DEPARTMENT OF THE TREASURY

Determination of Foreign Exchange Swaps and Foreign Exchange Forwards under the Commodity Exchange Act

AGENCY: Department of the Treasury, Departmental Offices.

ACTION: Notice of Proposed Determination.

SUMMARY: The Commodity Exchange Act ("CEA"), as amended by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), authorizes the Secretary of the Treasury ("Secretary") to issue a written determination exempting foreign exchange swaps, foreign exchange forwards, or both, from the definition of a "swap" under the CEA. The Secretary proposes to issue a determination that would exempt both foreign exchange swaps and foreign exchange forwards from the definition of "swap," in accordance with the relevant provisions of the CEA and invites comment on the proposed determination, as well as the factors supporting such a determination.

DATES: Written comments must be received on or before [INSERT DATE THAT IS 30 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER], to be assured of consideration.

ADDRESSES: Submission of Comments by mail: You may submit comments to: Office of Financial Markets, Department of the Treasury, 1500 Pennsylvania Avenue N.W., Washington, DC, 20220.

Submission of Comments via regulations.gov: You are encouraged to submit comments electronically through the Federal eRulemaking Portal—"Regulations.gov." Go to *http://www.regulations.gov* to submit or view public comments. The Regulations.gov home page provides information on using Regulations.gov, including instructions for submitting or viewing public comments, viewing other supporting and related materials, and viewing the docket.

Please include your name, affiliation, address, e-mail address and telephone number(s) in your comment. In general, comments received will be posted on regulations.gov without change, including any business or personal information provided. Treasury will also make such comments available for public inspection and copying in Treasury's Library, Room 1428, Department of the Treasury, 1500 Pennsylvania Avenue, NW., Washington, DC 20220, on official business days between the hours of 10 a.m. and 5 p.m. Eastern Time. You can make an appointment to inspect comments by telephoning (202) 622-0990. Comments received, including attachments and other supporting materials, are part of the public record and subject to public disclosure. Do not include any information in your comment or supporting materials that you consider confidential or inappropriate for public disclosure.

FOR FURTHER INFORMATION CONTACT: Office of Financial Markets, 1500 Pennsylvania Avenue N.W., Washington, DC, 20220, (202) 622-2730, fxproposal@treasury.gov; Thomas E. Scanlon, Office of the General Counsel, 1500 Pennsylvania Avenue N.W., Washington, DC, 20220, (202) 622-8170.

SUPPLEMENTARY INFORMATION: Title VII of the Dodd-Frank Act[1] amends the CEA, as well as Federal securities laws, to provide a comprehensive regulatory regime for swaps. Section 721 of the Dodd-Frank Act amends section 1a of the CEA, which, in relevant part, defines the term "swap" under the CEA and includes foreign exchange swaps and foreign exchange forwards in the definition.[2] Section 1a(47)(E) of the CEA authorizes the Secretary to make a written determination that "foreign exchange swaps"[3] or "foreign exchange forwards,"[4] or both— (I) should not be regulated as swaps under the CEA; and (II) are not structured to evade the Dodd-Frank Act in violation of any rule promulgated by the Commodity Futures Trading Commission ("CFTC") pursuant to section 721(c) of the Dodd-Frank Act.[5]

On October 28, 2010, the Department of the Treasury ("Treasury") published in the Federal Register a Notice and Request for Comments ("October 2010 Notice") to solicit public comment on a wide range of issues relating to whether foreign exchange swaps and foreign exchange forwards should be exempt from the definition of the term "swap" under the CEA.[6] In addition, Treasury staff has engaged in a broad outreach to representatives from multiple market segments, as well as market regulators and the Federal regulatory agencies. After assessing the comments in response to the

[1] Pub. L. 111–203, title VII.

[2] 7 U.S.C. 1a(47).

[3] 7 U.S.C. 1a(25).

[4] 7 U.S.C. 1a(24).

[5] 7 U.S.C. 1(a)(47)(E)(i).

[6] 75 FR 66,426 (Oct. 28, 2010). Thirty comments were submitted in response to the October 2010 Notice.

October 2010 Notice, consulting with Federal regulators, and preliminarily considering the factors set forth in section 1b(a) of the CEA, as discussed below, the Secretary believes that proposing a determination to exempt all “foreign exchange swaps” and “foreign exchange forwards” from the definition of the term “swap” under the CEA is appropriate.

In making a determination pursuant to sections 1a(47)(E) and 1b of the CEA, the Secretary must consider the following 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 the CEA 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.[7]

[7] 7 U.S.C. 1b(a). In addition, section 1b(b) of the CEA provides that, “[i]f the Secretary makes a determination to exempt foreign exchange swaps and foreign exchange forwards from the definition of the term ‘swap’,” the Secretary must submit a separate “determination” to the appropriate committees of Congress, which contains (1) an explanation why foreign exchange swaps and foreign exchange forwards are “qualitatively different from other classes of swaps” such that foreign exchange swaps and foreign exchange forwards are “ill-suited for regulation as swaps” and (2) an “identification of the objective differences of foreign exchange swaps and foreign exchange forwards with respect to standard swaps that warrant an exempted status” (i.e., as a result of the underlying “determination”).

Treasury is soliciting comment on this proposed determination,[8] as set forth below, which would exempt any foreign exchange swap and foreign exchange forward from the definition of the term "swap" under the CEA, as permitted by section 1a(47)(E) of the CEA.

