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Submitted electronically

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Ms. Elizabeth M. Murphy
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Re: *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping (76 Fed. Reg. 29818 (May 23, 2011))*

Ladies and Gentlemen:

Covington & Burling LLP is pleased to submit this comment letter in respect of the above-cited joint proposed rules and proposed interpretations (the "*Proposing Release*") on behalf of a client that is an active participant in the foreign exchange markets.

We fully agree with the Secretary of the Treasury's proposed determination (the "*Proposed Treasury Determination*") that foreign exchange swaps and foreign exchange forwards should not be regulated as swaps under the Commodity Exchange Act (the "*CEA*") and are not structured to evade the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "*Dodd-Frank Act*") in violation of any rule promulgated by the Commodity Futures Trading Commission (the "*CFTC*") pursuant to Section 721(c) of the Dodd-Frank Act.[1] We agree with the Secretary of the Treasury's conclusion that foreign exchange swaps and foreign

[1] Notice of Proposed Determination, Determination of Foreign Exchange Swaps and Foreign Exchange Forwards under the Commodity Exchange Act, 76 Fed. Reg. 25774 (May 5, 2011).

exchange forwards are substantively distinguishable from transactions commonly known as "swaps" in ways that make them ill-suited for regulation as swaps. In addition, and as discussed in more detail below, we note that empirical evidence supports the view that the FX markets in general functioned smoothly during the financial crisis.[2] Given the need to allocate scarce regulatory resources as effectively and efficiently as possible, the Proposed Treasury Determination reflects sound regulatory policy.

We disagree with the conclusion in the Proposing Release and in the Proposed Treasury Determination that a component of the FX forward market, non-deliverable forwards ("*NDFs*"), does not satisfy the statutory definition of a "foreign exchange forward" and is therefore not subject to the Secretary of the Treasury's exemptive authority.[3] For the reasons discussed in more detail below, we believe that the CFTC in proposed rule 1.3(xxx) under the CEA and the Securities and Exchange Commission (the "*SEC*" and, together with the CFTC, the "*Commissions*") in proposed rule 3a69-2 under the Securities Exchange Act of 1934 (the "*Exchange Act*") should clarify that NDFs are "foreign exchange forwards" under the CEA and Exchange Act as amended by the Dodd-Frank Act and should therefore be included in any exemption from swap treatment by the Secretary of the Treasury for FX forwards.

NDFs are economically and functionally indistinguishable from deliverable FX forwards (whether or not physically settled), and thus also satisfy the statutory considerations required by Section 1b(a) of the CEA for a determination of exemption by the Secretary of the Treasury. As discussed in more detail below, the market and regulatory practice both domestically and internationally is to treat NDFs and FX forwards as the same product.

NDFs exist solely to address a unique attribute of a limited number of currencies -- physical delivery outside of the home jurisdiction is either impossible or impracticable due to local law or other local requirements. Regulating NDFs differently than physically settled FX forwards will create regulatory uncertainty, potentially lead to distortions of existing markets, and create opportunities for market participants to direct NDF transactions to offshore jurisdictions they perceive to be preferable from a regulatory (and thus economic) point of view. We do not believe that this result would be consistent with the intent of Congress in creating the opportunity for the Secretary of the Treasury to exempt a portion of the FX market from the definition of swap under the CEA. If NDFs are driven to offshore markets, this will impair the ability of U.S. market participants to compete as dealers in this market. American businesses (and investors therein) that currently utilize NDFs to hedge commercial risks will be faced with increased risk (if they elect to refrain from entering into these hedges), or the inefficiencies and potential risks of offshore execution if dealers for NDFs migrate to other jurisdictions (for

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2 Michael R. King & Dagfinn Rime, *The $4 Trillion Question: What Explains FX Growth Since the 2007 Survey?*, BIS Q. REV., Dec. 2010, at 32.

3 *See* Letter from Covington & Burling LLP to the Office of Financial Markets of the Department of the Treasury (June 6, 2011), *available at* http://www.regulations.gov/#!documentDetail;D=TREAS-DO-2011-0004-0023.

example, risks and costs that could arise if resolution of any disputes would shift to venues outside the U.S., or were to be resolved under local law), or, if onshore execution remains a viable option, increased costs (in the form of potential margin or capital charges necessitated by Dodd-Frank swap regulations). We therefore believe the costs of any interpretation that causes NDFs to be regulated differently than FX forwards far outweigh any potential benefits.

We thus respectfully suggest that NDFs should, consistent with market practice, continue to be viewed as indistinguishable from deliverable FX forwards, and thus be subject to the same regulatory treatment as FX forwards under the CEA and the Exchange Act.

