

Coalition for Derivatives End-Users

November 29, 2010

The Honorable Timothy F. Geithner
Secretary
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Submitted via www.regulations.gov

*Re: Notice and Request for Comments, Determination of Foreign Exchange
Swaps and Forwards, 75 FR 66426 (Oct. 28, 2010)*

The Coalition for Derivatives End-Users (the “Coalition”) is pleased to respond to the Department of the Treasury’s (“Treasury”) Notice and Request for Comments regarding whether foreign exchange (“FX”) swaps and forwards should be exempt from the mandatory central clearing and trading requirements under the Commodity Exchange Act (the “CEA”) as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”).

The Coalition believes Treasury should exercise its authority to treat FX forwards and swaps differently from other OTC derivatives for five key reasons:

- The FX market has developed robust risk practices over the last two decades—including settlement systems and increased bilateral collateralization of exposures—that have successfully mitigated the potential for the market to create systemic risk;
- FX swaps and forwards are different from other “swaps” addressed by the Dodd-Frank Act and should not be regulated as if they were the same. As Secretary Geithner has pointed out, “they are not really derivatives” when compared to other “swaps;”
- The FX market is already subject to appropriate oversight by central banks around the world;
- The FX market has functioned remarkably well during the recent credit crisis; and
- Imposing new regulations on the FX market could *create*, not reduce, systemic risk, and would cost the economy in terms of jobs and growth.

We believe that FX swaps and forwards do not materially contribute to systemic risk. Indeed, we believe treating these products otherwise would create significant and potentially destabilizing burdens on companies and possibly the economy. As the New York Federal

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Reserve Foreign Exchange Committee concluded in a November 2009 analysis of the FX market, “the potential for negative unintended consequences of any efforts to improve market resiliency is quite large.”¹ Moreover, increased regulation would be particularly harmful to the economy at a time when added regulatory burdens and costs could dissuade market participants from hedging their foreign exchange risks, which would trigger cascading negative effects without benefits to economic stability commensurate with the costs.

As Treasury Secretary Geithner said about regulating FX swaps and forwards during a Senate Agriculture Committee hearing nearly one year ago, “we’ve got a basic obligation to do no harm, to make sure, as we reform, we don’t make things worse . . . because of the protections that already exist in these foreign exchange markets and because they are different from derivatives, have different risks, require different solutions, we’ll have to take a slightly different approach.”² Below, we discuss in detail the risk profile of foreign exchange swaps and forwards, their differentiation from other product classes, the established protections that have worked well through the financial crisis in these markets, and the harmful consequences of market instability should a one-size-fits-all regulatory regime be imposed on FX transactions.

Introduction

The Coalition represents thousands of companies across the United States that employ derivatives to manage risks they face in connection with their day-to-day businesses. Throughout the legislative process to reform our financial regulatory systems, the Coalition advocated for a strong derivatives title that reduces systemic risk, increases transparency in the over-the-counter (“OTC”) derivatives market, imposes thoughtful new regulatory standards, and

¹ New York Federal Reserve Foreign Exchange Committee, *Overview of the OTC Foreign Exchange Market: 2009*, at 7 (Nov. 9, 2009), available at http://www.ny.frb.org/fxc/news/2009/overview_nov_2009.pdf.

² *Over-the-Counter Derivatives: Hearing before the Senate Agriculture, Nutrition & Forestry Comm.*, 111th Cong. (Dec. 2, 2009) (*Congressional Quarterly* transcript) (statement of Treasury Secretary Timothy F. Geithner). Full statement: “[T]here are aspects to these [foreign exchange] markets where, for very important reasons, we’re going to have to have a slightly different approach, but the important thing is not to allow those carefully crafted exceptions to undermine the basic protections, to be exploited to undermine, to become the device for evading those protections. That’s the core thing . . . FX markets are different from these, and they’re not really derivatives in this sense, and they don’t represent the same set of risks. And there is an elaborate framework in place already, put in place starting 20 years ago, to limit settlement risk and other sets of risks that occur. And these markets have actually worked quite well. So, like in anything, you’ve got a—we’ve got a—basic obligation to do no harm, to make sure, as we reform, we don’t make things worse. And our judgment is that, because of the protections that already exist in these foreign exchange markets and because they are different from derivatives, have different risks, require different solutions, we’ll have to have a slightly different approach.”

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provides a strong, unambiguous exemption for end-users from the bill's clearing, trade execution, margin, and capital requirements. More than 270 companies and trade associations have signed letters the Coalition sent to Congress during debate on the Dodd-Frank legislation advocating for a carefully calibrated derivatives regulatory regime that would not impose undue burdens on end-users whose derivatives activities do not pose systemic risk.

In addition, the Business Roundtable conducted a survey of end-users' derivatives use and found that a 3% margin requirement could result in the loss of 100,000 jobs and tie up an average of \$269 million per year per company. These results are conservative as they reflect only the imposition of initial margin; variation margin charges could be much higher, tying up more capital, increasing costs, and putting more jobs at risk. The Coalition is in the process of conducting another survey of end-users and will share it with regulators when it is complete.

The Coalition's comments and letters and the Business Roundtable survey were cited during congressional debate over the derivatives provisions of the Dodd-Frank Act and are now part of the Congressional Record.³

In short, the Coalition has worked with Congress and regulatory agencies to achieve a new regulatory structure that will enhance the stability of the financial system while not unduly or unnecessarily burdening the components of that system that allow U.S. companies to manage their risks, to make investments, and to create jobs. Below, we work to continue that effort by providing comments on several of the questions posed by Treasury in its request for comments on the FX swaps and forwards exemption. The Coalition believes that examination of the five factors required to be considered in the Secretary's determination counsels firmly that all FX swaps and forwards be exempt from treatment as swaps.