I. Summary of Proposed Determination

The CEA, as amended by the Dodd-Frank Act, provides a comprehensive regulatory regime for swaps and derivatives, including a wide range of foreign exchange derivatives, such as foreign exchange options, currency swaps, or non-deliverable forwards ("NDFs"). Among other measures, this regulatory regime provides for clearing and exchange-trading requirements that are designed to mitigate risks, promote price transparency, and facilitate more stable, liquid markets for derivative instruments. In general, the payment obligations on currency swaps, interest rate swaps, credit default swaps, commodity swaps and other derivatives fluctuate in response to changes in the value of the underlying variables on which those derivative contracts are based. As a result, for most types of swaps and derivatives, the counterparties do not know their payment obligations and the full extent of their exposure throughout the life of the contract. Moreover, as the length of a swap or derivative contract increases, a party generally is exposed to greater counterparty credit risk. Settlement of most types of swaps and derivatives involves only payments of net amounts (not gross amounts) that are based on the change in value of the underlying variables. Given the features of most derivatives, including some types of foreign exchange derivatives, the clearing and

[8] 5 U.S.C. 553(b).

exchange-trading requirements under the CEA would mitigate the relevant risks, notably counterparty credit risks.

Foreign exchange swaps and forwards generally are subject to the requirements of the CEA. For these instruments, the most significant requirements under the regulatory regime enacted by the Dodd-Frank Act would be the potential for mandatory central clearing and exchange trading,[9] unless the Secretary makes a determination that foreign exchange swaps and forwards "(I) should not be regulated as swaps under [the CEA]; and (II) are not structured to evade [the Dodd-Frank Act] in violation of any rules promulgated by the [CFTC] pursuant to section 721(c) of the [Dodd-Frank Act]."[10]

The Secretary proposes to issue a determination to exempt foreign exchange swaps and forwards because of the distinctive characteristics of these instruments. As discussed below, unlike most other derivatives, foreign exchange swaps and forwards have fixed payment obligations, are physically settled, and are predominantly short-term instruments. This results in a risk profile that is different from other derivatives, as it is centered on settlement risk, rather than counterparty credit risk. Settlement risk in foreign exchange swaps and forwards already has been addressed through the extensive use of payment-versus-payment ("PVP") settlement arrangements. Even though central clearing could reduce counterparty credit risk, that risk is relatively small in the foreign exchange swaps and forwards market. Imposing central clearing and trading

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[9] 7 U.S.C. 2(h)(1)-(2). In general, this section provides that the CFTC must act for each swap, or a category of swaps, to be required to be cleared. In addition, the CEA provides several exceptions to the clearing and trading requirements and authorizes the CFTC to impose conditions or limitations on these exceptions.

[10] 7 U.S.C. 1a(47)(E)(i).

requirements under the CEA on foreign exchange swaps and forwards would introduce risks and operational challenges to the current settlement arrangements that significantly outweigh the marginal benefits.

A. Foreign Exchange Swaps and Forwards Differ in Significant Ways from Other Swaps and Derivatives

Under the CEA, a "foreign exchange swap" is narrowly defined as "a transaction that solely involves— (A) an exchange of 2 different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange" and "(B) a reverse exchange of [those two currencies] at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange."[11] Likewise, the CEA narrowly defines a foreign exchange forward as "a transaction that solely involves the exchange of 2 different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange."[12]

The Secretary's authority to issue a determination is limited to foreign exchange swaps and forwards and does not extend to other foreign exchange derivatives. Foreign exchange options, currency swaps, and NDFs may not be exempted from the CEA's definition of "swap" because they do not satisfy the statutory definitions of a foreign exchange swap or forward.

The payment obligations on foreign exchange swaps and forwards are fixed and predetermined. While the mark-to-market value of a position in a foreign exchange swap or forward may vary based on changes in the exchange rate, the actual settlement

[11] 7 U.S.C. 1a(25).

[12] 7 U.S.C. 1a(24).

amounts do not. These features make foreign exchange swaps and forwards more similar to funding instruments, such as repurchase agreements, which are not covered under the CEA. Businesses that sell goods in international trade, or that make investments in foreign countries, frequently ask their banks to arrange foreign exchange swaps and forwards to control the risk that their own country's currency will rise or fall against the other country's currency while the sale or investment is pending.

Foreign exchange swap and forward participants know their own and their counterparties' payment obligations and the full extent of their exposure throughout the life of the contract, whereas the counterparties to other derivatives contracts do not. Moreover, foreign exchange swap and forward contracts have a very short average length and, therefore, relative to other swaps and derivatives, create significantly lower levels of counterparty credit risk.

Settlement of foreign exchange swap and forward transactions requires the exchange of the full principal amount of the contract in two different currencies, whereas the payment obligations of most other derivatives are based on the incremental profit or loss on a transaction. The physical settlement requirement distinguishes foreign exchange swaps and forwards from other derivatives and contributes to a risk profile that is largely concentrated on settlement risk.

B. Settlement Risk Is the Main Risk and Already Is Effectively Mitigated

Settlement of foreign exchange swap and forward transactions requires the exchange of the full principal amount of the contract in two different currencies.[13]

[13] By contrast, the payment obligations of most other derivatives are based on the incremental profit or loss on a transaction and either party's payment may be made with a common currency.

Settlement risk is the risk that one party to a foreign exchange swap or forward transaction will deliver the currency it owes its counterparty, but not receive the other currency from its counterparty. In contrast to other derivatives, including the other foreign exchange derivatives discussed above, parties' ultimate payment obligations on a foreign exchange swap or forward are known and fixed from the beginning of the contract and involve the actual exchange of a predetermined amount of principal at settlement. The physical settlement requirement distinguishes foreign exchange swaps and forwards from other derivatives and contributes to a risk profile that is largely concentrated on settlement risk.

