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United States Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

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Ladies and Gentlemen:

CLS Bank International (CLS) welcomes the opportunity to share its views on the appropriateness of an exemption for foreign exchange (FX) swaps and FX forwards from the definition of a “swap” under the Commodity Exchange Act (CEA) pursuant to the authority granted to the Secretary of the Treasury (Secretary) under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act).

The Department of Treasury has solicited comments on the several factors identified in the Dodd-Frank Act which the Secretary is required to consider in making a determination regarding FX swaps and FX forwards, any relevant information that may bear on the regulation of such instruments, and comments on supplemental questions identified in the request for comments dated October 19, 2010.

Effective financial systems depend on safe and efficient payment systems and, in the context of FX, our settlement system has been structured to minimize the economic disturbances that could otherwise disrupt domestic and international financial markets. We are pleased that the members of the Global FX Division of SIFMA, AFME and ASIFMA agree with our view that CLS is a global, well-developed settlement system that has effectively mitigated settlement risk as the largest source of systemic risk for the FX market.¹ We view the position of and supporting arguments presented by the members of the Global FX Division in favor of exempting these FX transactions from such clearing and trading requirements as compelling and persuasive. The position and arguments are consistent with our discussions with members of our settlement service and various industry groups (including the Foreign Exchange Committee in New York, and the Foreign Exchange Joint Standing Committee in London),² the information in our systems

¹ Letter from James Kemp, Global FX Division, to US Department of Treasury. November 15, 2010.
<http://www.regulations.gov/search/Regs/home.html#documentDetail?R=0900006480b8c6c1>.

² The FXC includes representatives of major financial institutions engaged in foreign currency trading in the United States and is sponsored by the Federal Reserve Bank of New York. Aware of the strong integration of the global foreign exchange market, the FXC is also an active partner to other foreign exchange committees and industry associations worldwide. The London Foreign Exchange Joint Standing Committee (FX JSC) was established in 1973 under the auspices of the Bank of England, in the main part as a forum for banks and brokers to discuss broad market issues and the focus of the Committee's regular work remains issues of common concern to the different participants in the foreign exchange market.



regarding FX market activity,³ and the broader policy considerations raised by central banks regarding the impact of clearing of over-the-counter (OTC) FX for central counterparties (CCPs) and CLS. The application of clearing and trading requirements of the Dodd-Frank Act to FX swaps and FX forwards would not address settlement risk. It is highly unlikely CCPs will be able to guarantee settlement of these transactions given the sheer values associated with FX, a market which is essentially a global cross-border payment system.

In addition, CLS is committed to being a trade repository for FX and hopes the FX market agrees that we are well-situated to perform this role. In furtherance of this, CLS plans to present a proposal to relevant industry groups and regulatory authorities for the development and operation of a repository which satisfies applicable legal, regulatory and market requirements and expectations in a manner that is practical, efficient and effective for all interested stakeholders and, to the extent practicable, leverages existing systems as well as information provided to CLS by the market.

CLS effectively addresses largest source of systemic risk in the FX market

CLS is the provider of a global payment-versus-payment (PVP) settlement system for FX. The creation of our settlement service was the result of unprecedented cooperation and effort amongst the global financial community in response to regulatory concerns regarding the potential for FX settlement to be a major source of systemic risk.

Background. Beginning in the mid-1990s, central banks became increasingly concerned that the high level of settlement risk in existing practices, coupled with an unexpected event or failure, could trigger a serious disruption of the global FX markets and financial system liquidity. Settlement risk is the risk that a party to an FX transaction pays out the currency it sold but does not receive the currency it bought. Such an exposure to a counterparty, even if for a short, limited time, can be very significant as it may well represent a large portion of such parties' capital. Given that the parties to these transactions are financial institutions, the potential risk can be multiple in the markets. One of the key recommendations in the Allsopp Report prepared by the Committee on Payment and Settlement Systems ("CPSS")⁴ and published by the Bank for International Settlements ("BIS") in 1996 was for industry groups to develop an FX settlement risk-reducing multi-currency service that would protect against the loss of principal.⁵

