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June 6, 2011

Ms. Mary J. Miller
Assistant Secretary for Financial Markets
United States Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

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

Dear Ms. Miller:

The Investment Company Institute[1] welcomes the opportunity to provide comments to the Department of the Treasury ("Treasury") regarding its proposed determination to exempt foreign exchange ("FX") swaps and FX forwards from the definition of "swap" under the Commodity Exchange Act ("CEA").[2] As participants in the FX swaps and forwards market, our members have a strong interest in ensuring that these markets are suitably regulated to maintain highly competitive, transparent, fair, and efficient operations. Pursuant to Section 721(a)(21) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"),[3] the Treasury has proposed to issue a written determination exempting FX swaps and forwards from the definition of swap because the "unique characteristics and oversight of the FX swaps and forwards market already reflect many of Dodd-Frank's objectives for reform – including high levels of transparency, effective risk management, and financial stability." We strongly support the Treasury's proposed determination.

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[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs) (collectively "funds"). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $13.41 trillion and serve over 90 million shareholders.

[2] *See* Determination of Foreign Exchange Swaps and Foreign Exchange Forwards under the Commodity Exchange Act, 76 FR 25774 (May 5, 2011) ("Notice").

[3] *See* Section 1a(47)(E) of the Commodity Exchange Act, as amended by the Dodd-Frank Act.

I. Background

The proposed determination would provide a narrow exemption from certain of the Dodd-Frank Act requirements for a limited class of FX derivatives. Specifically, FX swaps and forwards would be exempt from the Act's clearing and exchange trading requirements. They would remain subject, however, to the trade reporting requirements, business conduct standards for swap dealers and major swap participants, and, for those transactions which are traded on a designated contract market or swap execution facility, enhanced anti-fraud and anti-manipulation rules. We believe this division of regulatory oversight strikes the appropriate balance in light of the existing regulatory regime, transparency and operation of the FX swaps and forwards market. Further, by providing only limited relief, the exemption should restrict the ability of market participants to evade regulatory requirements imposed by the CEA. For example, imposition of the reporting requirements will permit the Commodity Futures Trading Commission ("CFTC") to conduct surveillance of the FX swaps and forwards market, including monitoring risks.

II. Factors Supporting Exemption

We agree with the Treasury's assessment that the risk profile for the FX swaps and forwards market is "markedly different" from other derivatives markets and therefore warrants the proposed exemption. As identified by the Treasury, the primary differences in the risk profile stem from the fact that FX swaps and forwards have fixed payment obligations, are physically settled, and are predominantly short-term instruments – all features that mitigate risk and help ensure stability.[4] In reaching its proposed determination to exempt FX swaps and forwards, the Treasury was required by the Dodd-Frank Act to consider the following factors:

- Required trading and clearing of FX swaps and forwards would not create systemic risk, lower transparency, or threaten the financial stability of the United States;
- FX swaps and forwards are already subject to a regulatory regime that is materially comparable to that established by the CEA for other classes of swaps;
- Participants in the FX market are adequately supervised;
- Payment and settlement systems for FX swaps and forwards are adequate, particularly due to the role of the CLS; and

[4] We agree with the Treasury's assessment that these characteristics of FX swaps and forwards result in a risk profile that is focused largely on settlement risk, which is effectively addressed by the extensive use of the "payment-versus-payment" ("PVP") settlement system, of which CLS Bank International ("CLS") is the predominant system.

- An exemption for FX swaps and forwards could not be used to evade otherwise applicable regulatory requirements.

ICI concurs with the Treasury's analysis in the Notice regarding each of these factors and believes that sufficient safeguards already exists in the FX swaps and forwards market.

Indeed, we are concerned that, as discussed in the Notice, imposing central clearing and exchange trading requirements on the FX swaps and forwards market could threaten practices in this market that help limit risk and ensure that the market functions effectively. For example, requiring central clearing could increase systemic risk by concentrating risk in one or more clearinghouses. Imposing trading requirements could inhibit transparency if there was insufficient information to support quotes for customized trades and for the market to determine an appropriate market price. Such a quote could grow stale sitting on an exchange waiting to attract a bidder. Further, the increased difficulty and costs for market participants to manage their currency exposures, if they generally are limited to using standardized FX swaps and forwards because of clearing and trading requirements, likely would translate to increased risk to the financial system.

Moreover, central clearing and exchange trading are unlikely to meaningfully lower settlement risk in this market. Banking regulators have a long history and extensive experience in monitoring the FX swaps and forwards market and its major market participants. If necessary, the Federal Reserve Board of Governors could exercise authority to enhance the workings of the CLS or other PVP settlement systems.[5] In addition, the FX swaps and forwards market is highly transparent, with much of the market trading across electronic platforms. These platforms provide market participants with a high level of pre- and post-market transparency, enhancing pricing information, liquidity and efficiency in this market. Ultimately, the risks and operational challenges of adopting central clearing and trading practices would significantly outweigh the benefits by undermining the safety and efficiencies of the existing FX swaps and forwards market.

III. Extend Exemption to Non-Deliverable Forwards

The proposed determination would not include non-deliverable forwards ("NDFs") within the exemption because such FX derivatives do not satisfy the statutory definition of FX forward. Under Title VII of the Dodd-Frank Act, an FX forward is a transaction that solely involves the exchange of two different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange.[6] ICI believes that a reasonable interpretation of the definition of FX forward should include NDFs; limiting the definition to deliverable trades simply because the

[5] Under Title VIII of the Dodd-Frank Act, the Board of Governors has the authority to enhance the regulation and supervision of systemically important financial market entities. *See* Section 802 of the Dodd-Frank Act.

[6] *See* Section 1a(24) of the Commodity Exchange Act, as amended by the Dodd-Frank Act.

definition mentions the "exchange" of two different currencies takes a too restrictive reading. As with FX swaps and forwards more broadly, the minimal benefits to overseeing systemic risk from including NDFs within the central clearing and exchange trading regime do not justify the costs of narrowly interpreting the definition of FX forward to exclude NDFs. Consequently, we recommend that the Treasury modify its proposed determination to clarify that the term "foreign exchange forwards" includes both deliverable and non-deliverable forwards.[7]

NDFs are economically and functionally identical to FX forwards despite the fact that they are cash settled in just one currency and do not involve the exchange of underlying currencies because of currency controls or local law restrictions in certain foreign jurisdictions.[8] In fact, it is due only to these currency controls and local law restrictions that market participants must use NDFs to access emerging markets and currencies. Similar to FX forwards, NDFs can be settled through the CLS system.[9] Also similar to FX forwards, the market for NDFs is liquid and transparent, and NDFs are predominantly short-term instruments. Arguably, NDFs present less risk to market participants and the financial system, because the principal amounts are never exchanged, and should not be treated differently from deliverable FX forwards. In addition, NDFs have stringent documentation requirements.

Failure to clarify that NDFs are within the definition of FX forwards could create confusion for market participants regarding the treatment of the two types of FX forwards. It would result in operational difficulties for market participants when assessing their swaps activity for purposes of certain CFTC rules.[10] It also could allow for potential arbitrage between the two types of FX forwards. Finally, splitting up FX forwards and NDFs would increase fragmentation in the currency markets as NDFs are subject to clearing and trading requirements.

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[7] For these same reasons, we recommend that the CFTC amend its proposal which would include NDFs within the definition of swap. *See* Further Definition of "Swap," "Security-Based Swap,"' and "Security-Based Swap Agreement"'; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 FR 29818 (May 23, 2011).

[8] NDFs settle in cash, based on the difference between a price agreed upon at the inception of the contract and the spot price for the currency determined one or two days before the date of settlement.

[9] Instead of its PVP system, CLS settles NDF using bilateral end of day netting in the same currency, reducing risk through a single payment.

[10] For example, market participants engaging in NDF and FX forward transactions will be faced with the unnatural bifurcation of ensuring that NDF activity complies with the full panoply of regulatory requirements imposed by the Dodd-Frank Act while FX forwards remain subject to existing requirements.

If you have any questions on our comment letter, please feel free to contact me directly at (202) 326-5815, Heather Traeger at (202) 326-5920, or Ari Burstein at (202) 371-5408.

Sincerely,

/s/ Karrie McMillan

Karrie McMillan
General Counsel

cc: The Honorable Gary Gensler, Chairman
The Honorable Michael V. Dunn, Commissioner
The Honorable Jill E. Sommers, Commissioner
The Honorable Bart Chilton, Commissioner
The Honorable Scott D. O'Malia, Commissioner
Commodity Futures Trading Commission