The foreign exchange swap and forward market relies on the extensive use of PVP settlement arrangements, which permit the final transfer of one currency to take place only if the final transfer of the other currency also takes place. These settlement arrangements do not guarantee the contract but prevent payment flows from occurring if either party defaults. CLS Bank International ("CLS"), the predominant PVP settlement system, currently provides settlement services for 17 currencies that represent 94 percent of the total daily value of foreign exchange swaps and forwards traded globally.

Currently, roughly 75 percent of the entire foreign exchange market is estimated to settle without settlement risk to either party. This figure includes trades settled by PVP arrangements, as well as trades that are settled without settlement risk. (Transactions that are internally settled between corporate affiliates, cash settled, or settled across a single-bank's books for its clients are not subject to settlement risk.) In the foreign exchange swaps and forwards market in particular, CLS estimates that it settles more than 50 percent of foreign exchange swap and forward transactions that are subject to settlement risk. The use of CLS has also been growing steadily since its introduction in 2002, and CLS has announced plans to further expand its settlement services to include additional currencies, increase volume capacity and add additional settlement times.

C. Foreign Exchange Swaps and Forwards Are Subject to Less Counterparty Credit Risk than Other Derivatives

Counterparty credit risk is the risk of economic loss if either party defaults on a contract. Counterparty credit risk increases with the length of a contract because that increases the length of time during which a counterparty could suffer from adverse developments. Foreign exchange swap and forward contracts have a very short average length. Sixty-eight percent of foreign exchange swap and forward contracts mature in less than a week, and 98 percent mature in less than a year. Other derivatives, such as interest rate swaps, generally have much longer maturity terms (e.g., between two and thirty years) than foreign exchange swaps and forwards, and thus pose significantly more counterparty credit risk than foreign exchange swaps and forwards.

Central clearing could provide foreign exchange swap and forward participants with further protection against the risk of default by their counterparties (i.e., the replacement cost of a transaction if a counterparty fails to perform). However, imposing a central clearing requirement on the foreign exchange swaps and forwards market raises two concerns. First, requiring central clearing may lead to combining clearing and settlement in one facility, which would create large currency and capital needs for that entity due to: (i) the sheer size and volume of the foreign exchange swaps and forwards market; and (ii) the fact that the central clearing facility would be effectively guaranteeing both settlement and market exposure to replacement cost. We believe that it is unlikely a central counterparty ("CCP") would be able to provide the settlement services required by this market, either directly or in conjunction with another service provider, such as CLS.

In addition, providing central clearing separately from settlement presents the second concern, namely: required clearing would disrupt the existing settlement process by introducing additional steps between trade execution and settlement that pose significant operational challenges. The existing settlement process for this market functions well and has been critical to mitigating this market's main source of risk. The operational challenges and potentially disruptive effects on the foreign exchange swaps and forwards market associated with adding a central clearing requirement for these instruments thus significantly outweigh the marginal benefits that central clearing would provide.

D. Key Players within the Foreign Exchange Market Already Are Subject to Oversight

Unlike the derivatives markets, banks are the key players in the foreign exchange swaps and forwards market. Roughly 95 percent of foreign exchange swaps and forwards transactions occur between banks acting either on their own behalf or on behalf of their clients. Banks are subject to consolidated supervision, and supervisors regularly monitor their foreign exchange related exposures, internal controls, risk management systems, and settlement practices.

The foreign exchange market itself also has long been subject to comprehensive and coordinated oversight, reflecting its unique characteristics and functioning. Since the introduction of floating exchange rates in the early 1970s, G10 central banks and regulators have undertaken strong and coordinated oversight measures for the foreign exchange market, given its critical role in monetary policy and the global payments system. This global strategy, which was launched in 1996 by the Bank for International Settlements ("BIS"), resulted in the design and implementation of CLS and other PVP settlement arrangements. The Federal Reserve regularly conducts reviews of the risk management and operational processes of major foreign exchange market participants. These reviews inform Basel Committee on Banking Supervision ("BCBS") and Committee on Payment and Settlement Systems ("CPSS") updates to bank supervisory guidelines on managing foreign exchange settlement risk.

E. The Foreign Exchange Swaps and Forwards Market Already Is Highly Transparent and Traded Over Electronic Trading Platforms

Foreign exchange swaps and forwards already trade in a highly transparent market. Market participants have access to readily available pricing information through multiple sources. Approximately 41 percent and 72 percent of foreign exchange swaps and forwards, respectively, already trade across a range of electronic platforms and the use of such platforms has been steadily increasing in recent years.[14] The use of electronic trading platforms provides a high level of pre- and post-trade transparency within the foreign exchange swaps and forwards market. Thus, mandatory exchange trading requirements would not significantly improve price transparency or reduce trading costs within this market.

F. Foreign Exchange Swaps and Forwards Will Be Subject to Additional Oversight Under the CEA

[14] BIS, Greenwich Associates, Oliver Wyman analysis.

Even if the Secretary determines that foreign exchange swaps and forwards should not be regulated as "swaps" under the CEA, that determination would not affect the application of other provisions of the CEA that will prevent evasion by market participants and improve market transparency. Commenters who oppose an exemption argue that it would create a large regulatory loophole that exacerbates systemic risk. However, all foreign exchange transactions would remain subject to the CFTC's new trade-reporting requirements, enhanced anti-evasion authority, and strengthened business-conduct standards. Notably, the creation of a global foreign exchange trade repository, plans for which are already underway, will dramatically expand reporting to regulators and the market more broadly.