Late in 1994, a group of twenty major financial institutions joined forces to consider how the private sector might develop just such a solution to the problem of FX settlement risk. These banks conducted a one-year study of alternative approaches. The result of this study was the continuous linked settlement concept (CLS), a simultaneous exchange, PVP, of each of the two legs of an FX transaction which eliminates settlement risk. In close collaboration and discussion with the central banks, this group of banks formed CLS to develop and build a new multi-currency simultaneous settlement service. The development of CLS was given further support in September 2000 when the Chairman of the CPSS emphasized the importance of such private

³ See CLS Statistics on Foreign Exchange Activity. October 18, 2010. A copy is available at <http://www.cls-group.com/Media/Pages/NewsArticle.aspx?id=67>.

⁴ The CPSS serves as a forum for central banks to monitor and analyze developments in payment and settlement infrastructures and set standards for them. Its members are central banks from 24 countries and regions.

⁵ "Settlement Risk in Foreign Exchange Transactions", CPSS (March 1996) (Allsopp Report). See also "Progress in reducing foreign exchange settlement risk," CPSS (May 2008).



sector initiatives. At the end of 1997, CLS acquired both ECHO and Multinet in order to consolidate the providers of FX processing services.⁶ In spring 1998, other major financial institutions were asked to join the CLS Group resulting in 61 shareholders by the end of 1998. CLS Bank International was established as an Edge corporation in November 1999 following approval by the Board of Governors of the Federal Reserve System and is accordingly subject to supervision by the Federal Reserve.

Substantial progress made in reducing settlement risk. CLS went live with its settlement service in September 2002 with 39 Settlement Members and seven currencies: Australian dollar (AUD), Canadian dollar (CAD), Euro (EUR), Japanese yen (JPY), Swiss franc (CHF), UK pound sterling (GBP), and US dollar (USD). Since that time, ten additional currencies have been included in the Settlement Service: Danish krone (DKK), Norwegian krone (NOK), Singapore dollar (SGD) and Swedish krona (SEK) in 2003, followed by the Hong Kong dollar (HKD), Korean won (KRW), New Zealand dollar (NZD) and South African rand (ZAR) in 2004 and, most recently, the Israeli shekel (ILS) and Mexican peso (MXN) in 2008.⁷

To date, approximately 95% of the daily value of FX traded across the global are in the currencies eligible for settlement in CLS. Over 10,000 trading parties participate in the CLS system, of which 61 are direct participants (commercial and investment banks) and the remainder indirectly as customers of direct participants (banks, corporations, non-financial institutions and, predominantly, funds). This year, CLS settled an average daily volume of nearly 800K payment instructions (1.78 million peak) and average daily value of over 4 trillion USD equivalent (peak 10.3 trillion).

Our experience has made clear that the provision of an efficient, high-quality and cost-effective service which minimizes liquidity requirements within an extremely limited period of time (two hours of settlement activity from 07:00 – 09:00 Central European Time; and five hours of funding activity from 07:00 – 12:00 Central European Time) has been extremely challenging but successful. Disrupting or changing this process could have significant unintended effects.

CLS' commitment to extending its coverage to further reduce settlement risk. We are committed to extending coverage of the settlement system in several ways in order to achieve our key strategic objective of providing further settlement risk elimination for the global FX market, specifically:

- Additional currencies – the launch of a new currency program in 2011 which involves, in the first instance, active and focused engagement with a minimum of sixteen currency prospects.
- Additional settlement sessions – continued collaboration with our members to extend the PvP settlement service to same-day FX trading activity.

⁶ The Exchange Clearing House (ECHO) and Multinet International Bank were multilateral netting systems developed by the private sector in Europe and North America, respectively, to address pre-settlement risk by multilaterally netting FX transactions for settlement through a CCP.

⁷ The extension of CLS settlement service to any new type of payment instruction, including those relating to a new currency or type of transaction, is in each case subject to regulatory review and approval. In addition to its settlement processing on a PvP basis, CLS also extended settlement to single currency payment instructions relating to non-deliverable forward (NDF) FX transactions and OTC credit derivative transactions in 2007, and is continuing with its efforts to extend the service to FX option premium transactions.