The Dodd-Frank Act Text: Exemption Determination Process

Under the Dodd-Frank Act, the Treasury Secretary (the "Secretary") is given authority to exempt foreign exchange swaps and forwards from the regulations that will be applied to other derivative contracts. To exercise this authority, the Secretary must submit a written determination to Congress that FX swaps and forwards (1) should not be regulated as swaps and (2) are not structured to evade the Dodd-Frank Act. Dodd-Frank Act Sec. 721(a)(21) (7 U.S.C. §1a (47)(E)). The Secretary also must explain why FX swaps and forwards are "qualitatively

³ See, e.g., 156 CONG. REC. S3594 (daily ed. May 12, 2010) (Coalition letter entered into Congressional Record); *Congressional Quarterly* transcript of House-Senate Conference Committee Mark-Up of H.R. 4174, statement of Representative Frank Lucas (June 24, 2010) ("As I cited as the conference opened two weeks ago, a survey and analysis conducted by the Business Roundtable found the requirement to impose initial margin on OTC derivatives could lead to the loss of 100,000 to 120,000 jobs within S&P 500 companies alone."); *Congressional Quarterly* transcript of House-Senate Conference Committee Mark-Up of H.R. 4713, statement of Representative Scott Garrett (June 24, 2010) ("And on that job front, let me just point this out. There was a recent study by the Keybridge Research. They found that a requirement to impose initial margin [on] OTC derivatives could lead to 100,000 to 120,000 jobs lost within the S&P 500 companies.).

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different from other classes of swaps in a way that would make the foreign exchange swaps and foreign exchange forwards ill-suited for regulation as swaps” and identify “the objective differences of foreign exchange swaps and foreign exchange forwards with respect to standard swaps that warrant an exempted status.” Dodd-Frank Act Sec. 722(h) (7 U.S.C. § 1b).

In making this determination, the Secretary must consider the following five factors:

- (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;
- (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;
- (3) the extent to which bank regulators of participants in the foreign exchange market provide adequate supervision, including capital and margin requirements;
- (4) the extent of adequate payment and settlement systems; and
- (5) the use of a potential exemption of foreign exchange swaps and foreign exchange forwards to evade otherwise applicable regulatory requirements.

Id.

Even if FX swaps and forwards are exempted from the clearing and exchange trading requirements imposed on derivative contracts by the Dodd-Frank Act, all FX swaps and forwards must be reported either to a swap data repository (“SDR”), or if no SDR will accept the FX swaps and forwards, to the CFTC. Dodd-Frank Act Sec. 721(a)(21) (7 U.S.C. § 1a (47)(E)). In addition, any swap dealer or MSP that is a party to a FX swap or forward must conform to the same business conduct standards as swap dealers and MSPs engaged in other derivative contracts. *Id.* Finally, the vast majority of FX swaps and forwards (90% of interdealer trades⁴) are settled through the CLS Bank, which effectively eliminates settlement risk among CLS participants and renders further regulation of such transactions unnecessary and unlikely to mitigate systemic risk to the economy. Indeed, such regulation, particularly if applied to end-users, could increase systemic risk by introducing significant liquidity risks into the system where none existed, deterring prudent FX hedging and risk management by the corporations, or worse, encouraging companies to move production abroad to create “natural hedges” that would be deleterious to economic and jobs growth in the United States.

⁴ Commission of the European Communities, Staff Working Paper accompanying Commission Communication, *Ensuring Efficient, Safe & Sound Derivatives Markets*,” at 41 [hereinafter EC Staff Working Paper] (“CLS is currently used for 55% of FX transactions (90% of the interbank market”),” available at http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/report_en.pdf.

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Treasury Questions

(1)(A) 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?

FX swaps and forwards have significantly different risk profiles than other classes of swaps and thus, should not be regulated in the same way. Imposing the same regulatory burdens on FX swaps and forwards that are planned for other derivative contracts will only marginally reduce the amount of risk associated with such trades while, at the same time, introducing new risks to the system. Unintended consequences could include reducing prudent FX hedging due to increased costs, pushing manufacturing offshore, reducing economic growth, and affecting the U.S. dollar’s prominence as a reserve currency and as a safe haven during times of economic stress.

Global Linkage

Unlike the securities, credit, or rates markets whose reaches are more localized in nature, the foreign exchange market is fundamentally different from these product classes because of its important linkages to the proper functioning of the global economy. Such proper functioning facilitates both (1) the global flow of payments, investments, and financing and (2) market stabilization by central banks of the world.

In normal economic times, an efficient foreign exchange market encourages global trade and job creation by reducing the risks associated with doing business globally. It allows for U.S. companies to buy and sell globally without exposure to unmanageable exchange rate risks. It facilitates longer-term investments when participants can hedge their long-term exchange rate exposures efficiently and cost effectively. And it allows for cost effective cross-border financing in which companies can source capital where they have a comparative borrowing advantage and still manage to hedge any resulting exchange rate risks. In sum, the existence of the foreign exchange market and associated hedging products allow U.S. companies to compete globally and safely.

The imposition of mandatory central clearing on foreign exchange swaps and forwards would fundamentally alter the cost associated with hedging the underlying exchange rate risks. Many companies would find the liquidity requirements difficult to manage on a day to day basis unless they set aside, or arrange facilities to borrow, a considerable amount of working capital—capital that would otherwise be invested in their businesses. The application of mandatory clearing to the FX market would thus create a choice between two unattractive alternatives: (1) hedging by setting aside precious working capital and sacrificing economic and jobs growth or (2) not hedging and taking on exchange rate risks.