II. Background and Statutory Considerations

A. Overview

(i) Foreign Exchange Swaps and Forwards Distinguished from Other Swaps

Foreign exchange swaps and forwards that would be exempt from the CEA's definition of "swap" under the determination are narrowly defined transactions that are qualitatively different from other derivatives. First, foreign exchange swaps and forwards involve the actual exchange of the principal amounts of the two currencies exchanged and are settled on a physical basis. Unlike many other derivative instruments (e.g., interest rate swaps) whose payment obligations fluctuate daily in response to changes in the values of underlying variables, such as interest rates, the payment obligations of foreign exchange swaps and foreign exchange forwards, as defined by the CEA, are fixed at the onset of the agreement and involve the actual exchange of full principal for settlement.

Second, in stark contrast to other derivatives, over 98 percent of foreign exchange swaps and forwards mature in less than one year, and 68 percent mature in less than one week. For example, interest rate swaps and credit default swaps generally have maturity terms between two and thirty years and five to ten years, respectively. Since counterparty credit risk increases as the length of a contract increases, foreign exchange swaps and forwards carry significantly lower counterparty credit risk.

Third, the use of foreign exchange swaps and forwards is distinct from other derivatives. Because of their unique structure and duration, as outlined above, foreign exchange swaps and forwards are predominantly used as short-term funding instruments similar to repurchase agreements and other money market instruments and for hedging foreign currency risks. Other derivatives, such as interest rate and currency swaps, are used for a broader range of purposes.

Fourth, foreign exchange swaps and forwards already trade in a highly transparent and liquid market. Market participants have access to readily available pricing information through multiple sources.[15] Approximately 41and 72 percent of foreign exchange swaps and forwards, respectively, already trade across a range of electronic platforms.[16] As a result, mandatory exchange trading requirements under the CEA would be unlikely to improve price transparency significantly.

These distinguishing characteristics of foreign exchange swaps and forwards result in a risk profile that is largely concentrated on settlement risk, rather than

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[15] See, e.g., comment by Global FX Division of the Securities Industry and Financial Markets Assoc., Assoc. for Financial Markets in Europe, and the Asia Securities Industry and Financial Markets Assoc. ("Global FX Division"), at 11.

[16] BIS, Greenwich Associates, Oliver Wyman analysis.

counterparty credit risk. Settlement risk is effectively addressed in the market for foreign exchange swaps and forwards by the extensive use of CLS and other PVP settlement arrangements. PVP is a foreign exchange settlement mechanism that ensures that a final transfer of one currency occurs only if a final transfer of the other currency (or currencies) takes place, thereby virtually eliminating settlement risk. CLS is a specialized settlement system that operates a multilateral PVP settlement system to reduce foreign exchange settlement risk (but not credit risk, which is mitigated by other measures). CLS, which began operations in September 2002, is now the predominant global PVP settlement system. It currently provides settlement services for 17 currencies, which represent 94 percent of the total daily value of currencies traded globally. CLS estimates that it settles 58 percent of global foreign exchange trading, through 60 settlement member banks and approximately 9,000 third-party users. According to a September 2010 Foreign Exchange Committee ("FXC")[17] survey, roughly 75 percent of foreign exchange transactions are settled without settlement risk to either party. This figure includes trades settled by CLS, settled between affiliates of the same corporation, and settled across a single bank's books for its clients.

<u>(ii) Implications of a Determination to Exempt Foreign Exchange Swaps and Forwards from the Term "Swap" under the CEA</u>

If the Secretary issues a written determination to exempt foreign exchange swaps or forwards, or both, from the definition of a "swap" under the CEA, these transactions,

[17] Formed in 1978 under the sponsorship of the Federal Reserve Bank of New York, the FXC is a an industry group that produces best practice recommendations for the foreign exchange industry, addressing topics such as management of risk in operations and trading.

as well as certain parties that engage in these transactions, would not be subject to some requirements under the CEA, notably the clearing and exchange-trading requirements.

However, even if the Secretary issues such a determination, foreign exchange swaps and forwards and the parties to such transactions would still be subject to trade reporting requirements, business conduct standards (including the anti-fraud provision) in section 4s(h) of the CEA and the rules promulgated thereunder by the CFTC, and anti-evasion requirements promulgated by the CFTC. In this regard, section (c) of the proposed determination— which reflects the language of section 1a(47)(E)(iii)-(iv), 1b(c) of the CEA—would provide that, notwithstanding this determination, certain requirements under the CEA would apply to any foreign exchange swap or foreign exchange forward, or to any party engaged in such a transaction, to the extent provided by such requirements.

In addition, Treasury notes that section 1a(47)(F) of the CEA contains two other provisions applicable to foreign exchange swaps and foreign exchange forwards. First, subparagraph (47)(F)(i) provides that "[a]ny foreign exchange swap and any foreign exchange forward that is listed and traded on or subject to the rules of a designated contract market or a swap execution facility, or that is cleared by a derivatives clearing organization, shall not be exempt from any provision of [CEA], or the amendments under [Title VII of the Dodd-Frank Act] prohibiting fraud or manipulation."[18] Second, "[n]othing in subparagraph (E) [which authorizes the Secretary to issue such a determination] shall affect, or be construed to affect, the applicability of

[18] 7 U.S.C. 1a(47)(F)(i).