- Additional participation – support members’ efforts in extending participation in CLS to their customers/counterparties.

In addition to the foregoing, CLS has made and continues to make significant investments towards enhancing our capacity to ensure we can support FX trading activity during normal and, more importantly, volatile market conditions.

Comprehensive regulation, supervision and oversight over CLS

CLS Bank International is an Edge corporation, chartered by the Board of Governors of the Federal Reserve System under Section 25A of the United States Federal Reserve Act, as amended. As such, CLS Bank is regulated and supervised by the Federal Reserve as a bank under a program of ongoing supervision, combining full-scope and targeted on-site examinations with a variety of off-site monitoring activities. CLS Bank is located in New York.

In addition, the central banks whose currencies are settled in CLS have established a cooperative oversight arrangement for CLS as a mechanism for the central banks of issue of currencies eligible for settlement in the CLS system to fulfill their responsibilities to promote safety, efficiency, and stability in the local markets and payment systems in which CLS participates. The *Protocol for Cooperative Oversight of CLS* is designed to facilitate comprehensive oversight of CLS, enhance oversight efficiency by minimizing potential burden on CLS and duplication of effort by the participating central banks, foster consistent and transparent central bank communications with CLS, enhance transparency among the participating central banks regarding the development and implication of international and domestic policies applicable to CLS, and support fully informed judgments when participating central banks make their oversight assessments and decisions regarding CLS.⁸ The Federal Reserve organizes and administers the CLS Oversight Committee, which is the primary forum for the participating central banks to carry out their cooperative oversight of CLS.

CLS provision of information about FX market to regulatory community

Information provided by CLS as a systemically important payment system. In contrast to other payment systems, CLS requires the capture and matching of the economic details of individual, underlying FX trades as a condition for processing related payments for settlement. Market practice is that all payment instructions are sent to CLS within two hours of the trade (in practice this is nearer to 30 minutes). The details of the FX trades matched by CLS include the identification of the trading parties, currency amounts, settlement date and settlement (payment) banks. Trade date and exchange rate are also included.

CLS was created out of a cooperative effort to limit systemic risk and has had this as its principal purpose from inception. We recognize the responsibilities which come with our position as a systemically important settlement system and provide central banks on the CLS Oversight Committee with information necessary to fulfill their respective responsibilities over the years. Information has historically been and will continue to be provided on a regular and ad-hoc basis to the central banks, individually and collectively.

⁸ http://www.federalreserve.gov/paymentsystems/cls_protocol.htm.

Trade repository for FX. CLS supports regulatory efforts across the globe to improve the level of transparency and knowledge of regulators and the public. To this end, we are committed to being the trade repository for FX as required under the Dodd-Frank Act. We believe CLS is well-situated to perform this role and hope the FX market concludes the same once the process for selecting a provider for this service is completed.⁹ As noted above, as part of its existing processes, CLS captures a tremendous amount of valuable information and is well-experienced with analyzing and providing central banks with information in normal and, upon request, stressed situations.

Requirements for trade repositories due to be released by the U.S. Commodities Futures Trading Commission (CFTC) are likely to be comprehensive and exceed the information that CLS presently requires for processing FX payments for settlement. Notwithstanding that, we are committed to ensuring the development and operation of a trade repository service which complies with all legal, regulatory and market requirements and expectations for such a repository in a manner that is practical, efficient and effective for all interested stakeholders and, to the extent practicable, leverages existing systems as well as information provided to CLS by the market.

Central bank perspective / process for CCPs and CLS

Since the market events of 2008 and early 2009, CLS became aware that several CCPs were exploring the potential extension of their respective clearing services to OTC FX. Earlier this year, CLS briefed the central banks who participate on the CLS Oversight Committee of these efforts and the potential role(s) CLS may have. The central banks shared with CLS the following perspective, with we in turn shared with the CCPs:

In the [Oversight Committee's] subsequent discussion [with CLS], the community of central banks whose currencies are settled in CLS expressed a clear need to receive more information about the FX-related clearing proposals of [each individual CCP], as well as more information on how those proposals might involve CLS.