At times of economic stress, an efficient foreign exchange market facilitates stabilization of the global economy by allowing participants to shift their holdings into safer assets (such as U.S. Treasuries). The existence of a hedging market allows for efficient “flights to safety” while providing participants with cost effective ways to mitigate foreign exchange risks during such operations. This has facilitated the role of the U.S. dollar as the world’s reserve currency and the prominence of U.S. Treasuries as a safe asset class because global participants know they can hedge their exchange rate risks when they purchase U.S. Treasuries.

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In short, because of the fundamental linkage between the foreign exchange market (and associated hedging) and the vital operations of U.S. companies in the world and the U.S. government's monetary operations, the Coalition would recommend a cautious approach that would not radically remake a remarkably well-functioning market through regulations such as mandatory central clearing.

Maturity Profile

The foreign exchange hedging market is also different in its maturity profile from other types of OTC derivatives. Typically, foreign exchange hedges associated with global sales of goods and services are often short-dated in nature. The BIS estimates that over 60% of outstanding foreign exchange hedges are one year or less in maturity and the vast majority (approximately 80%) have a maturity of less than 5 years. In contrast, in the interest rates hedging market, only 43% of hedges are one year or less in maturity and approximately 72% are less than 5 years.

Furthermore, if one were to examine FX trades by trading volume (rather than examining outstanding hedges only), “90% of the traded FX value matures within three months, and over 75% within a week,” according to the CLS.⁵

The Dodd-Frank regulatory regime for derivatives seeks to reduce counterparty risk in a number of ways—chiefly, by maximizing central clearing. Because FX swaps typically have a shorter maturity than other derivative contracts, they already present considerably less counterparty credit risk than other swaps. Shorter maturities mean less time for, and less likelihood of, default. Moreover, “the market is deep and liquid, which *a priori* facilitates replacing a particular contract should the counterparty default.”⁶

Imposing clearing requirements on FX swaps would do little to alter the default risk between the counterparties, but would instead introduce a new risk in the form of fluctuating liquidity requirements. In many ways, the foreign exchange market was created precisely to mitigate volatility to cash flows. Ironically, a mandatory clearing requirement would obviate or significantly diminish this risk-reduction benefit and reintroduce cash flow volatility.

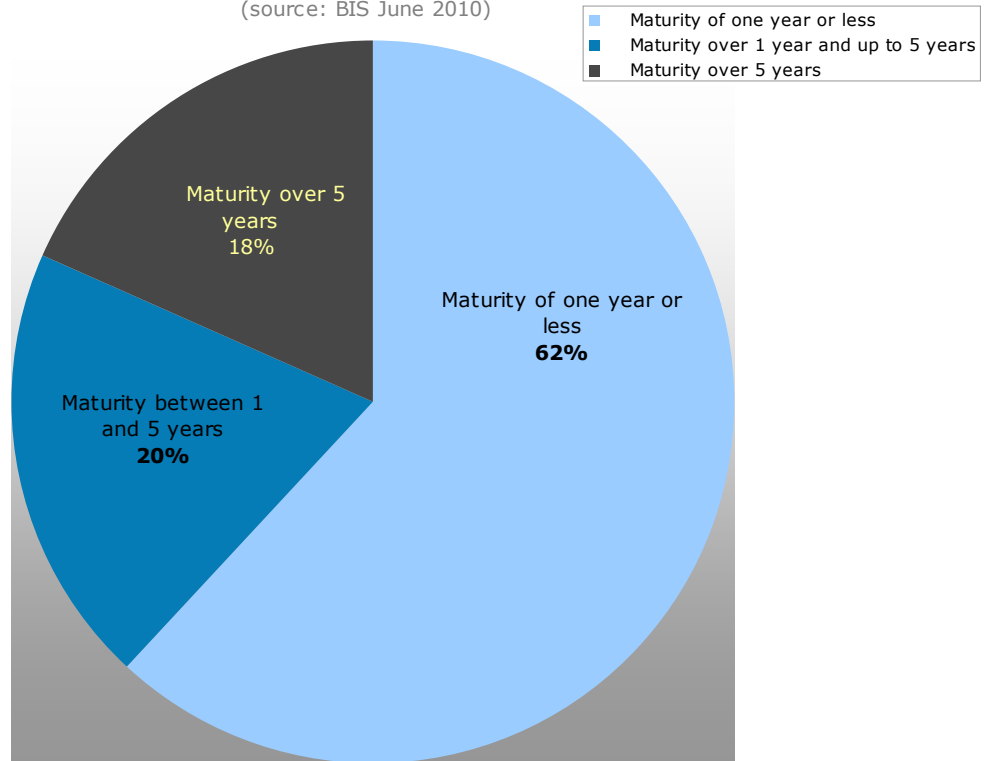
⁵ CLS Statistics on Foreign Exchange Activity, submitted to the CFTC Oct. 11, 2010.

⁶ EC Staff Working Paper at 40, *supra* note 4, at 4.

