the cooperation of central banks of all currencies included in the system. Time zone differences also present unique challenges in the foreign exchange market.³⁸ Any CCP for foreign exchange would likely need to either be available 24 hours a day or be linked to another CCP that is open during its overnight hours to call for margin or impose other risk-mitigation measures in response to volatility.

FX market operations are principally located outside the U.S. Although 85% of FX transactions involve the U.S. dollar,³⁹ only 18% of the foreign exchange market is located in the United States, with 37% in the United Kingdom.⁴⁰ Of the FX transactions that involve U.S. dealers, approximately 84% of foreign exchange forwards and approximately 88% of foreign exchange swaps are with foreign counterparties.⁴¹

The following chart illustrates the relatively small percentage of FX transactions that are executed in the United States.⁴²

**Value of FX Transactions by Location
as of April 2010**



3.2.2 Structural changes in the FX market would require cooperation from central banks across the globe.

A clearing regime, whether a central system or one involving a series of local CCPs, would need to operate under disparate legal and regulatory regimes in many

jurisdictions and would require significant global coordination. Since 65% of foreign exchange transactions occur between counterparties located in different countries, and all foreign exchange transactions involve two sovereign currencies, market participants would likely need to clear transactions through CCPs in multiple jurisdictions. Harmonizing regulation covering those CCPs, in particular bankruptcy regimes, would require significant international cooperation. Even if harmonization were achievable, it could take many years to effect.

CLS Bank was created as a global settlement bank for FX as the result of a years-long cooperative effort among central banks. Similarly, effecting a central clearing system for transactions that occur in multiple global currencies, which are overseen by multiple central banks and are central to the payment systems and economies of multiple jurisdictions, could not occur successfully without significant international coordination, cooperation and consensus.

3.2.3 Settlement of FX transactions cleared through a CCP poses challenging issues.

A CCP is unlikely to be able to guarantee settlement itself because of the magnitude of settlement risk and because of the need for liquidity arrangements with the central bank for each currency involved. Since settlement risk comprises an overwhelming portion of the counterparty default risk for FX contracts, the failure of an FX CCP to guarantee settlement risk would largely defeat the purpose of clearing through the CCP, particularly for a market that is essentially a payment system. If a CCP that guaranteed settlement did not use CLS Bank, the CCP would need to settle through a private bank, in which case any default by the private bank would pose serious liquidity and other risks to the clearing house and thus to all its participants. If a CCP did not guarantee settlement and did not use CLS Bank, its clearing participants would be subject to settlement risk, which would be substituting settlement risk — by far the larger risk in an FX transaction — for mark-to-market credit risk.

For a CCP to use CLS Bank for any transaction, the CCP and its counterparty would each need to participate in the settlement service of CLS Bank, either directly as a settlement member or indirectly as a third party participant. Direct settlement membership in CLS Bank is currently limited to commercial and investment banks that satisfy certain financial conditions, including access to liquidity. If it could arrange to be a direct settlement member, the CCP would then be faced with expected as well as unexpected funding requirements to CLS Bank each day. Allowing a CCP to participate in CLS Bank indirectly through a direct settlement member would expose the direct settlement member to the credit risk of the CCP, which is likely to be systemically important.⁴³ It would also expose the CCP to the settlement member's credit risk.

3.2.4 Central banks have raised concerns about the introduction of CCPs into the FX settlement system.

The interdependency risks involved in the CLS Bank settlement system are well understood, accepted and managed. Insertion of one or more CCPs into the settlement process for FX forwards and FX swaps would involve more and different interdependency risks, ones that would likewise need to be understood, accepted and managed by the central banks whose currencies are subject to clearing by the CCP.

Our understanding is that when briefed recently on the possibility of introducing a mandatory CCP for FX transactions, central banks whose currencies settle in CLS Bank raised a number of issues and made requests for further information and analyses

regarding the concept of clearing foreign exchange contracts. These issues include the potential effects of mandatory clearing on the central banks' home currencies and on the safety and soundness of the foreign exchange market generally (including on CLS Bank).⁴⁴ The central banks' concerns stem from their need to understand and evaluate the impact of a CCP's activities on the FX market and on payments in their home currencies from a broad policy perspective. In addition to their respective needs to determine the safety and soundness of any CCP's proposal to clear foreign exchange, central banks have also separately expressed a need to determine the safety and soundness of CLS Bank's acceptance of such cleared transactions for settlement processing. It is reasonable to assume that central banks will be unlikely to embrace mandatory clearing and trading requirements for the FX market in the absence of evidence that it can be implemented without causing more harm than good to sovereign currencies and existing settlement processes.

