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May 1, 2013

Chairwoman Debbie Stabenow  
Ranking Member Thad Cochran  
Senate Committee on Agriculture, Nutrition and Forestry  
United States Senate  
Washington, DC 20510

Dear Chairman Stabenow and Ranking Member Cochran:

The Investment Company Institute (“ICI”),<sup>1</sup> ICI Global,<sup>2</sup> the American Bankers Association (“ABA”),<sup>3</sup> and the ABA Securities Association<sup>4</sup> appreciate this opportunity to submit a recommendation pursuant to your letter of March 5, 2013, requesting input on the reauthorization of the Commodity Futures Trading Commission (“CFTC”) to regulate futures, swaps, and options markets pursuant to the Commodity Exchange Act (“CEA”). We wish to bring to your attention an important issue concerning the fact that one type of foreign exchange forward – non-deliverable forwards (“NDFs”) – has not been included in the

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<sup>1</sup> The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds and unit investment trusts. ICI seeks to encourage adherence to high ethical standards, promote public understanding and otherwise advance the interest of funds, their shareholders, directors and advisers. Members of ICI manage total assets of \$14.96 trillion and serve over 90 million shareholders.

<sup>2</sup> ICI Global is the global association of regulated funds publicly offered to investors in leading jurisdictions worldwide. ICI Global seeks to advance the common interests and promote public understanding of global investment funds, their managers, and investors. Members of ICI Global manage total assets in excess of US \$1 trillion.

<sup>3</sup> The American Bankers Association represents banks of all sizes and charters and is the voice for the nation’s \$14 trillion banking industry and its two million employees

<sup>4</sup> The ABA Securities Association is a separately chartered affiliate of the ABA, representing those holding company members of ABA that are actively engaged in capital markets, investment banking, and broker-dealer activities.

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exemption for foreign exchange forwards granted by the Secretary of the Treasury under the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”). As a result, NDFs are being subject to unnecessary and costly regulation, creating problems for both the providers and users of NDFs, including U.S. investors and businesses engaged in international trade.

The problem arises because of the definition of “foreign exchange forward” found in Section 1a(24) of the CEA (7 U.S.C. § 1a(24)). That definition, as amended by the Dodd-Frank Act, has been interpreted as excluding NDFs. This differential treatment of NDFs, we strongly believe, was not intended by Congress.

An NDF is a type of foreign exchange forward that is used when it is impractical or impossible for one of the currencies involved to be physically delivered outside the home country of that currency due to local law or other requirements. Because one of the currencies involved cannot be physically delivered, NDFs are settled in a single currency -- usually U.S. dollars – in an amount that reflects the movement in the value of the underlying currencies.

The CEA, as amended by the Dodd-Frank Act, defines a foreign exchange forward as follows:

The term ‘foreign exchange forward’ means 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.

The differential treatment has resulted from the following language in this definition: “that solely involves the exchange of 2 different currencies.” Both the Treasury and the CFTC staffs have interpreted this language as excluding NDFs from the CEA definition of foreign exchange forward. Therefore, when the Treasury, using its authority in the Dodd-Frank Act, exempted foreign exchange swaps and forwards from the definition of swap, NDFs were not covered by the exemption.<sup>5</sup>

There is every reason to believe that this result was unintended by Congress when it defined foreign exchange forward. There is nothing in the legislative history to indicate that Congress intended to differentiate NDFs or, in fact, was even aware of the existence of NDFs, which are a very small, though important, part of the foreign exchange forward market. Conversations we have had with Congressional staff have reinforced that view.

There is no valid public policy reason for treating NDFs differently than other foreign exchange forwards.

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<sup>5</sup> See “Determination of Foreign Exchange Swaps and Foreign Exchange Forwards” under the Commodity Exchange Act (Nov. 16, 2012).

- NDFs and other foreign exchange forwards are treated as functional equivalents in the marketplace.
- Standard foreign exchange market documents treat NDFs as a subset of the foreign exchange forward.
- There is nothing in the record to show that NDFs present any material regulatory issues or risks different from other foreign exchange forwards.
- NDFs, like other forwards, functioned smoothly before and during the financial crisis.

NDFs are used by a variety of end-users and are an important tool to facilitate trade and investment between the U.S. and developing market countries. For example, asset managers (operating through mutual fund structures, private funds, or separately managed accounts) routinely use NDFs to hedge currency risks in investments in these countries. Likewise, U.S. businesses of all sizes engaged in trade with important developing economies such as Brazil, Taiwan, South Korea, India, and Indonesia use NDFs to limit currency risk in their businesses.