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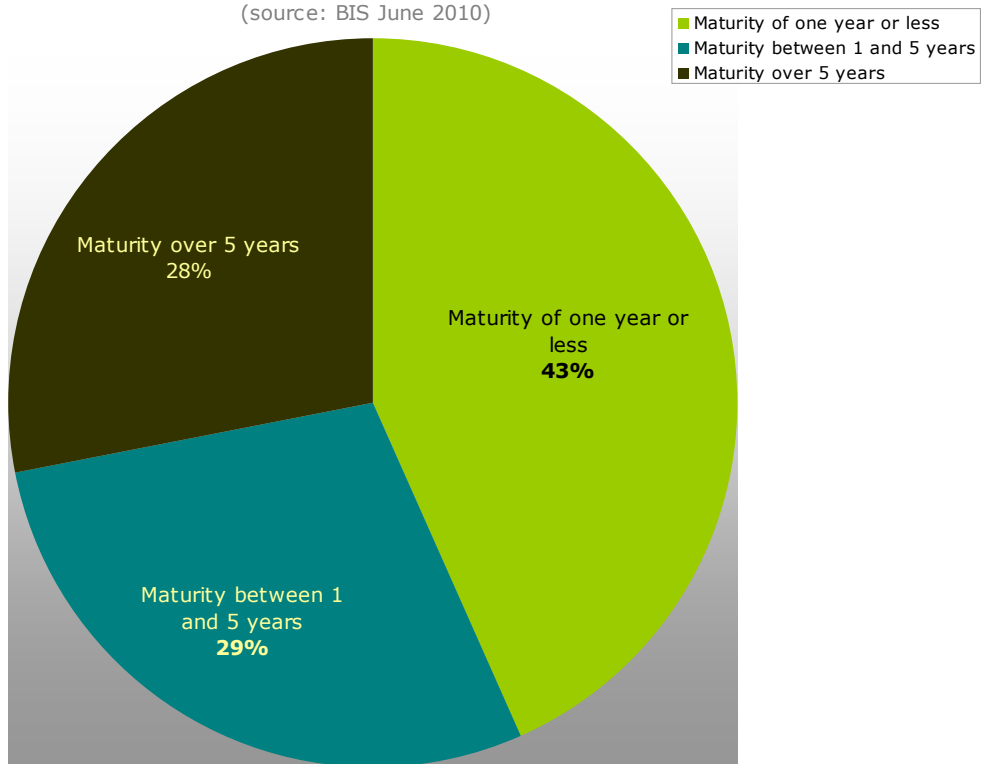
Maturities of outstanding FX hedges as of 2010-H1

(source: BIS June 2010)



Maturities of outstanding Interest Rate hedges as of 2010-H1

(source: BIS June 2010)



As the European Commission puts it:

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“Since 2002, the FX derivative market is using CLS, which has significantly reduced the systemic risk associated with FX. Other characteristics of the FX derivative market also attenuate the systemic risk, e.g. extremely liquid market, a relatively high degree of standardisation, dispersed market structure.”⁷

(1)(B) Are there similarities between foreign exchange swaps and/or foreign exchange forwards and other products not defined as swaps under the CEA?

The Coalition has no comments on this question at this time.

(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?

FX swaps and forwards are different than other “swaps” under the Dodd-Frank Act and should not be regulated as if they were the same. As Secretary Geithner has commented, “FX markets are different from [other swaps], and they’re not really derivatives in this sense, and they don’t present the same set of risks. . . . And our judgment is that, because of the protections that already exist in these foreign exchange markets and because they are different from derivatives, have different risks, require different solutions, we’ll have to have a slightly different approach.”⁸

They are different than other “swaps” for a number of reasons discussed in various places within this comment letter. One additional way in which they are different is that foreign exchange swaps and forwards are often ultimately physically settled—much like commodity forwards. This is significant because the definition of “swap” in section 721 of the Dodd-Frank Act excludes from the definition of “swap” “any contract of sale of a commodity for future delivery” and “physically settled” nonfinancial commodities or securities for deferred shipment or delivery. There is little legislative history behind the exclusion for commodities, but the physical settlement lends an important degree of certainty to such markets, particularly in the context of the ways in which end-users employ such forwards and swaps—to hedge risks.

It is important to note that physical settlement in the foreign exchange market can take on several forms. It is common for companies to “roll/extend” FX forwards and swaps periodically. For example if a company anticipates physically settling a forward one year hence, but towards the maturity of this forward realizes the physical settlement needs to be postponed, the company can roll/extend the expiring hedge for a longer period. This is done by first cash-settling the expiring hedge and then re-entering into a longer dated hedge. As such, the preponderance of physical settlement in the FX market is often associated with a significant degree of cash-settlement as well.

⁷ EC Staff Working Paper at 44, *supra* note 4, at 4.

⁸ Geithner, *supra* note 1.

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It also is important to remember that some currencies cannot be hedged with physically settled forwards—for example USD/CNY. As a result, companies may elect to hedge with non-deliverable forwards (“NDF”) and perform the physical settlement with a separate spot trade on the hedge expiration date. In such cases, the hedge is equivalent to a physically settled forward in economics and in purpose, and very much akin to a physically settled commodity hedge.

Foreign exchange swaps and foreign exchange forwards are economically equivalent products and thus should be treated the same vis-à-vis an exemption. A foreign exchange swap is simply the combination of a forward and a spot trade. FX swaps are most often associated with cross-border investments where a company would convert one currency into another in the spot market, and hedge the re-conversion in the forward market.

(3)(A) 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?

The Coalition believes it would be unwise to regulate short-dated and long-dated transactions under different regimes. As noted earlier, longer-dated transactions are important risk mitigation tools for cross-border investments with longer horizons. They are also important to secure the lowest cost cross-border financing and mitigation of associated exchange rate risks. U.S. companies should be encouraged to hedge these longer-dated risks instead of being discouraged from proper FX risk management—a potential unintended consequence of mandating clearing in this market.