3.3 Mandatory exchange or SEF trading is unnecessary and would decrease liquidity in the FX market.

Price transparency is often cited as a principal benefit of trading on SEFs.⁴⁵ In the FX market, however, real-time price transparency is already widespread through single-dealer and multi-dealer ECNs that trade FX. Regardless of whether FX swaps and FX forwards are included in the definition of "swap" under the CEA, and irrespective of whether FX transactions are effected on exchanges or SEFs, regulatory transparency as to transaction and market size will be enhanced through the implementation of the FX swap data repository requirements of the Dodd-Frank Act.

Mandatory SEF trading might preclude U.S. market participants from effecting transactions on the highly efficient and effective FX trading systems currently in existence, decreasing liquidity and causing unnecessary dislocation to the FX market. Many of the existing trading systems are single dealer platforms that currently offer the most competitive pricing in the foreign exchange market⁴⁶ but likely would not qualify as SEFs under the definitions contemplated by the CFTC.⁴⁷ For SEF trading to work effectively, standardization around a discrete number of contracts is necessary in order to ensure that multiple bid and ask quotes will develop for each contract on an exchange or SEF. Because FX swaps and FX forwards are used to fund payment obligations, however, their notional amounts and settlement dates are designed to match the underlying commercial obligations. This is why so many FX transactions are bespoke, and why, despite the availability of exchange trading for certain instruments for the past 30 years, exchange-traded FX transactions account for only 4% of FX transactions.⁴⁸

4. Central Banks Actively Oversee and Are the Appropriate Primary Regulators of the FX Market.

4.1 Industry groups, under the auspices of central banks, disseminate "best practices" for the FX market, and central banks supervise compliance with these best practices as part of their safety-and-soundness review of banks they regulate.

Central bank oversight of the foreign exchange market distinguishes the foreign exchange market from other asset classes.

The Foreign Exchange Committee, an independent body sponsored by the FRBNY 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 seek to clarify common

market practices and offer “best practice recommendations” with respect to trading activities, relationships, and other matters. For instance, the Guidelines encourage electronic trading, review of large concentrations of trading with particular institutions, timely confirmation of trades, use of a sophisticated and independent risk management system and certain procedures to mitigate credit and settlement risk. They also encourage use of a payment-vs-payment settlement system such as CLS Bank. 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.

Similarly, foreign exchange dealers located in London, which is by far the largest center of foreign exchange activity, are regulated by the FSA, which has expressed a “clear expectation” that foreign exchange dealers will follow the best practices guidelines set forth in the Non-Investment Products Code promulgated by FXJSC, which is a committee that exists under the auspices of the Bank of England.⁴⁹ The Non-Investment Products Code, which in many respects parallels the Foreign Exchange Committee guidelines, covers such topics as know-your-counterparty obligations (for risk control purposes, among others), prompt confirmation of transactions through immediate, secure, electronic communication systems (such as the Society for Worldwide Interbank Financial Telecommunication (SWIFT)), best execution of customer trades and prohibitions against fraud and market manipulation. Many other foreign exchange industry groups operate under the auspices of central banks, including the Australian Foreign Exchange Committee, the Canadian Foreign Exchange Committee, the European Central Bank Foreign Exchange Contact Group, the Singapore Foreign Exchange Market Committee and the Tokyo Foreign Exchange Market Committee.

4.2 In the United States and abroad, the potential for systemic risk is carefully monitored by central banks through capital adequacy requirements, safety-and-soundness reviews, and regulation of CLS Bank.

The FRBNY carries out foreign exchange-related activities on behalf of the Federal Reserve and the U.S. Treasury. In this capacity, the FRBNY monitors and analyzes global financial market developments, manages U.S. foreign currency reserves, and from time to time intervenes in the foreign exchange market. The FRBNY also executes foreign exchange transactions on behalf of customers.