[the CEA] or the jurisdiction of the [CFTC] with respect to agreements, contracts, or transactions in foreign currency pursuant to section 2(c)(2) [of the CEA]."[19]

(iii) Summary of Comments in Response to October 2010 Notice

Commenters who support issuing an exemption generally argue that foreign exchange swaps and forwards are functionally different from other over-the-counter ("OTC") derivatives because foreign exchange swaps and forwards, as defined by the CEA, involve an actual exchange of principal, are predominantly very short in duration and have high turnover rates. These commenters note that this market functions predominantly as a global payments market and is used significantly by end-users for hedging purposes.[20] Many corporate participants expressed concern that the additional costs associated with clearing foreign exchange swaps and forwards would adversely impact their business activities and discourage hedging activity. These commenters also cautioned that imposing mandatory clearing and exchange trading requirements on the foreign exchange market would increase systemic risk by concentrating risk in one or more clearinghouses. They also noted that central clearing could negatively affect U.S. dollar liquidity and threaten the role of the dollar as the world's reserve currency, citing the potential that such requirements could push foreign exchange transactions further offshore and challenge the Federal Reserve's ability to conduct monetary policy.

[19] 7 U.S.C. 1a(47)(F)(ii) (referring, in turn, to 7 U.S.C. 2(c)(2)).

[20] See comment by 3M, Cargill Inc. et al., at 2.

Settlement risk, they argue, is the primary risk associated with foreign exchange swaps and forwards, and they state that the settlement of trades through CLS has largely addressed these concerns.[21]

Given the short duration of foreign exchange swaps and forwards, most commenters emphasized that counterparty credit risk is not as significant a risk for these transactions (relative to other derivative transactions) and that the use of credit support annexes ("CSAs") and standard ISDA documentation mitigates this risk.

Moreover, commenters who favor an exemption maintain that foreign exchange swaps and forwards generally trade in a heavily liquid, efficient, and transparent inter-bank market, where bank regulators have substantial visibility and exercise strong regulatory oversight over the major market participants, which generally consist of either depository institutions or affiliates of depository institutions. A number of these commenters also stressed that the Federal Reserve has ample authority to craft appropriate regulations governing systemically important financial market utilities and payment, clearing, and settlement activities under Title VIII of Dodd-Frank Act. These commenters also cite the effective functioning of the foreign exchange market during the financial crisis of 2008.

In contrast to these views, commenters who oppose an exemption for foreign exchange swaps and forwards are primarily concerned that the exemption would create a large regulatory loophole, citing the large size of this market, as well as the lack of a fundamental economic difference, in their view, between foreign exchange swaps and

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[21] See, e.g., comment by Global FX Division, at 12-14.

forwards and other derivative products.[22] In light of the recent financial crisis, these commenters argue that such loopholes can play a significant role in undermining financial stability by preserving an opaque, unregulated and under-capitalized market. Opponents also express concerns that an exemption could be used to mask complex transactions in an effort to avoid subjecting them to clearing and trading requirements.

B. Statutory Factors

As discussed above, in considering whether to exempt foreign exchange swaps and forwards from the definition of the term "swap," the Secretary must consider five factors. Treasury is continuing to consider each of these statutory factors and invites comment on the analysis of each of these factors, as follows.

(i) Systemic Risk, Transparency, Financial Stability

Treasury has considered several factors to assess 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. Treasury believes that, given the reduced counterparty credit risk profile of this market, the challenges of implementing central clearing within this market significantly outweigh the marginal benefits that central clearing and exchange trading would provide.

Regulating foreign exchange swaps and forwards under the CEA would require insertion of a CCP into an already well-functioning and highly interconnected settlement process, which could result in unnecessary operational and settlement challenges. Other derivative transactions, such as interest rate swaps and credit default swaps, create settlement obligations that equal only the change in the market price of the notional value

[22] See, e.g., comment by Council for Institutional Investors, at 1-2.

of the underlying instrument—not the full principal amounts—and, thus, result in much smaller daily payment obligations for those markets. While the existing CLS and other PVP settlement systems protect against the risk of principal loss in the foreign exchange swaps and forwards market, central clearing would further protect participants against the economic loss of profit on a transaction. However, combining these two functions in a market that involves settlement of the full principal amounts of the contracts would require massive capital backing in a very large number of currencies, representing a much greater commitment for a potential CCP than for any other derivatives market.

To date, no CCP has developed a practical solution to guarantee the extraordinarily large volumes of transactions in foreign exchange swaps and forwards, including provision of or coordination with the settlement services that are essential to the foreign exchange swaps and forwards market. Introducing a central clearing facility without settlement capabilities would not improve market functioning; instead, requiring central clearing would raise unnecessary operational challenges by introducing additional steps between trade execution and settlement. Given that any risks created through the increased complexity would be magnified by the number of currencies involved, among other factors, Treasury believes that requiring the use of a CCP for clearing foreign exchange swaps and forwards is not warranted, particularly because existing settlement arrangements currently function well and address the main source of risk, settlement risk.

In response to the October 2010 Notice, end-users of foreign exchange swaps and forwards have expressed significant concern that requiring centralized clearing would substantially increase the costs of hedging foreign exchange risks. Commenters argue that additional costs associated with collateral, margin, and capital requirements required by the CCP would potentially reduce their incentives to manage foreign exchange risks.[23] Such additional costs borne by non-financial end-users could lead to lower cash flows or earnings, which would divert financial resources from investment and discourage international trade, thereby limiting the growth of U.S. businesses.[24] Several commenters also suggest that requiring centralized clearing of foreign exchange swaps and forwards could lead non-financial end-users to move production facilities overseas in order to establish "natural hedges" through the consistent use of local currencies and force them to reconsider the use of CLS in light of the additional costs associated with central clearing.[25]

As noted above, the market for foreign exchange transactions is one of the most transparent and liquid global trading markets. Pricing is readily available through multiple sources and a large portion of foreign exchange trades currently are executed through electronic trading platforms.[26]

In light of these and similar factors raised by the commenters, Treasury believes that mandating centralized clearing and exchange trading under the CEA for foreign

[23] See, e.g., comment by National Assoc. of Manufacturers, at 4.