The central banks' need for more information on each CCP's individual proposal reflects, in the first instance, the importance for central banks – from a broader policy perspective – to understand and to review the potential implications of each proposal for their currencies and for the FX market more broadly.

Of note, this important policy interest of the central banks exists irrespective of the central banks' additional need to review, from a CLS oversight perspective, the potential implications of the CCPs' respective proposals for the safety and efficiency of CLS per se.

In contrast to the interdependency risks involved with the CLS settlement service which were analyzed, well understood, accepted and managed by all stakeholders leading up to and since the commencement of the service in 2002, the same cannot be said of the application of CCPs to OTC FX activity at this time.

⁹ See Press Release issued by the Global FX Division, AFME Global FX Division to launch trade repository selection. November 15, 2010. <http://www.afme.eu/AFME/Home/151110FXTRreleasefinal.pdf>.



Enhanced risk management standards under Title VIII

Under Title VIII of the Dodd Frank Act, the Financial Stability Oversight Council (FSOC) has responsibility for designating (i) financial market utilities (FMUs) such as payment, clearing and settlement systems as systemically important, and (ii) payment, clearing or settlement activity of a financial institution as systemically important. The Federal Reserve Board of Governors, in consultation with the FSOC and relevant supervisory authorities, will prescribe risk management standards governing the conduct of such systemically important systems and, separately, for any such activity of financial institutions.

With respect to our settlement system, CLS meets or exceeds the standards set out in the *Core Principles for Systemically Important Payment Systems*.¹⁰ These are principles published by the CPSS as guidelines for the design and operation of safer and more efficient systemically important payment systems. The CPSS and International Organization of Securities Commissions (“IOSCO”)¹¹ announced earlier this year a joint, comprehensive review of their existing standards for financial market infrastructures such as payment systems, securities settlement systems and CCPs, as well as trade repositories, with view to strengthening them where appropriate.¹² Both international regulatory forums publicly acknowledge the essential contribution of robust financial market infrastructures to financial stability by reducing what could otherwise be a major source of systemic risk and, insofar as such infrastructures enable settlement to take place without significant counterparty risk, by helping markets to remain liquid even during times of financial stress.

With our proven track record, CLS is committed to ensuring that it meets or exceeds these and any other applicable principles, standards or policies (including those issued by the Federal Reserve under Title VIII of the Dodd-Frank Act) for the operation of our settlement system. CLS makes the same commitment to principles applicable to the operation of a trade repository service for the FX market.

Finally, we wish to note that extension of our coverage of the settlement service described above would support and complement any determination by the FSOC and Federal Reserve under Title VIII of the Dodd-Frank Act to promote, encourage or otherwise require further use of settlement risk reduction services or practices.

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¹⁰ The Policy on Payments System Risk of the Board of Governors of the Federal Reserve System establish an expectation that systemically important systems publicly disclose self assessments of compliance with the Core Principles. “Policy on Payments System Risk”, Federal Register 72 (19 January 2007): 2518-2527. The Board believes such a self assessment can assist users of the system and other interested persons in identifying, evaluating and managing the risks and costs of using the system’s services while furthering global financial stability. A copy of CLS’ self assessment, last published in December 2009, is available at <http://www.cls-group.com/About/Pages/WhatIsCLS.aspx>.

¹¹ IOSCO is a policy forum for securities regulators. The organization’s membership regulates more than 95% of the world’s securities markets in over 100 jurisdictions.

¹² <http://www.bis.org/press/p100202.htm>. The review is being led by representatives of the central banks that are members of the CPSS and those of the securities regulators that are members of the IOSCO Technical Committee. The International Monetary Fund and the World Bank are also participating in the review. The review is part of the Financial Stability Board’s work to reduce the risks that arise from interconnectedness in the financial system.



We appreciate your consideration of our views on the potential exemption for FX swaps and FX forwards, and Titles VII and VIII of the Dodd-Frank Act, as they relate to CLS as a critical financial market infrastructure for the FX market. Please do not hesitate to contact me should you have any questions.

Sincerely,

A handwritten signature in black ink, reading "Ala A. Bozji". The signature is written in a cursive style with a large initial 'A'.