CLS Bank International is an Edge corporation, chartered by the Federal Reserve under Section 25A of the United States Federal Reserve Act, as amended. As such, CLS Bank is regulated and supervised by the Federal Reserve as a bank under a program of ongoing supervision, combining full-scope and targeted on-site examinations with a variety of off-site monitoring activities. CLS Bank is located in New York.

The central banks whose currencies are settled in CLS Bank have established a cooperative oversight arrangement for CLS Bank among the central banks that are issuers of currencies eligible for settlement in the CLS system. This fulfills their responsibilities to promote safety, efficiency, and stability in the local markets and payment systems in which CLS Bank participates. The *Protocol for Cooperative Oversight of CLS* is designed to facilitate comprehensive oversight of CLS Bank, enhance oversight efficiency by minimizing potential burden on CLS Bank and duplication of effort by the participating central banks, foster consistent and transparent central bank communications with CLS Bank, enhance transparency among the participating central banks regarding the development and implication of international and domestic policies

applicable to CLS Bank, and support fully informed judgments when participating central banks make their oversight assessments and decisions regarding CLS Bank. The Federal Reserve organizes and administers the CLS Oversight Committee, which is the primary forum for the participating central banks to carry out their cooperative oversight of CLS Bank.

In January 2001, the CPSS of the BIS published the Core Principles for Systemically Important Payment Systems (the “**Core Principles**”) relating to, among other things, managing credit and liquidity risk, timely settlement, multilateral netting, operational reliability and governance. Compliance with the Core Principles is encouraged for systemically important payment systems (which includes CLS Bank) pursuant to the Federal Reserve’s Policy on Payment Systems Risk. CLS Bank publishes a self-assessment of its compliance with the Core Principles on the CLS Bank website.

CLS Bank also complies with the Interagency Paper on Sound Practices to Strengthen the Resilience of the US Financial System, published by the Federal Reserve, the OCC and the Securities and Exchange Commission (“**SEC**”), which sets best practices for payment and settlement systems, in particular ensuring that payment and settlement systems are able to quickly recover from any disruption and that sufficient back-up facilities exist.

5. The Federal Reserve Has Authority to Regulate “Systemically Important” Payment Activities Under Title VIII of the Dodd-Frank Act.

To the extent that increased oversight of the foreign exchange market is deemed appropriate, Title VIII of the Dodd-Frank Act provides the Federal Reserve with a valuable tool to exercise such oversight. Title VIII provides a new framework for the prudential regulation of financial market utilities, such as clearing agencies and payment and settlement systems, and extends the Federal Reserve’s regulatory authority in this area to non-bank financial institutions.

Under Title VIII, the new Financial Stability Oversight Council may designate a financial market utility or a payment, clearing or settlement activity as systemically important. CLS Bank would almost assuredly be considered a systemically important financial market utility under Title VIII. Once designated as systemically important, CLS Bank will be subject to such prudential standards (“**Prudential Standards**”) as may be applied by the Federal Reserve, which may address areas such as risk management policies and procedures, margin and collateral requirements, participant or counterparty default policies and procedures and the ability to complete timely settlement of financial transactions.

In addition, settlement of foreign exchange transactions for certain financial institutions could be considered designated activities by financial institutions requiring the application of Prudential Standards. Specifically, under Section 805(a)(1) of the Dodd-Frank Act, the Federal Reserve “shall prescribe risk management standards, taking into consideration relevant international standards and existing prudential requirements, governing the conduct of designated activities by financial institutions.” Title VIII of the Dodd-Frank Act thus would permit the Federal Reserve to mandate compliance with Prudential Standards by “financial institutions” (which is broadly defined to include banks, other regulated financial institutions and any company that is “engaged in activities that are financial in nature or incidental to a financial activity” as described in the Bank Holding Company Act of 1956) whose settlement activities are deemed systemically important. These Prudential Standards might, for example, include, compliance with

FXC's best practice guidelines for foreign exchange trades. Prudential Standards for institutions regulated by the SEC or CFTC may also be set by those agencies, subject to Federal Reserve review.

6. Regulators Have Ample Tools to Address Any Potential Abuses of the Exemption to Evade Otherwise Applicable Regulatory Requirements.