[24] See, e.g., comment by 3M, Cargill Inc. et al., at 6.

[25] See, e.g., comment by Coalition for Derivatives End-Users, at 16-17.

[26] Furthermore, Treasury understands that plans are being made for the creation of at least one global foreign exchange trading repository pursuant to section 21 of the CEA (7 U.S.C. 24a, as added by section 728 of the Dodd-Frank Act), which will dramatically expand reporting coverage for swaps, including foreign exchange swaps and forwards, regardless of whether the Secretary issues a determination that these transactions should not be regulated as "swaps" under the CEA. 75 FR 76,574 (Dec. 8, 2010). (In its proposed rule regarding swap data recordkeeping and reporting requirements, the CFTC explains that, for the purposes of reporting requirements, foreign exchange swaps and forwards would be included within the category of "currency swap." Id. at 76,586. The CFTC also has proposed rules relating to the registration and regulation of swap data repositories that would adopt new part 49 of the CFTC's regulations, 17 CFR Part 49. See CFTC, Notice of Proposed Rulemaking: Swap Data Repositories, 75 FR 80898 (Dec. 23, 2010)).

exchange swaps and foreign exchange forwards actually would introduce significant operational challenges and potentially disruptive effects in this market which would outweigh any marginal benefits for transparent trading or reducing risk in these instruments.

(ii) Regulatory Scheme Comparable to That of the CEA

Treasury has considered several factors to assess whether foreign exchange swaps and foreign exchange forwards are already subject to a regulatory scheme that is materially comparable to that established by the CEA for other classes of swaps.

Since the introduction of floating exchange rates in the early 1970s, central banks and regulators have undertaken strong and coordinated oversight measures for the foreign exchange market because of the critical role this market plays in the conduct of countries' monetary policy. More specifically, in 1996, the Bank for International Settlements ("BIS") launched a globally coordinated strategy on behalf of the G10 central banks, calling for specific actions by individual banks, industry groups and central banks to address and reduce risk in the foreign exchange market. This strategy has resulted in specific actions undertaken to address settlement risk, mitigate counterparty credit risk and develop global supervisory guidelines on managing foreign exchange risk. Largely as a result of these measures, many market observers note that the foreign exchange market was one of the few parts of the financial market that functioned effectively throughout the financial crisis.[27]

One of the key goals of this work was to expand the use of PVP settlement systems. Such systems largely eliminate settlement risk, which is the predominant risk in

[27] See, e.g., comment by Global FX Division, at 11-12.

a foreign exchange swap or forward. As noted, PVP settlement ensures that the final transfer of one currency occurs only if a final transfer of the other currency or currencies takes place, thereby virtually eliminating settlement risk. In order to support such PVP arrangements, central banks undertook significant actions by extending operating hours, providing cross-border access to central bank accounts and enhancing the legal certainty around such settlement arrangements.

The creation of CLS was the most successful outcome of this work. As noted earlier, CLS is the predominant PVP settlement system, settling the majority of all global foreign exchange transactions in 17 currencies, through 60 settlement member banks and approximately 9,000 third party users.[28]

A comparable regulatory scheme applies to the settlement system conducted through CLS. While the Federal Reserve is the primary regulator for CLS, a CLS Oversight Committee[29] consisting of 22 central banks was established to provide coordinated oversight of CLS by all central banks whose currencies are settled through its system. As a result of this group's efforts, each participating central bank now maintains accounts for CLS and has created a window period during which real-time gross settlement systems are open to accommodate the funding necessary for the settlement of payment instructions. This group has also developed a set of risk management tests that CLS must apply to each instruction it submits for settlement to mitigate the associated credit, market and liquidity risks.

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[28] See, e.g., www.cls-group.com.

[29] Federal Reserve Board, "Protocol for Cooperative Oversight Arrangement for CLS," Nov. 25, 2008, available at http://www.federalreserve.gov/paymentsystems/cls_protocol.html.

In addition, Treasury notes that the established regulatory scheme also actively encourages the use of CSAs and master netting agreements to reduce counterparty credit exposures. Similar to changes made to enable the use of PVP settlement arrangements, central banks and governments worked to strengthen the legal foundations of bilateral and multilateral netting. Master netting agreements mitigate credit risk by enabling closeout netting in the event of a default or bankruptcy. CSAs can also be negotiated as a supplement to master agreements to further reduce and mitigate exposures to counterparties by collateralizing transactions.

(iii) Adequacy of Supervision

Treasury also has assessed the extent to which bank regulators supervise participants in the foreign exchange market, including by imposing capital and margin requirements.

The predominant participants in the foreign exchange swaps and forwards market are banks which have long been subject to prudential supervision. In fact, nearly all trading within the foreign exchange market involves bank counterparties. Roughly 95 percent of foreign exchange trading occurs between banks acting in the capacity of either principal or agent. Compared to non-bank entities, banks have distinct advantages to provide the liquidity and funding necessary to conduct foreign exchange swaps and forwards, which involve the exchange of principal, rather than variable cash flows. In conjunction with providing the liquidity and funding needs to conduct these transactions, banks are uniquely qualified to have access to CLS to settle transactions on a real-time basis, and thereby meet the payment and short-term funding needs of the end users. Prudential supervisors regularly monitor the activities, exposures, internal controls and risk management systems of these banks.[30] In order to meet safety-and-soundness requirements, banks have implemented monitoring systems, limits, internal controls, hedging techniques, and similar risk-management measures. Counterparty credit risk management is a fundamental issue for banking supervisors and is extensively addressed in bank supervisory guidelines as well as under the Basel Accords. In addition, CLS itself is subject to comprehensive oversight by 22 central banks whose currencies are settled through its system.