Comparison of NDFs to Physically Settled FX Forwards. An NDF is economically and functionally the same transaction as a physically settled FX forward. The sole difference between these two transactions is that in a physically settled FX forward, the trade closes out at maturity upon delivery by each party to the transaction of the gross amount of the respective currency specified in the contract. In comparison, in an NDF, the trade closes out at maturity upon delivery of the net value of the underlying exchange, denominated in a pre-determined currency. In each structure, the net value transferred is exactly the same and the counterparty initiating the transaction can achieve exactly the same economic outcome, whether it be to hedge a particular asset or liability or to speculate in a given currency. For non-deliverable currencies, an NDF is the only viable means by which to effect a forward transaction.

While in theory NDFs could be used in lieu of physically settled FX forwards with respect to any unrestricted currency pair, it is our understanding that in practice this rarely occurs in the market. NDFs are used almost exclusively to effect the substance of a physically settled FX forward when one of the underlying currencies cannot be physically delivered as a matter of local law or is, as a practical matter, not deliverable due to local law or other local requirements.[4] Non-deliverability is a feature of many emerging market currencies and of virtually no developed market currencies. Thus, NDFs are in effect an emerging market product. Many of these currencies are important to the global financial markets.[5]

NDFs and physically settled FX forwards are both typically short-term in duration. Virtually all mature in one year or less, and a significant majority mature in three months or less. We are not aware of any meaningful difference in average maturities of physically settled FX forwards as compared with NDFs.

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[4] We believe that there is clear consensus in the market as to the list of currencies that are non-deliverable and thus only traded on a forward basis using NDFs. The Commissions and Treasury could consult with relevant trade associations or working groups (*e.g.,* the Foreign Exchange Chief Dealers Working Group of the Federal Reserve Bank of New York) to develop and maintain such a list.

[5] Among currencies that are widely traded as NDFs (and not traded as FX forwards) are South Korean Won, Taiwanese Dollars, Brazilian Reais, Indonesian Rupiahs and Chinese Yuan. As noted below, currency controls in China have recently been relaxed to permit physical delivery of Yuan in Hong Kong.

NDFs constitute a small part of the overall FX market -- comprising approximately 1.5% of the U.S. $4 trillion daily volume in the global FX market. As noted above, NDFs are a key component of the FX markets in non-deliverable currencies, as physically settled FX forwards are not capable of being executed in those markets (or, in some markets, it is sufficiently impractical to physically deliver the local currency that would be traded on a forward basis). NDFs thus have a significance to the global FX markets that arguably transcends their overall share of those markets. For that reason, proper regulatory treatment of NDFs takes on enhanced regulatory policy significance.

Given the economic and functional congruity between the two products, there is already substantial market and regulatory precedent in the United States and globally for treating NDFs and physically settled FX forwards comparably. Indeed, as noted in the Proposing Release, CFTC rule 35.1(b)(1)(i) includes a "forward foreign exchange agreement" in the definition of "swap agreement" without distinguishing with respect to deliverability.[6] We note the following additional examples:

- NDFs are traded as part of a bank's or broker's FX desk (sometimes as an emerging market sub-desk on the FX floor).

- In a 1998 publication regarding the FX markets, the Federal Reserve Bank of New York described an NDF as "an instrument similar to an outright forward, except that there is no physical delivery or transfer of the local currency."[7] The New York Fed has long recognized NDFs as a viable means by which to engage in forward transactions in non-deliverable currencies.

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6 *See* Joint Proposed Rules, Proposed Interpretations, Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 Fed. Reg. 29818, 29836, n. 133 (May 23, 2011). We note that this footnote in the Proposing Release also asserts that some market participants currently view NDFs as swaps, citing a Credit Suisse marketing document regarding NDFs. *Id*. We believe that this is not relevant to the analysis. The question is not whether NDFs, FX swaps or FX forwards are viewed by the market as swaps. They are clearly within the definition of that term under the Dodd-Frank Act. The question is whether NDFs are sufficiently similar to FX forwards to merit the same treatment under the CEA.

7 Sam Y. Cross, *Main Instruments: Over-the-Counter Markets*, *in* THE FOREIGN EXCHANGE MARKET IN THE UNITED STATES 31, 39 (Fed. Res. Bank of N.Y., 1998), *available at* http://www.newyorkfed.org/education/addpub/usfxm/. "Outright forward" as used in this publication means FX forwards, including NDFs.

- The Bank for International Settlements ("*BIS*") treats NDFs as a component of the outright forward category.[8]
- International regulators do not distinguish between FX forwards and NDFs.[9]
- Standard FX market documentation structures do not distinguish between FX forwards and NDFs.[10]
- FX forwards are subject to special rules under the U.S. tax code that apply equally to physically settled and cash settled transactions.[11]

The Commissions' failure to interpret "foreign exchange forward" to include NDFs would not only be inconsistent with these precedents, it would introduce uncertainty where none should exist.