The Dodd-Frank Act in Section 721(c) grants the CFTC the authority to define "swap" to include transactions structured to evade Title VII, which is a sufficient tool to ensure that an exemption of FX swaps and FX forwards from the definition of "swap" will not serve as a vehicle for non-compliance with Title VII. Whether or not the exemption is granted, market participants will be obligated to report data on FX swap and FX forward transactions to a swap data repository or the CFTC. Thus regulators will have full transparency concerning FX swap and FX forward transactions and will be able to monitor the FX market for potential evasion of Title VII.

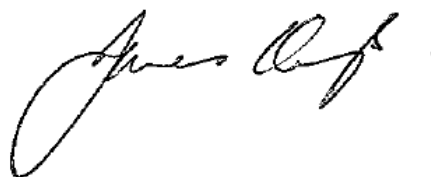
The definitions of "foreign exchange forward" and "foreign exchange swap" under the Dodd-Frank Act already describe very narrow and straightforward instruments.⁵⁰ Both types of transactions solely involve the payment of currencies at pre-agreed rates. They do not reference any asset classes other than FX, and they cannot be used as building blocks to replicate any transaction that includes a variable payment leg. Unlike most derivatives, FX swaps and FX forwards are typically physically settled.

It is important to note that an exemption of FX swaps and FX forwards from the definition of "swap" in Title VII of the Dodd-Frank Act will not exempt those products from a number of other requirements of Title VII, including certain business conduct standards and anti-manipulation provisions in addition to trade reporting requirements. An exemption also will have no impact on the provisions of the Dodd-Frank Act or the Food, Conservation and Energy Act of 2008 that expanded the CFTC's authority with respect to retail FX transactions.

* * * * *

We appreciate the opportunity to share our views on the potential exemption for FX swaps and FX forwards. Please do not hesitate to contact me at +44 (0) 207 743 9319, or the Global FX Division's counsel, Annette L. Nazareth, Davis Polk & Wardwell LLP, at 202-962-7075 or Linda A. Simpson, Davis Polk & Wardwell LLP, at 212-450-4332.

Sincerely,

A handwritten signature in black ink, appearing to read "James Kemp", with a stylized flourish at the end.

James Kemp
Managing Director
Global Foreign Exchange Division

ANNEX 1**Locations of Answers to Questions**

<i>Factor</i>	<i>Relevant Sections of this Letter</i>
<i>Statutory Considerations</i>	
1. Whether the required trading and clearing of foreign exchange swaps and foreign exchange forwards would create systemic risk, lower transparency, or threaten the financial stability of the United States.	Section 3
2. Whether foreign exchange swaps and foreign exchange forwards are already subject to a regulatory scheme that is materially comparable to that established by this Act for other classes of swaps.	Sections 4 and 5
3. The extent to which bank regulators of participants in the foreign exchange market provide adequate supervision, including capital and margin requirements.	Section 4
4. The extent of adequate payment and settlement systems.	Section 2
5. The use of a potential exemption of foreign exchange swaps and foreign exchange forwards to evade otherwise applicable regulatory requirements.	Section 6
<i>Supplemental Questions</i>	
1. Are foreign exchange swaps and/ or foreign exchange forwards qualitatively different from other classes of swaps in a way that makes them ill-suited for regulation as “swaps” under the CEA? Are there similarities between foreign exchange swaps and/or foreign exchange forwards and other products not defined as swaps under the CEA?	Section 1 Section 1.1
2. Are there objective differences between swaps and foreign exchange swaps and/or foreign exchange forwards that warrant an exemption for either or both of these instruments?	Section 1
3. Are there objective differences between long-dated and short-dated foreign exchange forwards and swaps such that one class may be less suited to regulation as “swaps” under the CEA than the other? Is the same true for dealer to dealer transactions versus transactions where one counterparty is a non-dealer? Similarly, does one or more of the above-referenced, five statutory factors support the application of certain requirements set forth in the CEA, but not others (e.g., centralized clearing, but not exchange trading), to foreign exchange swaps and/or foreign exchange forwards?	Section 1.4 Section 3.3
4. What are the primary risks in the foreign exchange swaps and forwards market, how significant are these risks, and how are these risks currently managed by market participants? Would centralized clearing and exchange trading address these risks? To what extent do current payment-versus-payment settlement arrangements address settlement risk?	Sections 1.3.1, 1.3.2 and 2 Sections 1.3.2, 3.2.3 and 3.3 Section 2