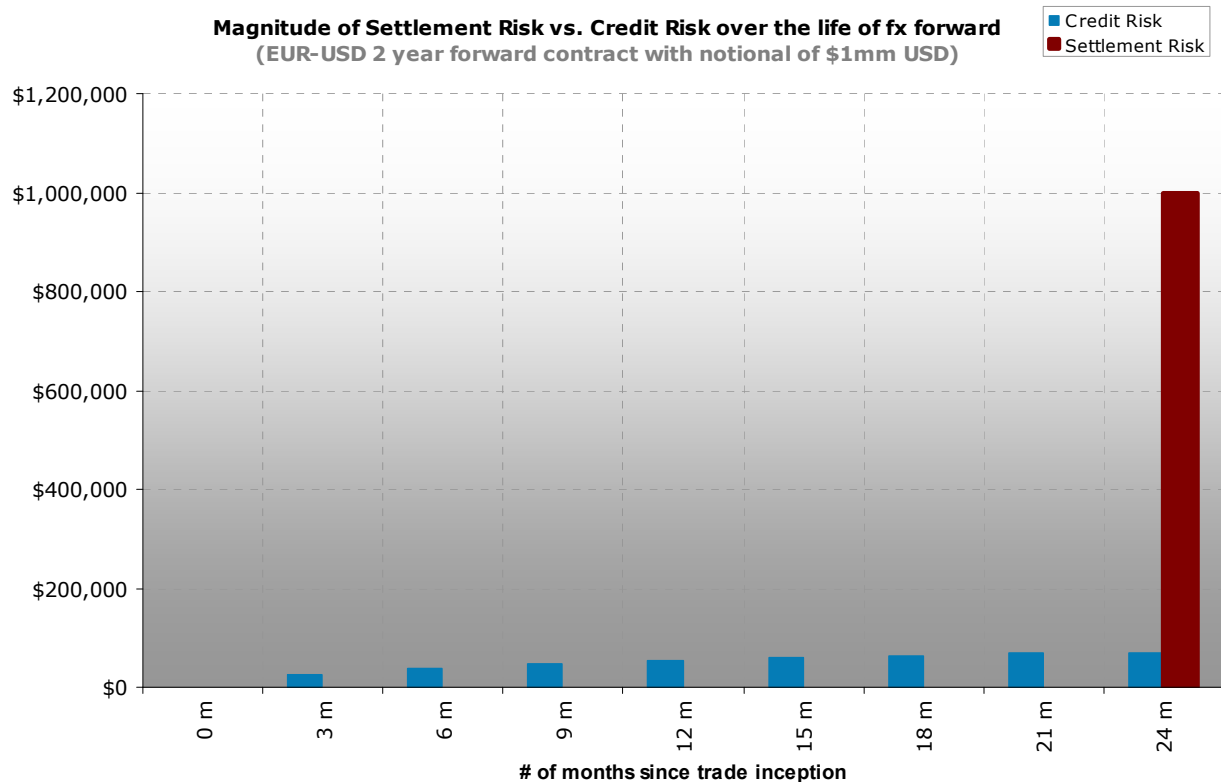
Some may argue that companies can still hedge long-term risks with short-dated instruments by “rolling” or “extending” short-dated hedges periodically. For example, a company hedging a 5-year investment may hedge with a 1-year forward, and at the maturity of this forward, re-hedge with another 1-year forward, and so on until the end of the 5-year period. Such hedging programs can work and indeed are employed where there is no liquid market for a straightforward 5-year hedge. However, it does introduce a new risk in the form of “roll risk.” Roll risk occurs when companies have to cash-settle the short-dated hedges periodically, each time paying out (or receiving) cash that is equivalent to the value of the expiring hedge. Although a hedging program through periodic rolls is fundamentally sound, these intermittent cash events can create undesirable liquidity issues for companies. Eliminating roll risk allows companies to time the expiration and cash settlement of their hedge to the timing of their hedged cash flow. The hedged cash flow typically produces ample liquidity with which to settle the hedge obligation, allowing for the elimination altogether of any undesirable liquidity event.

As such, the Coalition believes that both short-dated and long-dated foreign exchange forwards and swaps should be exempted so that companies can efficiently and effectively mitigate their risks using the most appropriate hedges that match the maturity of the underlying risks. This would be best accomplished by ensuring companies are not artificially forced to choose a less optimal hedging program because of differentiated regulatory regimes based on hedging maturities

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(4)(A) 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?

The primary risks in the foreign exchange swaps and forwards market are settlement and credit risk, with the former dwarfing the latter in magnitude.⁹ For example, a 2-year EUR-USD forward contract with a notional of \$1mm USD would have a settlement risk of up to \$1mm USD. But the credit risk of this transaction (based on expected future credit exposure) would be at most approximately \$70K USD over the 2-year period.