The FX market is a uniquely global market. Harmonization of international regulation of the financial markets is a well-recognized goal, one that has taken on increased significance as regulators develop responses to the financial crisis. For example, the Dodd-Frank Act encourages the harmonization of U.S. regulation of derivatives with international regulation.[12] Distinguishing between FX forwards and NDFs would result in the U.S. taking a different approach than other major participants in the financial markets. This would not benefit

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8 *Triennial Central Bank Survey - Report on Global Foreign Exchange Market Activity in 2010* (Bank for Int'l Settlements, Monetary and Econ. Dept., Basel, Switz.) Dec. 2010 (hereinafter, "*BIS Triennial Survey*") at 32. "Outright forward" as used by BIS also means FX forwards, including NDFs.

9 *See, e.g.*, the European Commission's Markets in Financial Instruments Directive, or "*MiFID*," Directive No. 39/2004, Annex I, § C(4), 2004 O.J. (L 145) 1, 58 (EC); *see also* the U.K. Financial Services Authority's ("*FSA*") regulations implementing MiFID, Financial Services and Markets Act 2000 (Markets in Financial Instruments) Regulations 2007, 2007/126, sched. 7, tbl. 3 (U.K.). In addition, current discussions in the European Parliament of the regulatory treatment of FX derivatives do not distinguish between NDFs and FX forwards (although we acknowledge that these discussions are in early stages).

10 *See, e.g.,* ISDA, 1998 FX AND CURRENCY OPTION DEFINITIONS (ISDA, Inc. 1998) §§ 1.12 and 1.15 (a "Non-Deliverable FX Transaction" is defined as a subset of FX Transactions that settles net (pursuant to § 2.2(b) of the FX and Currency Option Definitions) as opposed to gross (pursuant to § 2.2(a) thereof)); 1997 INTERNATIONAL FOREIGN EXCHANGE MASTER AGREEMENT (Foreign Exch. Comm. 1997) (the "*IFEMA*"), § 1 (definition of "FX Transaction") (definition of FX Transaction includes both physically settled and net settled transactions; no separate mention of non-deliverable transactions in the IFEMA).

11 *See* 26 U.S.C. § 1256(g)(2).

12 Section 752 of the Dodd-Frank Act requires the CFTC, the SEC, and the prudential regulators to consult with foreign regulatory authorities in order to seek to establish consistent international standards with respect to the regulation of swaps and of futures and options contracts. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 752, 124 Stat. 1376, 1749-50 (2010).

efforts to promote harmonization of regulatory standards, nor do we believe it is warranted by the structure of this product.

The Proposing Release emphasizes that NDFs do not involve an "exchange" of two different currencies. It is true that physically settled FX forwards involve an exchange of known quantities of the paired currencies at maturity, whereas NDFs involve a net payment in a specified currency based on spot exchange rates at maturity.[13] Notwithstanding the focus in the Proposing Release, however, we respectfully submit that the distinction between physical settlement in deliverable FX forwards and net settlement in NDFs is not necessarily dispositive from a regulatory policy point of view. While each party to a physically settled FX forward does know at inception the precise quantity of the specific currency it must deliver at maturity, it does not know the market value of the currency it will receive, relative to the currency it must deliver, until the maturity of the transaction. In this sense, the value of a physically settled FX forward is not a sum certain. In fact, were one to simultaneously enter into a physically settled FX forward and NDF with identical underlying currencies, notional amount and maturity date, the value of the transactions would be identical throughout their tenor. Thus, the distinction between physical settlement in deliverable FX forwards and net settlement in NDFs does not appear to be a sufficient basis upon which to base disparate regulatory treatment of otherwise identical instruments.

The Proposing Release attempts to distinguish NDFs from instruments that fall outside the definition of "swap" by observing that that NDF markets appear to be driven in large part by speculation and hedging.[14] Because NDFs and physically settled FX forwards are economically and functionally indistinguishable, they are used to effect similar transactions. For example, NDFs are commonly employed by U.S. corporations that use the U.S. Dollar as their functional currency to hedge exposure to a non-deliverable emerging market currency (by taking the short side of an NDF transaction involving the emerging market currency). The same trade enables a mutual fund to hedge exposure to a portfolio of emerging market equities or debt denominated in a non-deliverable currency. Physically settled FX forwards (as well as spot transactions) are used in the same manner (*e.g.*, to hedge downside risk in U.S. equities by going long Japanese Yen or another currency that is viewed as inversely correlated to the U.S. Dollar, or to hedge downside risk in European equities by going short the Euro).[15] Physically settled FX forwards are also commonly used as payment vehicles to enable an entity with a payment

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[13] If a physically settled FX forward (or NDF) terminates prior to maturity due to the occurrence of a termination event or event of default, then, pursuant to standard ISDA or IFEMA documentation, the transaction will settle net on a bilateral basis (outside of CLS Bank, which we discuss in more detail below) in the termination currency specified by the counterparties in their transaction documentation. Thus, through this industry-standard bilateral documentation, both physically settled FX forwards and NDFs address counterparty risk by using the same risk mitigation structure.