Factor	Relevant Sections of this Letter
5. To what extent is counterparty credit risk a significant concern in the foreign exchange swaps and forwards markets? If so, to what extent do current market practices (including netting and bilateral collateral support arrangements) mitigate these risks? What evidence, particularly during the period between 2007 and present, illustrate how current market practices have either addressed, or failed to respond, to these risks?	Sections 1.3.1, 1.3.2 and 2.1 Sections 1.3.1 and 1.3.2 Sections 1.5, 2.4 and 2.5
6. Are there ways to mitigate the risks posed by the trading of foreign exchange swaps or foreign exchange forwards without subjecting these instruments to regulation under the CEA?	Section 5
7. Are there existing safeguards or systems that should be enhanced in order to protect against systemic or other risks in the foreign exchange swaps and forwards markets? What considerations are relevant to the application of Title VIII of the Dodd-Frank Act to the foreign exchange swaps and forwards markets, specifically to enhance supervision, strengthen risk management, and lower systemic risk?	Sections 2.4, 2.5 and 5 Section 5
8. Given that the Dodd-Frank Act requires all foreign exchange swaps and forwards be reported to a swap data repository, what is the current standard or practice in the foreign exchange market for reporting trades?	Section 2.5
9. What would be the likely effects of mandatory U.S. clearing of foreign exchange swaps and/or forwards on foreign exchange market liquidity in the dollar? What would be the impact on the operations of U.S. end-users and U.S. dealers?	Sections 1.2, 3.1.1, 3.1.2 and 3.2.1 Sections 1.2, 3.1.1, 3.1.2 and 3.2.1
10. What other factors should the Secretary of the Treasury consider in determining whether to exempt foreign exchange swaps and/or forwards pursuant to section 1a(47) of the CEA?	

¹ FX swaps and FX forwards are considered swaps under the CEA unless the Secretary makes a written determination that FX swaps or FX forwards should not be regulated as swaps and are not structured to evade the Dodd-Frank Act in violation of any rule promulgated by the CFTC pursuant to Section 721(c) of the Dodd-Frank Act. Section 721(c) of the Dodd-Frank Act gives the CFTC authority to modify the definition of “swap” to include transactions that have been structured to evade the provisions of the Dodd-Frank Act. The CFTC has not yet proposed or passed any rule under Section 721(c).

In determining whether to exempt FX swaps and FX forwards from the definition of “swap”, the Secretary must consider a number of factors related to regulatory oversight, systemic risk and financial stability. Section 1b of the CEA, added by Section 722(h) of the Dodd-Frank Act. Annex 1 to this letter sets forth the five questions and indicates the section of this letter in which our answers to the questions can be found.

In addition, if he makes such a determination, under Section 1a(47) of the CEA, added by Section 721 of the Dodd-Frank Act, the Secretary is directed to explain to the appropriate committees of Congress why FX swaps and FX forwards are qualitatively different from other classes of swaps in a way that would make FX swaps and FX forwards ill-suited for regulation as swaps, and identify the objective differences of FX swaps and FX forwards with respect to standard swaps that warrant exempted status. The Treasury Department has invited comment on whether an exemption is warranted, on the application of the factors and on ten supplemental questions in a Notice and request for comments dated October 19, 2010 (75 Fed. Reg. 66426). Annex 1 to this letter sets forth the ten questions and indicates the section of this letter in which our answers to the questions can be found.

² Testimony of Timothy Geithner, Secretary of the Treasury, Before the United States Senate Committee on Agriculture, Nutrition & Forestry Hearing on December 2, 2009 on Over-the-Counter Derivatives Reform (as reported in Reuters. “Highlights: Geithner’s testimony on derivatives and risk.” December 2, 2009. <http://uk.reuters.com/article/idUKTRE5B13JW20091202>).

³ Oliver Wyman analysis based on BIS data.

⁴ Systems operators estimated that foreign exchange settlements comprised 50% of the daily turnover value in the Clearing House Interbank Payments System (CHIPS) and the Clearing House Automated Payment System (CHAPS), 80% of the daily turnover in the Euro Access Frankfurt (EAF) system and 90% of the daily turnover in the Swiss Interbank Clearing (SIC) system. Bank for International Settlements Committee on Payment and Settlement Systems. Settlement Risk in Foreign Exchange Transactions. March 1996. Section 2.2, p. 4, footnote 3. (“**1996 Allsopp Report**”)

⁵ Bank for International Settlements, Monetary and Economic Department. Triennial Central Bank Survey 2010: Foreign exchange and derivatives market activity in April 2010. Preliminary results. September 2010. p. 9 (“**BIS**”).