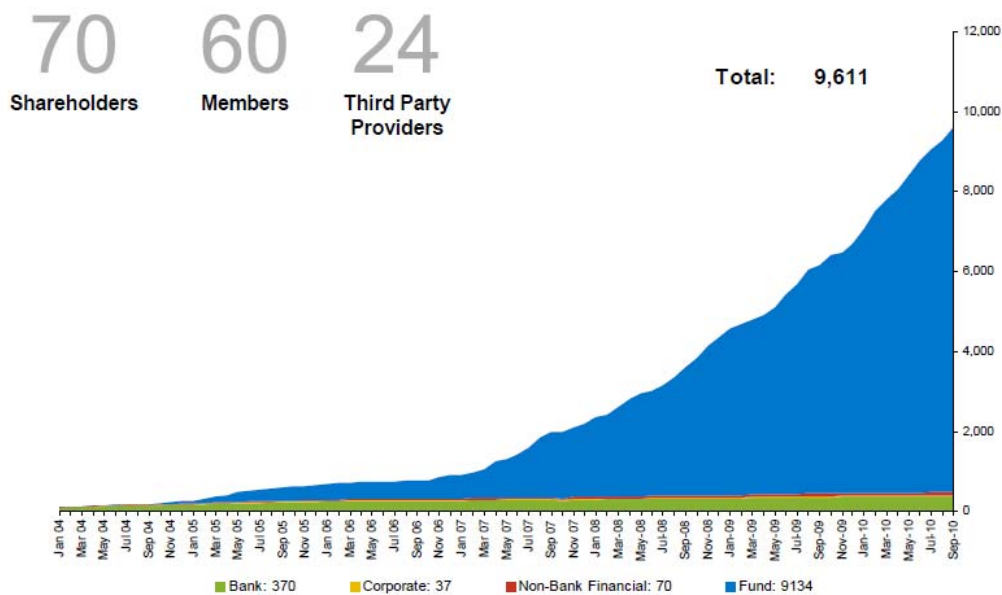
Therefore, the proper mitigation of settlement risks can eliminate much of the overall risks associated with foreign exchange transactions. Dealer-to-dealer FX transactions, as well as some non-dealer transactions, are settled through the Continuous Linked Settlement System (“CLS”), operated by CLS Bank International. According to the European Commission’s 2009 Staff

⁹ EC Staff Working Paper at 41, *supra* note 4, at 4 (The predominant risk in FX markets is cross-currency settlement risk, i.e. the risk that a settlement does not take place as expected.”).

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Working Paper,¹⁰ approximately 90% of interdealer FX transactions and 55% of all FX transactions are settled through the CLS Bank. CLS's participation effectively manages settlement risk throughout the market as evidenced by how well it worked during Lehman's default.¹¹ Furthermore, the market's participation in CLS settlement has been expanding at an accelerated pace over the last few years. We believe this is a positive trend that will further reduce settlement risk in the market.

CLS participation – September 2010



Dodd-Frank's mandatory clearing requirement would not be the solution to settlement risks. Instead, the Coalition believes the proper usage of CLS for interdealer transactions, and

¹⁰ EC Staff Working Paper at 41, *supra* note 4, at 4 ("CLS is currently used for 55% of FX transactions (90% of the interbank market).").

¹¹ EC Staff Working Paper at 41, *supra* note 4, at 4. ("The benefits of CLS were illustrated during autumn 2008. All transactions related to Lehman were in CLS and hence were protected (even though Lehman was not a direct bank member of CLS, but was using Citi. When the problems emerged with the Icelandic banks, some transaction fell outside CLS, which accordingly generated losses.").

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“controlled-delivery settlement”¹² for non-interdealer transactions would largely mitigate settlement risks, and thus much of the overall risk of the FX market.

Though CLS Bank settlement addresses the settlement risk associated with the final exchange of currency, it does not protect against counterparty credit risk. However, as previously noted, counterparty credit risk is much smaller in magnitude. In addition, the use of credit support annexes, especially between larger financial institutions, further reduces credit risk in the FX derivatives market. According to the 2009 ISDA Margin Survey, around 50% of FX credit exposure was covered by collateral as of the end of 2009.¹³ Moreover, the majority of the inter-dealer FX credit exposure (where systemic exposure, if any, would lie) is well-collateralized.

FX market participants have become adept at managing their own risks, as demonstrated by their relative stability during the financial crisis. Companies in the Coalition tend to follow strict hedging policies that prohibit speculative trading in derivatives and require that certain measures are taken to mitigate operational, market, and credit risks when entering into derivatives trades for risk management purposes. Frequently, market participants spread their trades among a variety of counterparties with good credit quality. Moreover, because the market is highly liquid and transparent even in times of market stress, there is significant agreement on market prices and bilateral margining amounts, resulting in efficient collateralization of the FX market.

(4)(B) Would centralized clearing and exchange trading address these risks?

Central clearing and exchange trading are unlikely to appreciably lower settlement and counterparty risk associated with foreign exchange transactions. As noted, CLS and “controlled delivery settlement” already provide for safe settlement. The remaining counterparty risk is effectively managed through increased use of bilateral collateral agreements, appropriate bank capital¹⁴ as recommended by Basel guidelines, and credit charges built into hedge pricing. The Coalition believes that these three factors effectively manage the vast majority of credit risk.

Central clearing would, however, introduce liquidity risk into the market, which heretofore has not been a significant risk in these markets. The Coalition believes that regulators should not

¹² In the absence of CLS participation (due to cost issues), two counterparties can still elect to use “controlled-delivery” to settle FX trades. In such circumstances, the less creditworthy entity would wire its payment obligation first. Upon receipt of one leg of the payment, the more creditworthy entity would then wire its payment obligation.

¹³ 2009 ISDA Margin Survey, *available at* http://www.isda.org/c_and_a/pdf/ISDA-Margin-Survey-2009.pdf.

¹⁴ Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Standardized Framework, 73 Fed. Reg. 43982 (proposed July 29, 2008) (Banks must hold much higher amount of capital to safeguard foreign exchange OTC derivatives relative to interest rate derivatives of similar tenor. Risk conversion factor for foreign exchange OTC derivatives of maturity greater than five years is 0.075, which is five times greater than that for interest rate derivatives of similar tenor.).

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introduce this new risk into a well-functioning market. Central clearing could create liquidity risks for companies due to the onerous daily margin posting requirement—even if the foreign currency hedges they have employed perfectly offset the underlying risks. At worst, such liquidity burdens could actually lead to a company’s default, even if such companies otherwise would have had the ability to meet their obligations upon maturity.

To a large degree, the foreign exchange market has led the way in adopting transparent electronic trading platforms. This is largely due to the market’s liquid nature and the large number of participants. High liquidity and high decentralization create a market structure in which liquidity can exist easily on multiple electronic platforms (for example ICAP’s EBS platform allows trading 24 hours a day. The platform facilitates trading even in exotic instruments such as emerging market non-deliverable forwards). Because of these and other transparency mechanisms already present in this market, the Coalition does not believe a blanket application of Dodd-Frank Title VII would improve pricing transparency for foreign exchange transactions to any notable degree.

(5)(A) To what extent is counterparty credit risk a significant concern in the foreign exchange swaps and forwards markets?

Please see response to Question 4, above.

Even if FX swaps and forwards are not treated as swaps for clearing and exchange trading purposes, they will still be subject to reporting requirements. These markets will be transparent to regulators, and should problems arise, regulators would have the authority to act accordingly. Similarly, swap dealers and MSPs who engage in FX transactions still must conform to the same business conduct standards as those swap dealers and MSPs who engage in other swaps transactions. In addition, bank swap dealers and MSPs are subject to prudential regulation, including capital requirements that apply to FX swaps and forwards.

(5)(B) If so, to what extent do current market practices (including netting and bilateral collateral support arrangements) mitigate these risks?

According to the 2010 ISDA Margin Survey, 57% of FX derivatives are traded under the ISDA master agreement with the associated credit support annex.¹⁵ For the remaining FX derivatives, there are often good reasons why they are traded without a credit support annex. Existing ISDA agreements, which facilitate netting benefits and collateral posting, significantly reduce counterparty credit risk. CLS’s central netting function does as well. While it is difficult to quantify the extent to which risk is reduced by these practices, the Coalition believes that the risk-mitigation is substantial—to the point where whatever risk that remains is insignificant.

¹⁵ 2010 ISDA Margin Survey at 10, *available at* http://www.isda.org/c_and_a/pdf/ISDA-Margin-Survey-2010.pdf.

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(5)(C) What evidence, particularly during the period between 2007 and present, illustrates how current market practices have either addressed, or failed to respond, to these risks?

Between 2007 and the present, the FX markets have remained stable compared to other swaps markets. No banks failed due to their foreign exchange derivatives activity. Even during the credit crisis—arguably the greatest stress test in generations—the FX markets operated remarkably well. While the credit markets contracted, firms were able to execute FX swaps and forwards with minimal interruption. Foreign central banks and non-governmental market participants were able to safely convert their holdings to safe U.S. Treasuries due largely to the efficient FX market and the ability to hedge the currency risks of such operations. A mandatory clearing requirement would likely inhibit such activities in the future due to the increased cost of hedging and unpredictable liquidity requirements to collateralize hedges. Furthermore, the markets have implemented changes since the crisis to ensure continued safe operation, including increased use of bilateral agreements to exchange collateral, and higher charges for credit in FX forward and swap pricing.

(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?

The Coalition believes the nature of the FX market and existing risk practices are adequately protecting market stability, as evidenced by the smooth operation of these markets during the recent credit crisis. We believe the use of Title VIII of the Dodd-Frank Act—including the reporting requirements and business conduct standards therein—can and will further enhance existing risk management practices, and that the application of clearing requirements is unnecessary to effectuate this objective. Further, other parts of Dodd-Frank allow for additional strengthening risk management practices, even if FX swaps and forwards are exempted. Please also see our response to Question 7, below.

(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?

Title VIII of the Dodd-Frank Act provides the Board of Governors with authority to enhance the regulation and supervision of systemically important financial market utilities. This could include market utilities that facilitate payments and settlements such as the CLS. In general, the CLS already performs well under the existing regulatory framework.¹⁶ There has been no

¹⁶ EC Staff Working Paper at 40, *supra* note 4, at 4. (“CLS supervised by the Federal Reserve Bank of New York. It is designated by the Bank of England for the purposes of the UK legislation that implements the Settlement Finality Directive (SFD) and it is notified to the [European] Commission under Article 10(1) of the SFD.”).

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failure associated with the CLS. However, should the Board of Governors choose to enhance the workings of the CLS or like utilities, it has the regulatory authority to do so under Title VIII.

In light of the fact that settlement risk makes up the majority of the overall risk of the FX market and is largely mitigated through use of CLS, and the expanded authority granted by Title VIII of the Dodd-Frank Act, the Coalition believes that sufficient safeguards in the foreign exchange markets exist, and subjecting these transactions to mandatory clearing requirements is unnecessary—and quite possibly counterproductive. As Secretary Geithner testified, “we’ve got a basic obligation to do no harm, to make sure, as we reform, we don’t make things worse. And our judgment is that, because of the protections that already exist in these foreign exchange markets and because they are different from derivatives, have different risks, require different solutions, we’ll have to have a slightly different approach.”¹⁷

(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?

Currently, no centralized reporting for OTC derivatives exists for foreign exchange swaps or forwards, although the CLS captures data for a large portion of the FX trading volume. If the Secretary should exempt foreign exchange swaps and forwards from Title VII of Dodd-Frank, there will still be a reporting requirement. The Coalition believes one or more data repositories will develop to serve as a market utility for this purpose. The CLS Bank announced in October 2009 its commitment to expand its “existing trade information coverage in providing 100% coverage of the FX market.”¹⁸ Because data elements needed to describe foreign exchange swaps and forwards are relatively simple,¹⁹ we believe the market will be ready for mandatory reporting and regulators will have unfettered access to the data to help them oversee the FX market.

¹⁷ *Over-the-Counter Derivatives: Hearing before the Senate Agriculture, Nutrition & Forestry Comm.*, 111th Cong. (Dec. 2, 2009) (*Congressional Quarterly* transcript) (statement of Treasury Secretary Timothy F. Geithner).

¹⁸ Foreign Exchange Joint Standing Committee of the Bank of England, Report (Nov. 11, 2009).

¹⁹ EC Staff Working Paper at 40, *supra* note 4, at 4. (“FX products are easy to define. There is industry agreement on market definition of all products’ characteristics, including half of the more exotic products. The market is accordingly standardised in terms of contract specifications.”).

Coalition for Derivatives End-Users

(9)(A) 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 U.S. dollar?

Unlike other derivative asset classes, the foreign exchange swaps and forwards market is closely linked to the cash market.²⁰ Forwards, for example, are nothing more than spot transactions occurring in the future on a predefined date. Drastic changes such as mandatory clearing will most probably reduce liquidity in the hedging market significantly due to the costs increase and operational challenges of daily or even intraday margin posting to a central clearing party. Additionally, because of the linkage to the cash market, a mandatory clearing requirement may also impede liquidity in the cash market. Further, market participants may have diminished capacity to perform certain spot trades if they are unable to hedge cost efficiently and effectively in the swaps and forwards market simultaneously.

Secondly, because of the USD's current preminent role as the world's reserve currency of choice, a large proportion of foreign exchange trades involve the USD as one leg of a transaction. Mandatory clearing likely would add transactional friction to foreign exchange transactions, and by logical extension, the liquidity of the USD. In light of the U.S. Government's desire to continue encouraging the USD's use as the premier reserve currency²¹ (a position that would likely be challenged by the EUR, or even potentially the CNY in the distant future), regulators would be prudent to not dramatically change the regulatory regime governing foreign exchange transactions where much of the USD liquidity resides.

For companies choosing to conduct and finance their businesses in US dollars versus competing currencies, the imposition of mandatory clearing may very well drive their choice of functioning currency away from the USD. This already occurs (for example, several U.S. corporations recently issued corporate bonds in Renminbi) and would only be exacerbated by placing significant economic liquidity burdens on companies. Because of the important relationship between the FX market and capital formation, we would recommend that regulators do not radically remake a well-functioning market where the USD still plays a dominant role.

(9)(B) What would be the impact on the operations of U.S. end-users and U.S. dealers?

Mandating the clearing of FX swaps and forwards would increase the burdens and costs on end-users, but would not significantly reduce risk. Not only would mandated central clearing result in the direct imposition of clearing costs on end-users and drain substantial sums of investment capital from a still-fragile economy, it would expose end-users to significant and potentially destabilizing liquidity risks.

²⁰ EC Staff Working Paper at 28, *supra* note 4, at 4. (The FX derivative market traditionally is closely interlinked with the underlying cash market.”).

²¹ *The Passing of the Buck?*, ECONOMIST, Dec. 2, 2004 (“The dollar’s position as the world’s main reserve currency allows it to attract finance on exceptionally favourable terms.”).

Coalition for Derivatives End-Users

The liquidity costs associated with mandatory clearing introduce uncertainty to an end user's business, in direct contradiction to the primary objective of hedging—to mitigate or eliminate risk and unpredictability. Large price movements would trigger a spike in demand for short-term liquidity and would draw cash away from business expansion and job creation. Indeed, central clearing and margin calls could have the effect of triggering forced unwinds of transactions which would further exacerbate already volatile markets.

Furthermore, increasing transaction costs could dissuade end-users from managing their risks through FX swaps and forwards, or could create an incentive for end-users to take their swap execution offshore, resulting in reduced liquidity and a divergence between offshore and onshore rates—and therefore reduced stability—within domestic markets, thereby increasing the risks for the remaining participants. Mandatory clearing requirements also could drive some end-user exporters to seek “natural hedges” by locating their manufacturing facilities offshore, in the countries where they sell their goods, thereby eliminating the need to fund costly strategies in the United States.

(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?

Some caution that an exemption of foreign exchange swaps and forwards could open the door for other product classes to disguise themselves as foreign exchange trades and thus find a loophole to escape regulation. The Coalition finds that this claim is unfounded both in logic and in practice. Foreign exchange hedges are relatively simple instruments with much fewer economic terms than other types of derivatives. Moreover, the class of derivatives that Treasury has the authority to exempt are specifically identified and described in Dodd-Frank. Variants to such structures would not be able to benefit from the exemption. As such, we believe a foreign exchange swaps and forwards exemption can be achieved without jeopardizing the regulatory authority and safeguards provided by the Dodd-Frank Act.

Conclusion

We thank the Treasury for the opportunity to comment on these important issues. The Coalition looks forward to working with the Treasury to help implement rules that will strengthen the derivatives market without unduly burdening business end-users or the economy at large. We are available to meet with the Treasury to discuss these issues in more detail.

Sincerely,

Business Roundtable
National Association of Corporate Treasurers
National Association of Manufacturers
National Association of Real Estate Investment Trusts
The Real Estate Roundtable
U.S. Chamber of Commerce