[14] Proposing Release, *supra* note 6, at 29836 and nn. 134-35.

[15] *See* King & Rime, *supra* note 2, at 31.

obligation in a particular currency at a specified future date to fix the cost of that payment in its functional currency by entering into a physically settled FX forward. NDFs are less efficient for this purpose but are typically the trade of choice when currency controls or other factors make physically settled FX forwards unavailable or impracticable.

While these trade structures are all hedges of commercial exposures, it is also possible to use NDFs or physically settled FX forwards to speculate. Because of the congruity of the economics underlying the two structures, they are equally capable of being used to hedge or speculate, except that a party desiring to hedge or speculate in a non-deliverable currency would have to use an NDF to do so. To the extent a party to a physically settled FX forward was using the transaction to speculate and did not wish to receive gross payment in a currency that was due to it, the FX trading desk with which it had entered into the transaction would convert the gross proceeds to the currency of such party's choice. Because the transactions are economically equivalent, any difference in the extent to which NDFs are used for speculation relative to physically settled FX forwards relates to speculators' views regarding the currencies underlying the transactions rather than to differences between NDFs and physically settled FX forwards. Again, neither transaction lends itself to speculation more than the other and therefore NDFs are no more risky, from a speculative use point of view, than physically settled FX forwards.

Both physically settled FX forwards and NDFs are primarily institutional products; our client transacts in NDFs solely with Eligible Contract Participants (as that term is defined in the CEA). Thus, treating NDFs and physically settled FX forwards as identical trades from a regulatory point of view will not impair the ability of the CFTC to regulate FX transactions involving retail counterparties.[16] We therefore do not believe that it is necessary to distinguish between physically settled FX forwards and net settled NDFs as a matter of regulatory policy in order for the CFTC to effectively regulate the retail markets for these transactions.[17]

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16 We acknowledge that the current authority of the CFTC to regulate FX transactions with retail counterparties is limited to certain leveraged or margined transactions. 7 U.S.C. § 2(c)(2)(C). We do not understand that the language of the statutory definition of FX forward in the Dodd-Frank Act, or the proposed interpretation thereof in the Proposed Treasury Determination and the Proposing Release, to be influenced by a desire to expand the CFTC's authority to regulate retail FX transactions. Interpreting the FX forward definition to include NDFs will have no impact on the CFTC's ability to regulate the retail transactions specified in Section 2(c)(2)(C) of the CEA.

17 We note that an NDF (as well as any other net-settled forward) could be viewed as a Contract for Difference ("<u>*CFD*</u>") if one were to give a literal reading to the CFTC's proposed definition of that instrument in the Proposing Release (*supra*, Note 6, at 29838). For the reasons described above regarding the potential issues that can be created when economically identical products are regulated differently, we believe it would be inadvisable to so conclude. In addition, NDFs are functionally distinguishable from CFDs, in that CFDs are used to create synthetic exposure to an underlying asset that is in many, if not most, instances physically deliverable, whereas an NDF is designed to replicate a physically settled FX forward

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Comparison of NDFs to Currency Swaps. At the same time, NDFs are materially different from currency swaps (sometimes also referred to as cross-currency swaps), a category of FX transactions that the Secretary of the Treasury does not have the authority to exempt from the definition of swap under the CEA. A currency swap involves exchanges of principal amounts in the paired currencies at inception and maturity, along with ongoing exchanges of interest payments in the paired currencies during the life of the swap. These transactions are often used to synthetically convert a borrowing denominated in one currency into a different currency. Unlike physically settled FX forwards or NDFs, currency swaps involve more frequent exchanges of gross amounts of the currency pair, typically for durations significantly exceeding the one-year or less duration of virtually all physically settled FX forwards and NDFs. In addition, currency swaps are not among the products that are settled by CLS Bank, so large and recurring gross payments in currency pairs settle on a bilateral basis over an extended period of time, thus increasing settlement risk. Currency swaps are also typically tailored to the specific needs of a counterparty, and thus there is little, if any, liquidity or price transparency in a given trade (and we understand that liquidity in currency swaps tends to decline rapidly after the first year or so of the trade). Bespoke transactions, on the other hand, comprise a smaller portion (although not an insignificant portion) of the physically settled FX forward and NDF market, such that there is meaningful liquidity and price transparency for the larger, standardized portion of this market.

Systemic Risk. As discussed above, NDFs certainly present no greater risk to the U.S. financial system than physically settled FX forwards. In fact, as noted above, NDFs likely pose less risk to the U.S. financial system than physically settled FX forwards in similar aggregate notional amounts due to the lower settlement and counterparty risk posed by net settlement as opposed to the gross notional settlement at maturity of FX forwards and also to the fact that NDFs are a very small portion of the overall FX market. In these circumstances, it seems difficult to conclude that NDFs warrant different regulatory treatment than physically settled FX forwards.