⁶ See International Monetary Fund. Currency Composition of Official Foreign Exchange Reserves. Second Quarter of 2010.

⁷ New York Federal Reserve Foreign Exchange Committee. Overview of the OTC Foreign Exchange Market: 2009. November 9, 2009. pp. 2-3. (“**FXC Overview**”)

⁸ BIS, p. 10.

⁹ Oliver Wyman analysis based on BIS data.

¹⁰ Oliver Wyman analysis.

¹¹ Bank of England Foreign Exchange Joint Standing Committee. FXJSC Paper on the Foreign Exchange Market. September 2009. p. 2. (“**FXJSC**”)

¹² Reporting dealers represent approximately 66% of the FX market.

¹³ These calculations assume that all trades under 1 year have the mark-to-market credit risk vs. settlement risk breakdown of a 6-month trade, and that all trades over 1 year have the breakdown of a 2-year trade (based on Oliver Wyman’s volatility assumptions for certain major currency pairs, using historical data from 2000 – 2010). These are conservative assumptions. The actual mark-to-market credit risk number is probably even lower, since 68% of FX forwards and FX swaps have a maturity of less than 1 week.

¹⁴ Oliver Wyman analysis.

¹⁵ Deutsche Bank analysis.

¹⁶ FXC Overview, p. 7

¹⁷ FXC Overview, pp. 1, 4

¹⁸ FXJSC, p. 12.

¹⁹ 1996 Allsopp Report, Section 2.1, p. 4. *See also* BIS CPSS. Central Bank Payment and Settlement Services With Respect to Cross-Border and Multi-Currency Transactions. September 1993. Section 2.3, p. 2. (“**1993 Noël Report**”) (“the loss of principal in settling ... a foreign exchange trade would dwarf any gain or loss that might have accrued to the counterparties to the original transaction.”).

²⁰ Oliver Wyman analysis.

²¹ All else being equal, the amount of mark-to-market credit risk is higher for longer maturities because there is more time for the exchange rate to move.

²² BIS CPSS, Progress in reducing foreign exchange settlement risk. May 2008. Section 4.6, pp. 38-39. (“**CPSS 2008 Progress Report**”)

²³ 2008 CPSS Progress Report, Section 3.1, p. 24.

²⁴ *Compare* CLS Bank. CLS Statistics on Foreign Exchange Activity. October 18, 2010. p. 17 (“**CLS Statistics**”) *with* BIS, p. 8.

²⁵ *Compare* CLS Statistics, p. 12 *with* BIS, p. 11.

²⁶ CLS Bank.

²⁷ These dealers include Bank of America Merrill Lynch, Barclays Capital, BNP Paribas, Citigroup, Credit Suisse AG, Deutsche Bank AG, Goldman, Sachs & Co., HSBC Group, JP Morgan Chase, Morgan Stanley, The Royal Bank of Scotland plc, Société Générale, UBS AG and Wells Fargo Bank, N.A. Participants in the process also include State Street Global Markets and Bank of New York Mellon.

²⁸ *See* Letter from the Foreign Exchange and Currency Derivatives Major Dealers to the OTC Derivatives Supervisors Group. September 27, 2010.

²⁹ *See* CPSS 2008 Progress Report, Section 3.2, p. 26.

³⁰ FXC Overview, p. 7.

³¹ In its 2008 review of the interdependencies of payment and settlement systems, the CPSS concluded:

“Over the past 30 years, technological innovations, globalisation and financial sector consolidation have fostered a broad web of interconnections among a large number of payment and settlement systems, both within and across CPSS countries. These interconnections reflect efforts on the part of systems and institutions to seek new business opportunities and to reduce clearing and settlement costs. They also reflect efforts by central banks and the financial industry to promote the low-cost and safe transfer of money and financial instruments. The focus of the CPSS on reducing foreign exchange settlement risk and the work of the G30 to reduce risk in securities settlement systems, for example, have both led to tighter, more integrated settlement processes.”