As an example of the continuing supervisory efforts in this market, the Federal Reserve will conduct an assessment of current risk management practices, in conjunction with other jurisdictions, in order to better inform the development of supervisory guidance covering the use of CLS, CSAs, and other systems and controls. Treasury understands that this process might ultimately highlight the need for any additional supervisory or regulatory action, including potential actions under Title VIII of the Dodd-Frank Act. This review will inform BCBS and CPSS updates to bank supervisory guidelines on managing foreign exchange settlement risk.

In addition to the supervisory measures discussed above, the OTC Derivatives Supervisors Group, which includes market and banking regulators from the U.S., France, Germany, Japan, Switzerland and the U.K., has been securing commitments from market participants since 2005 to strengthen market infrastructure, risk management practices, and transparency in the OTC derivatives market. This group is currently engaged with

[30] See, e.g., supervisory and examination standards for wholesale payments systems developed by the Federal Financial Institutions Examination Council, available at http://ithandbook.ffiec.gov/it-booklets/wholesale-payment-systems/wholesale-payment-systems-risk-management.aspx.

foreign exchange industry groups and market participants, such as the FXC, to secure and monitor new commitments that advance risk management in this market.

(iv) Adequacy of Payment and Settlement Systems

Treasury also has assessed the extent of adequate payment and settlement systems for foreign exchange swaps and forwards. With respect to this factor, as noted, the G10 strategy successfully resulted in the establishment of PVP settlement systems to virtually eliminate the settlement risk associated with foreign exchange swaps and forwards, with CLS being the primary example of this work. Central banks undertook significant actions to support these robust PVP settlement arrangements. As a result, roughly 75 percent of notional foreign exchange is either settled through CLS or otherwise settled without risk, including trades that are settled between affiliates of the same corporation or across a single bank's books for its clients. In the foreign exchange swaps and forwards market in particular, CLS estimates that it settles more than 50 percent of foreign exchange swap and forward transactions that are subject to settlement risk. Furthermore, CLS has announced a multi-year strategic objective to expand settlement services to include additional currencies, increase volume capacity, and add additional settlement times. Treasury understands that the Federal Reserve and the CLS Oversight Committee are currently reviewing these plans, as well as encouraging the expansion of other PVP settlement services.

(v) Possible Use of Exemption to Evade Requirements

Treasury has considered several factors to assess whether the use of an exemption for foreign exchange swaps and foreign exchange forwards could be used to evade otherwise applicable regulatory requirements. Treasury believes that the unique characteristics of foreign exchange swaps and foreign exchange forwards, as defined by the CEA, make it difficult for these products to be structured to replicate currency or interest rate swaps to evade regulatory requirements under the CEA.

Unlike other types of swaps, foreign exchange swaps and forwards are distinct because, as defined by the CEA, these transactions must (1) involve the exchange of the principal amounts of the two currencies exchanged, as opposed to an additional set of cash flows based upon some floating reference rate (e.g. LIBOR), and (2) be settled on a physical basis.[31]

A "swap" regulated under the CEA, such as a currency swap, interest rate swap, or other derivative, generally involves a periodic exchange of a floating amount of cash flows between the counterparties based on some notional amount, whereas a foreign exchange swap (which would be exempt from the definition of "swap" under this determination) involves a simple exchange of principal at one point in time and a reversal of that exchange at some later date. For example, a user of a currency swap could seek funding advantages by obtaining financing in a foreign currency and swapping those cash flows back to the user's locally denominated currency. This would then entail paying or receiving a series of floating interest rate payments (i.e., based on prevailing interest rates) over the life of the transaction. This ability to receive periodic payments during the term of a transaction is a significant feature of "swaps" that will be regulated under the CEA, which is absent from a foreign exchange swap or foreign exchange forward.

[31] In this regard, Treasury notes that, in other swaps transactions, the parties may, by agreement, physically settle their obligations.

While there is a possibility that foreign exchange swaps could be used by some market participants to speculate on the short term path of interest rates, Treasury believes that the operational challenges and transaction costs associated with transforming these instruments to replicate currency or interest rate swaps significantly reduce the likelihood that market participants would actually do so in order to evade regulatory requirements under the CEA.

To begin with, the transactions costs associated with replicating currency swaps through the use of foreign exchange swaps would likely be significant because a market participant would need to regularly roll over its foreign exchange swap position as it seeks to replicate a currency swap. For example, a participant would need to consider the costs associated with the series of separate bid-ask spreads accompanying each of the foreign exchange swap transactions, as well as the costs of monitoring those positions. Moreover, whether a participant would structure foreign exchange swap transactions in order to replicate other, non-exempt swaps that are subject to central clearing requirements would be highly dependent on the costs associated the operational or systems arrangements necessary to execute the foreign exchange swap transactions, relative to the costs imposed by CCPs to clear the other, non-exempt swap transactions (such as margin costs), which could vary among market participants.

Importantly, a determination to exempt foreign exchange swaps and forwards from regulation as “swaps” under the CEA would not affect the application of other provisions that will prevent evasion by market participants and improve market transparency. Opponents of an exemption argue that such a determination would create a large regulatory loophole that exacerbates systemic risk. However, all foreign exchange swaps and forwards would remain subject to the CFTC's new trade-reporting requirements, enhanced anti-evasion authority, and strengthened business-conduct standards for swaps dealers and major swap participants.[32] Notably, the creation of global foreign exchange trade repositories, plans for one of which already are underway, will dramatically expand reporting to regulators and the market more broadly. This additional reporting will also provide regulators with information that can be used to detect attempts by market participants to use foreign exchange swaps or forwards to replicate other derivatives in order to evade regulatory requirements. Lastly, the Dodd-Frank Act amends the CEA and other laws to provide other measures to enhance oversight of key players in the swaps market, which will further reduce the risk that foreign exchange swaps and forwards could be used to evade regulatory requirements.

III. Procedural Analysis

A. Executive Order 12866 and Executive Order 13563

Executive Orders 13563 and 12866 direct agencies to assess all costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility. This rule has been designated a "significant regulatory action" although not economically significant, under section 3(f)

[32] In addition, Treasury notes that section 753 of the Dodd-Frank Act amends section 6(c) of the CEA to provide, in relevant part, that "it shall be unlawful for any person, directly or indirectly, to manipulate or attempt to manipulate the price of any swap, or of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity." 7 U.S.C. 9, 15.

of Executive Order 12866. Accordingly, the rule has been reviewed by the Office of Management and Budget.

B. Regulatory Flexibility Act

The Regulatory Flexibility Act (5 U.S.C. 601 et seq.) generally requires agencies to prepare a regulatory flexibility analysis unless the agency certifies that the rule will not have a significant economic impact on a substantial number of small entities. It is hereby certified that this determination would not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that entities that engage in foreign exchange swaps and forwards, as defined by the CEA and as described in this proposed determination, tend to be large entities. Accordingly, a regulatory flexibility analysis is not required. Notwithstanding this certification, Treasury invites comments on the impact on small entities.

IV. Proposed Determination

For the reasons set forth in sections I and II, which are incorporated into and made part of this section IV, the Secretary proposes to issue a determination, as follows:

(a) Authority and purpose. This determination is issued under section 1a(47)(E) and 1b of the Act in order to implement the provisions of the Act relating to the treatment of foreign exchange swaps and foreign exchange forwards as swaps under the Act.

(b) Findings and exemption. (1) Considerations. The Secretary has considered—

(i) 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, and finds that the required trading and clearing of these instruments would introduce new challenges and could result in negative consequences, without improving transparency;

(ii) 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, and finds that the regulatory scheme for foreign exchange swaps and foreign exchange forwards applicable in the U.S., as well as the regulatory schemes in other jurisdictions, have required specific actions that address settlement risk, mitigate counterparty credit risk, and manage other risks associated with foreign exchange swaps and forwards;

(iii) The extent to which bank regulators of participants in the foreign exchange market provide adequate supervision, including capital and margin requirements, and finds that regulators are adequately supervising these participants, in part by requiring the implementation of risk-management and operational processes, including the use of payment-versus-payment settlement arrangements for settling transactions and the adoption of credit support annexes with counterparties;

(iv) The extent of adequate payment and settlement systems, and finds that these systems are adequate for foreign exchange swaps and foreign exchange forwards, particularly because a specialized settlement system, which is subject to Federal oversight, has proven capabilities to settle the majority of all global foreign exchange transactions in multiple currencies; and

(v) The use of a potential exemption of foreign exchange swaps and foreign exchange forwards to evade otherwise applicable regulatory requirements, and finds that foreign exchange swaps and foreign exchange forwards, as defined under the Act, are distinguished from other derivatives, widely used by supervised banks for bona fide funding transactions, and not likely to be used to evade otherwise applicable regulatory requirements because of operational and transactions costs associated with potentially transforming these instruments into other derivatives that are subject to regulatory requirements under the Act.

(2) Exemption. Upon consideration of each of the factors set forth in section 1b of the Act, the Secretary finds that—

(i) Foreign exchange swaps and foreign exchange forwards should not be regulated as swaps under the Act; and

(ii) Foreign exchange swaps and foreign exchange forwards are not structured to evade the requirements of the Dodd-Frank Act, in violation of any rule promulgated by the Commission, pursuant to section 721(c) of the Dodd-Frank Act (15 U.S.C. 8321)—and, accordingly, hereby determines that any foreign exchange swap or foreign exchange forward hereby is exempt from the definition of the term "swap" under the Act.

(c) Scope—As provided in sections 1a(47)(E) and 1b(c) of the Act—

(1) Reporting. Notwithstanding this determination, all foreign exchange swaps and foreign exchange forwards shall be reported to a either a swap data repository or, if there is no swap data repository that would accept such swaps or forwards, to the Commission, pursuant to section 4r of the Act (7 U.S.C. 6r) within such time period as the Commission may by rule or regulation prescribe.

(2) Business standards. Notwithstanding this determination, any party to a foreign exchange swap or forward that is a swap dealer or major swap participant (as such terms are defined under the Act or under section 721(c) of the Dodd-Frank Act

(15 U.S.C. 8321)) shall conform to the business conduct standards contained in section 4s(h) of the Act (7 U.S.C. 6s(h)).

(3) Effect of determination. This determination shall not exempt any foreign exchange swap or foreign exchange forward traded on a designated contract market or swap execution facility from any applicable antimanipulation provision of the Act.

(d) Definitions.

For the purposes of this determination, the following definitions apply:

(1) Act means the Commodity Exchange Act.

(2) Commission means the Commodity Futures Trading Commission.

(3) Dodd-Frank Act means the Dodd-Frank Wall Street Reform and Consumer Protection Act.

(4) Foreign exchange forward shall have the same meaning as in section 1a(24) of the Act.

(5) Foreign exchange swap shall have the same meaning as in section 1a(25) of the Act.

(6) Swap shall have the same meaning as in section 1a(47) of the Act.

Dated: April _____, 2011.

[signed]

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Alastair Fitzpayne
Deputy Chief of Staff and Executive Secretary

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