In addition, we believe it is fair to view the NDF market as, in effect, a finite market that will continue to be important, but will not develop into a significantly larger market presenting risks to the U.S. financial system different than those being evaluated today. It is, of course, possible that the NDF market will grow in absolute terms if trading volumes in currently non-deliverable currencies increase. However, it is highly unlikely that any currently deliverable currency that is widely traded in the FX market will become non-deliverable. Instead, it is more likely that one or more currently non-deliverable currencies will shed their restrictions in the

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when that trade is not possible due to currency controls or other restrictions that make physical delivery impossible or impracticable. A CFD can be used in lieu of a long or short trade in an underlying asset, whereas an NDF is used as the only means by which to gain exposure to an undeliverable currency. Thus, as noted below, we believe that the Commissions should clarify that NDFs (as well as other net-settled forwards) are not CFDs.

future.[18] Any such shift would reduce the size of the NDF market and correspondingly increase the size of the physically settled FX forward market on a dollar-by-dollar basis. Thus, the NDF market will continue to be an important component of the FX market, and an indispensable market for transacting in non-deliverable currencies, but it will not encounter growth such that our analysis of the potential risks to the U.S. financial system would cease to be accurate over time.

Addressing systemic risk more broadly, we are aware of disruptions in the FX swap market during the recent financial turmoil. We note that certain commenters on the Proposed Treasury Determination point to this disruption as evidence that the FX market "almost collapsed" during the financial crisis.[19] We strongly disagree with that assertion. We briefly summarize below the basis for our earlier statement that empirical evidence supports the view that the FX market in general functioned smoothly during the financial crisis.[20]

Detailed studies of the impact of the financial crisis on the FX market demonstrate that the disruptions that occurred were limited to the FX swap market; other aspects of the FX market were not disrupted in any material way. The FX swap market was affected by an unprecedented shortage in U.S. dollar-denominated funding for non-U.S. financial institutions.[21] This shortage, which dates back at least a decade, largely stemmed from a sharp growth in the U.S. dollar assets of European, Asian and other non-U.S. banks and financial institutions. Traditional U.S. dollar funding from banks, non-banks and depositors historically only covered part of this structural shortage, so non-U.S. institutions became increasingly reliant upon the FX swap market to make up this shortfall. During the financial crisis, U.S. banks

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18 The Chinese Yuan, for example, recently became deliverable in Hong Kong. Although it remains non-deliverable elsewhere in the world, there are indications that the Chinese government will continue to loosen deliverability restrictions on the Yuan over time. *See, e.g.,* Tom Orlik, *Get Ready: Here Comes the Yuan*, WALL ST. J., June 2, 2011, at C7.

19 Letter of Better Markets, Inc. to the Office of Financial Markets of the Department of the Treasury (June 6, 2011), *available at* http://www.regulations.gov/#!documentDetail;D=TREAS-DO-2011-0004-0019; *see also* Letter of Americans for Financial Reform to the Office of Financial Markets of the Department of the Treasury (June 6, 2011), *available at* http://www.regulations.gov/#!documentDetail;D=TREAS-DO-2011-0004-0022.

20 See note 2, *supra*, and accompanying text.

21 *See generally*, Randall S. Kroszner & William Melick, *The Response of the Federal Reserve to the Recent Banking and Financial Crisis* (Dec. 2009), *available at* http://faculty.chicagobooth.edu/randall.kroszner/research/pdf/KrosznerMelickFedCrisisResponse.pdf; Patrick McGuire & Götz von Peter, *The U.S. Dollar Shortage in Global Banking and the International Policy Response*, BIS WORKING PAPERS NO. 291 (Oct. 2009), *available at* http://www.bis.org/publ/work291.htm; Naohiko Baba & Frank Packer, *From Turmoil to Crisis: Dislocations in the FX Swap Market Before and After the Failure of Lehman Brothers*, BIS WORKING PAPERS NO. 285 (July 2009), available at http://www.bis.org/publ/work285.htm.

curtailed their lending and money market mutual funds effectively withdrew from the commercial paper markets, both due to increasing concern over counterparty risk. Inter-bank lending of U.S. dollars and money market mutual fund purchases of U.S. dollar-denominated commercial paper were significant sources of U.S. dollar funding for non-U.S. banks and financial institutions. As a result of these shifts, the availability of U.S. dollar funding to banks and other financial institutions was further reduced.[22] At the same time as these factors caused the effective maturity of non-U.S. financial institutions' U.S. dollar funding to shorten (as lenders tended to reduce the duration of their transactions with borrowers, or as particular credit tools ceased to be available), the effective maturity of their U.S. dollar assets lengthened as those assets became increasingly illiquid, thus exacerbating the issue. As demand for U.S. dollar funding by non-U.S. financial institutions far outstripped a decreasing supply, one-sided order flow in the FX swap market resulted, causing a severe impairment of liquidity that market. This, in turn, introduced volatility to the international market for U.S. dollars, which impaired the ability of the Federal Reserve to conduct monetary policy by maintaining a targeted Federal Funds rate.