“The development of tighter interdependencies has helped to strengthen the global payment and settlement infrastructure by reducing several sources of cost and risk. Yet, tightening interdependencies have also increased the potential for disruptions to spread quickly and widely across multiple systems and markets.” Interdependencies Report, p. 1.

³² BIS Group of Experts on Payment Systems. Report on Netting Schemes. February 1989. Section 7.20, p. 25 (“**1989 Angell Report**”)

³³ The chart assumes that a trade repository is added to a potential FX market structure that includes CCPs. Following recent meetings with the CFTC, EC and FSA, the Global FX Division expects shortly to issue an RFP to prospective vendors to provide a central FX trade repository.

³⁴ See 1993 Noël Report, Section 5.4, p. 26 (discussing similar concerns for multi-currency settlement systems generally).

³⁵ See 1993 Noël Report, Sections 5.7, 5.9 & 5.11, pp. 27-28 (discussing a similar concern regarding settlement). In considering this issue, the 1990 Lamfalussy Report found that “Any requirement to pledge assets to secure obligations that are not currently secured in the foreign exchange markets would increase demand for the eligible assets. If the total market for the assets held as collateral were small, there could be a reduction in the depth of the secondary market and unwelcome price effects at times when the collateral was pledged or liquidated. In some countries any substantial effect in reducing the availability of collateral in the banking system for other purposes, including the securing of central bank credit, could be viewed as a cause for concern by the authorities.” BIS, Committee on Interbank Netting Schemes. Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten countries. November 1990. Section 3.12, p. 14. (“**1990 Lamfalussy Report**”)

³⁶ See 1993 Noël Report, Section 2.18, pp. 6 - 7 (discussing similar concerns for multi-currency settlement systems generally).

³⁷ See 1993 Noël Report, Section 2.17, p. 6; 1996 Allsopp Report, Section 4.2.2, p. 26 (discussing similar concerns for certain types of multi-currency settlement systems, including CCPs).

³⁸ When CLS Bank was created, certain central banks had to extend the availability of their real-time gross payment services, so that they would all be available for payment-vs-payment settlement by CLS Bank between 7:00 and 9:00 a.m. Central European Time to make CLS Bank workable. Many also increased access to their intraday liquidity facilities to accommodate CLS Bank. In normal circumstances, all payments by settlement members to CLS Bank and payments from CLS Bank to settlement members occur between 7:00 and 10:00 a.m. Central European Time, while all of the relevant central banks’ real time gross settlement systems are open, and continuing through 12:00 noon Central European Time for the non-Asia Pacific currencies.

³⁹ BIS, p. 9.

⁴⁰ BIS p. 11.

⁴¹ See Federal Reserve Bank of New York. The Foreign Exchange and Interest Rate Derivatives Markets: Turnover in the United States, April 2010. Annex III, Table A2.

⁴² BIS, p. 11.

⁴³ Memorandum from Rob Close, Chief Executive Officer of CLS Group to CCPs Proposing Clearing Services for OTC FX re: Regulatory Perspective / Process. May 26, 2010. p. 4, footnote 3 ("**CLS Memorandum**").

⁴⁴ CLS Memorandum

⁴⁵ See Financial Stability Board OTC Derivatives Working Group. Implementing OTC Derivatives Market Reforms. October 25, 2010. p. 10. (discussing the benefits of trading on exchanges or trading platforms, all of which relate to transparency).

⁴⁶ "The chasing pack narrows the gap". Euromoney. Volume 41, Number 493. May 2010. p. 71.

⁴⁷ Himaras, Eleni. "CFTC's Gensler: No Dealer-Only/Single-Dealer SEFs". Compliance Reporter. October 8, 2010.

⁴⁸ Deutsche Bank analysis. By contrast, approximately 80% of the interest rate derivatives market is exchange-traded. BIS, p. 12.

⁴⁹ FXJSC, p. 6.

⁵⁰ Under Section 1a(24) of the CEA, "The term 'foreign exchange forward' means a transaction that solely involves the exchange of 2 different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange." Under Section 1a(25) of the CEA, "The term 'foreign exchange swap' means a transaction that solely involves (A) an exchange of 2 different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange and (B) a reverse exchange of the 2 currencies described in subparagraph (A) at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange."