MEMO# 25254

June 7, 2011

ICI Letter on Treasury's Proposed Exemption for FX Swaps and Forwards from Definition of Swap

[25254]

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 42-11
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 15-11
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 17-11
ETF ADVISORY COMMITTEE No. 36-11
EQUITY MARKETS ADVISORY COMMITTEE No. 29-11
FIXED-INCOME ADVISORY COMMITTEE No. 44-11
SEC RULES MEMBERS No. 64-11
SMALL FUNDS MEMBERS No. 38-11 RE: ICI LETTER ON TREASURY'S PROPOSED EXEMPTION FOR FX SWAPS AND FORWARDS FROM DEFINITION OF SWAP

As we previously informed you, the Department of the Treasury ("Treasury") has issued a proposed determination that, pursuant to Section 721 of the Dodd-Frank Act, would exempt foreign exchange ("FX") swaps and forwards from the definition of "swap" in the Commodity Exchange Act ("CEA"). [1] ICI has submitted a comment letter to the Treasury supporting the proposed determination. ICI's letter also recommends that the Treasury interpret the definition of swap to include non-deliverable forwards ("NDFs").

Factors Supporting Exemption

The proposed determination would provide a narrow exemption from the definition of swap for FX swaps and forwards. These derivatives would be exempt from the Dodd-Frank Act's clearing and exchange trading requirements but would remain subject to the trade reporting requirements, business conduct standards for swap dealers and major swap participants, and, for those transactions that are traded on a designated contract market or swap execution facility, enhanced anti-fraud and anti-manipulation rules. ICI's letter explains that 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 proposed exemption should restrict the ability of market participants to evade regulatory requirements imposed by the CEA.

ICI’s letter supports 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. The letter concurs with the Treasury’s analysis that sufficient safeguards already exist in the FX swaps and forwards market. Moreover, the letter expresses concern that 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. In addition, ICI’s letter states that central clearing and exchange trading are unlikely to meaningfully lower settlement risk in this market.

Extend Exemption to NDFs

ICI’s letter recommends that the Treasury modify its proposed determination to clarify that the term “foreign exchange forwards” includes both deliverable and non-deliverable FX forwards. As proposed, NDFs would not be included within the exemption because, according to the Treasury, such FX derivatives do not satisfy the statutory definition of FX forward. ICI’s letter argues that limiting the definition to deliverable trades simply because the definition mentions the “exchange” of two different currencies takes a too restrictive reading.

ICI’s letter states that 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. Among other similarities, the letter explains that NDFs are economically and functionally identical to FX forwards despite the fact that they are physically 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. It further states that failure to clarify that NDFs are within the definition of FX forwards could create confusion and result in operational difficulties for market participants, as well as allow for potential arbitrage between the two types of FX forwards. The letter concludes by noting that splitting up FX forwards and NDFs would increase fragmentation in the currency markets.

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Attachment

endnotes

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