In response, the Federal Reserve opened up reciprocal currency arrangements (also referred to as "swap lines") with 14 European and Asian central banks, pursuant to which the Fed swapped U.S. dollars for the home currency of the respective central bank. The recipient central banks would, in turn, auction the U.S. dollars to financial institutions in their respective jurisdictions.[23] The opening of these lines (which have historical precedent dating back to the early 1960s and were most recently opened in 2001 in response to the terrorist attacks) significantly increased the supply of U.S. dollars in the international markets, and thus eased the pressures on those markets, including the market for FX swaps, that provided U.S. dollar funding to financial institutions located outside of the United States.

It is important to note that these disruptions were not caused by the FX swap market (or any other aspect of the FX market). Instead, the disruption of the FX swap market was an effect of the shortage of U.S. dollars outside of the United States, an unrelated cause. The disruption affected not just the FX swap market, but the offshore market for U.S. dollars generally, as the shortage compromised the supply and demand equilibrium that would be present when the market is functioning smoothly.[24] Of necessity, when demand so completely

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22 Commentators have also noted that allegations of flawed reporting of LIBOR rates during the crisis, if true, could have contributed to difficulties in accurately pricing U.S. dollar lending to non-U.S. financial institutions during this period.

23 This supplemented the Federal Reserve's concurrent Term Auction Facility program, which provided U.S. depositary institutions with access to longer-term U.S. dollar denominated federal funds, and also avoided any perceived stigma associated with borrowing from the Fed's discount window.

24 As an indication of the extent of the disruption caused by the shortage of U.S. dollars outside of the United States, U.S. financial institutions reportedly sought to utilize the FX swap market to procure U.S. dollars

(continued…)

outstrips supply, markets can be disrupted. [25] In fact, it can be argued that the FX swap market behaved appropriately in the face of unprecedented volatility in the broader market for U.S. dollars -- market participants adjusted pricing and availability to protect themselves rather than incurring inappropriate risk by continuing to transact at traditional levels notwithstanding the troubles evident in the market.[26] Thus, the Federal Reserve's action in opening the reciprocal currency arrangements was taken not to stabilize the FX swap market, but instead to stabilize the broader market for U.S. dollars outside of the United States, of which the FX swap market was but a part. We do not believe that this episode should be construed as justifying regulation of FX swaps or FX forwards as swaps under the Dodd-Frank Act.

Transparency. As noted above and also in the Proposing Release, if NDFs are considered to be "foreign exchange forwards" as defined in the Dodd-Frank Act, and thus afforded the same exemption from the definition of swap under the CEA as physically settled FX forwards, both products would be subject to the new transactional reporting requirements, in each case as imposed by the Dodd-Frank Act, as well as the Commissions' enhanced anti-evasion authority and new business conduct standards. These changes will enhance regulatory transparency for the FX swap and forward markets, including NDFs. This would only be a positive step for the NDF market and would maintain congruity with physically settled FX forwards. In addition, indicative pricing for NDFs, like FX forwards, is regularly quoted on Bloomberg, Reuters and other publicly-available data dissemination services, in addition to the broker-to-broker and bank-to-bank pricing discussions that are common in the institutional capital markets.

Regulatory Oversight. In addition to the enhanced regulatory oversight that will apply to all products exempted from the definition of swap under the CEA as discussed above, banks, which are the key players in the FX market, are already subject to meaningful regulatory oversight. In addition, CLS Bank is regulated primarily by the Federal Reserve. To the extent transaction participants trade NDFs away from CLS Bank, bank counterparties will be subject to

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during the crisis, using non-U.S. currencies as a source for U.S. dollar funding. This would be a highly unusual, perhaps unprecedented, phenomenon.

25 Another example of market distortions caused by mismatches in supply and demand is the volatility experienced in the market for longer-dated U.S. treasury bonds when the U.S. government announced, on October 31, 2001, that it had decided to discontinue the issuance of 30-year treasury bonds. The announcement caused the yields on 30-year treasury bonds (which move inversely to the price of the bonds) to immediately drop 30 basis points and the yields on 10-year treasury bonds to immediately drop 12 basis points. These changes, which massively disrupted the markets for these securities, were not caused by any structural flaw in the markets for, or structure of, U.S. treasury bonds, but instead by a massive shift in supply and demand.

26 *See* Michael Melvin & Mark P. Taylor, *The Crisis in the Foreign Exchange Market*, CESIFO WORKING PAPER NO. 2707 (July 2009), at 14, *available at* http://www.ifo.de/portal/pls/portal/docs/1/1186164.PDF.

the same regulatory encouragement to utilize master netting agreements and credit support annexes as with respect to the physically settled FX forward market.[27]

Adequacy of Payment and Settlement Systems. We believe that the adequacy of payment and settlement systems for a given product should be evaluated against the actual settlement and counterparty risk inherent in that product. Adequate payment and settlement systems currently exist for the net settlement payment at maturity structure that is inherent in NDFs. CLS Bank can be utilized to settle NDFs that are executed in one of the 17 currencies currently settled through the CLS system.[28] By net settling through a regulated settlement system, the parties to a trade mitigate a portion of their settlement risk. In addition, bilateral cross-product settlement of NDFs and other FX transactions denominated in the same currency is offered by CLS Bank. By netting NDFs with other products involving the same counterparties, counterparty risk is reduced. In addition, a significant amount of NDF transactions are executed by banks or brokers on behalf of clients. These entities are currently subject to extensive regulation, including capital regulations, which enhance the protections afforded the counterparty on the other side of the trade. To the extent swap dealers are involved, upon adoption of regulations implementing aspects of the Dodd-Frank Act regarding swap dealers, similar obligations will be imposed. In addition, many of these transactions are settled internally pursuant to existing collateral or other arrangements. Such internal settlement eliminates settlement risk.[29] We believe that these factors support the conclusion that adequate payment and settlement systems are in place for NDFs to support the exclusion of this product from the definition of swap under the CEA.

Use to Evade. We are not aware of any factor that would lead market participants to structure trades not involving restricted currencies as NDFs to avail themselves of the exemption from swap status should the Secretary of the Treasury finalize the Proposed Treasury Determination and should the Commissions, as we propose, consider "foreign exchange forwards" to include NDFs, given that such a transaction would effectively constitute an FX forward transaction. For the same reasons enumerated in the Proposed Treasury Determination with respect to physically settled FX forwards, NDFs are also not structured to evade any CFTC rule promulgated pursuant to Section 721(c) of the Dodd-Frank Act.[30] Thus, we do not believe

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[27] As noted above, standard ISDA and IFEMA documentation accommodates NDF transactions as a subset of FX forwards.

[28] As noted in the Proposed Treasury Determination, CLS Bank has announced a program to expand settlement services by, among other goals, including additional currencies. Proposed Treasury Determination, *supra* note 1, at 25776.

[29] The dual exchange of principal at maturity in a physically settled FX forward results in heightened settlement risk as compared with the net settlement payment at maturity in an NDF. The availability of payment-versus-payment ("*PVP*") settlement via CLS Bank significantly abates settlement risk in physically settled FX forwards denominated in currencies currently settled through the CLS system.

[30] Proposed Treasury Determination, *supra* note 1, at 25781.

that including NDFs in the definition of FX forwards will create any form of loophole, particularly in light of anti-avoidance regulations relating to these instruments.

Potential Consequences if NDFs are Not Considered to be FX Forwards. If Treasury were to finalize the Proposed Treasury Determination and the Commissions, respectively, were to finalize proposed Rules 1.3(xxx)(v)(C) and 3a69-2(c)(5)(iii), the rulemakings would, in addition to having other unintended consequences, put U.S. corporations doing business in emerging markets at a disadvantage relative to U.S. corporations doing business solely in developed markets. As noted at the outset, NDFs are widely used by U.S. corporations that do business in emerging markets to hedge their exposure to the currencies of those markets. Regulating NDFs as swaps would significantly increase the cost of hedging these exposures, to the detriment of the competitiveness of these companies. For mutual funds and pension funds that utilize NDFs to hedge exposure to emerging market equity or debt securities, regulation of NDFs would increase hedging costs, and those increased costs would be borne primarily, perhaps exclusively, by the mutual fund investors and pension fund beneficiaries on behalf of whom these investments are made. At the same time, to the extent any end-user elected to refrain from entering into these hedges rather than incur the added costs to maintain them, additional risk would be introduced into the U.S. financial system. And again, to the extent that the U.S. regulatory approach to NDFs differs from that of other jurisdictions, U.S. banks that transact in NDFs could see this business migrate to other jurisdictions that may be perceived to be preferable from a regulatory (and thus economic) point of view. This could impair the competitiveness of U.S. financial institutions that trade in NDFs and risk the loss of jobs in this country.

As noted above, significant regulatory protections would become part of the NDF market if the swap exemption were to apply to those trades -- new transaction reporting, enhanced anti-manipulation provisions and new business conduct requirements. Also imposing margin, capital, mandatory central clearing and exchange trading and other attributes that would apply if NDFs were to be regulated as swaps would not appear to be warranted given the functional and economic congruity with physically settled FX forwards, the relatively small size of the NDF market and the combination of a net payment settlement structure and short duration trades. Imposing these requirements would also create operational difficulties for FX market participants engaging in both NDFs and FX forward transactions in deliverable currencies. These market participants would be forced to unnaturally bifurcate their FX forward business to address the different regulatory treatment of NDFs and physically settled FX forwards.

We also believe that mandating central clearing of NDFs would pose unusual and potentially costly risks. For example, a clearing organization could not, by definition, maintain capital in the respective underlying currencies to support its performance obligations, as the currencies are non-deliverable. Thus, the clearing organization would have to maintain capital denominated in a currency other than the currencies of its underlying obligations, introducing currency risk into a utility that is intended to abate, rather than create, risk for transaction participants.[31] This risk, as well as the cost to the clearing organization of managing it, would be borne by members of the clearing organization (or, in a failure situation, by counterparties and the U.S. financial system in general). Adopting a regulatory structure that creates this risk (and concomitant cost) would appear to be inconsistent with regulatory mandates that central clearing parties be structured so as to operate to reduce risk to the U.S. financial system.[32] It also appears to be unjustified from a cost-benefit point of view.

Finally, we note that it is important that the regulatory treatment of NDFs in the U.S. be consistent with that of other major financial center regulators such as the European Commission and the FSA and with that of the BIS.

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We submit the following responses to the specific requests for comment in the Proposing Release:

52. Should the proposed rules explicitly define the term "swap" to include foreign exchange forwards and foreign exchange swaps, unless the Secretary determines to exempt them? Should the proposed rules clarify that, if the Secretary determines to exempt foreign exchange swaps or foreign exchange forwards, those transactions remain subject to certain reporting requirements, and swap dealers and major swap participants entering into such transactions remain subject to certain business conduct standards, imposed by Title VII and CFTC regulations promulgated thereunder? Why or why not?

Although we have no objection to the explicit inclusion of foreign exchange forwards and foreign exchange swaps in the definition of "swap" should the Secretary of the Treasury not determine to exempt them (and we note that the term "foreign exchange swap" is explicitly included in the definition as it currently appears in the CEA), we believe that clause (A)(iii) of the "swap" definition adequately captures foreign exchange forwards (including NDFs). As there will always be specific products that fall within the definition but are not explicitly listed, we do not have a strong preference for or against explicitly listing foreign exchange forwards (including NDFs) in the definition of "swap."

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31 We note that CLS Bank provides only settlement services for NDFs; clearing occurs outside of CLS Bank, and thus CLS Bank does not face this risk.

32 Both the CEA and CFTC regulations require Designated Clearing Organizations ("*DCOs*") that centrally clear futures to manage risks posed by their clearing. *See* 7 U.S.C. §7a-1(c)(2)(D); *see also* DCO Core Principle D, 17 C.F.R. Pt. 39, App. A. The Dodd-Frank Act and regulations proposed thereunder reaffirm this risk management obligation. *See, e.g.,* Dodd-Frank Act, Pub. L. No. 111-203, §725(c), 124 Stat. 1376, 1687-92 (2010) (amending 7 U.S.C. § 7a-1(c)(2)(D)); Risk Management Requirements for Derivatives Clearing Organizations, 76 Fed. Reg. 3698, 3720 (Jan. 20, 2011) (to be codified at 17 C.F.R. § 39.13(a)).

We do not believe it will be necessary to clarify in the rules that, if the Secretary of the Treasury determines to exempt foreign exchange swaps or foreign exchange forwards, those transactions remain subject to certain reporting requirements, and swap dealers and major swap participants entering into such transactions remain subject to certain business conduct standards, imposed by Title VII and CFTC regulations promulgated thereunder. As the reporting obligations are imposed by the statute, there does not appear to be a need to repeat them in the rules.

54. Should the proposed rules explicitly define the term "swap" to include NDFs and clarify that NDFs are not foreign exchange forwards or foreign exchange swaps? Why or why not?

To the contrary, should the Secretary of the Treasury determine to exempt foreign exchange forwards and foreign exchange swaps from regulation as "swaps," for the reasons discussed above, we believe that NDFs should be captured in the exemption. The proposed rules should therefore clarify that NDFs are foreign exchange forwards.

56. Is additional detail needed within the proposed rules regarding foreign exchange-related products to provide greater clarity regarding the specific products listed in the proposed rules? If so, what additional detail would be necessary?

As discussed in footnote 4 above, we believe that a list of currencies that are non-deliverable and thus only traded on a forward basis using NDFs could easily be developed and maintained.

64. Should the Commissions provide additional guidance regarding CFDs? Why or why not? If so, please provide a detailed description of any particular CFD and what additional guidance would be necessary.

As discussed above, we believe that an NDF (or any other forward that is net settled) could be characterized as a CFD. Such characterization would create regulatory confusion by blurring the regulatory distinction between forwards and swaps. We thus believe that the Commissions should clarify that NDFs (and other net settled forwards) are not CFDs.

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We appreciate this opportunity to comment upon the Proposing Release. If we can be of any further assistance regarding these important issues, please feel free to contact the undersigned at 212-841-1060 or bbennett@cov.com.

Very truly yours,

Bruce C. Bennett

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