The importance of this matter to a variety of businesses is evident from comment letters submitted to the Treasury and/or the CFTC requesting that NDFs, like other foreign exchange forwards, be exempted from the definition of swap. Among those submitting such letters, in addition to the Investment Company Institute and the ABA Securities Association, were the Coalition of Derivatives End-Users and the Committee on Investment of Employee Benefit Assets.

The inability to include NDFs in the Treasury exemption for foreign exchange forwards causes a number of problems:

- Because the electronic nature of this trading means it can be moved readily, the jobs and capital associated with NDF trading may easily be relocated to other jurisdictions that will not bifurcate the regulation of their foreign exchange markets or impose unnecessary costs on transacting in NDFs.
- Treasury already has determined that regulation of foreign exchange forwards as swaps is unnecessary and, indeed, counter-productive. These findings also should be applicable to NDFs. The additional regulatory costs imposed on NDFs, however, will increase the costs both for U.S. investors and for U.S. companies trading in developing countries.
- U.S. investors and companies seeking to avoid the extra costs imposed on NDFs will either choose not to hedge, thereby increasing their own risk as well as the risk to the U.S. financial system, or they may take the risk

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of trading NDFs in foreign jurisdictions that may lack U.S. regulatory and judicial protections.

- The differential regulatory treatment creates confusion among market participants and creates legal and operational difficulties for market participants in complying with CFTC rules.

It should be noted that including NDFs in the Treasury exemption would not by any means result in their being unregulated. In particular, NDFs would be subject to the same rules governing foreign exchange forwards.

Our associations have recently filed a petition for exemptive relief with the CFTC. A copy of this petition, which provides greater detail on this issue, is enclosed. Unfortunately, it is far from certain if and when the CFTC may consider our petition, and the CFTC has no legal obligation to consider it. Therefore, we recommend that this issue be addressed through a legislative clarification of the definition of foreign exchange forward.

Thank you for the opportunity to provide this recommendation for your consideration. If you or your staff have any questions, please call Karrie McMillan (202-326-5815) at the ICI, Dan Waters (44-203-009-3101) at ICI Global or Timothy Keehan (202-663-5479) at the ABA.

Sincerely,

/s/ Karrie McMillan

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Building Success. Together.



ABA Securities Association  
ABASA, an ABA subsidiary

February 26, 2013

Ms. Melissa Jurgens  
Secretary  
Commodity Futures Trading Commission  
1155 21st Street, NW  
Washington, D.C. 20581

Re: Petition for Exemptive Relief for Non-Deliverable Foreign  
Exchange Forwards

Dear Ms. Jurgens:

The Investment Company Institute,<sup>1</sup> ICI Global,<sup>2</sup> the American Bankers Association<sup>3</sup> and the ABA Securities Association<sup>4</sup> hereby petition the Commodity Futures Trading Commission (the “*CFTC*”) for exemptive relief under Section 4(c) of the Commodity Exchange Act (the “*CEA*”) from certain aspects of the swap regulatory regime for non-

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<sup>1</sup> The Investment Company Institute (“*ICI*”) is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds and unit investment trusts. ICI Global seeks to encourage adherence to high ethical standards, promote public understanding and otherwise advance the interest of funds, their shareholders, directors and advisers. Members of ICI manage total assets of \$14.2 trillion and serve over 90 million shareholders.

<sup>2</sup> ICI Global is the global association of regulated funds publicly offered to investors in leading jurisdictions worldwide. ICI Global seeks to advance the common interests and promote public understanding of global investment funds, their managers, and investors. Members of ICI Global manage total assets in excess of U.S.\$1 trillion.

<sup>3</sup> The American Bankers Association (“*ABA*”) represents banks of all sizes and charters and is the voice for the nation’s \$14 trillion banking industry and its two million employees.

<sup>4</sup> The ABA Securities Association (“*ABASA*”) is a separately chartered affiliate of the ABA, representing those holding company members of ABA that are actively engaged in capital markets, investment banking and broker-dealer activities.

deliverable foreign exchange forwards (“*NDFs*”). Specifically, we respectfully request that the CFTC use its Section 4(c) authority to exempt NDFs from certain aspects of swap regulation under the CEA, so that they are regulated in the same manner as foreign exchange (“*FX*”) forwards and FX swaps.

## I. Overview of Request

As amended by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“*Dodd-Frank*”),<sup>5</sup> the CEA sets forth a new comprehensive regulatory scheme for swaps. The CEA provides that “foreign exchange swaps” and “foreign exchange forwards” will be considered “swaps” subject to comprehensive regulation unless the Secretary of the Treasury determines that they should not be regulated as swaps and are not structured to evade Dodd-Frank.<sup>6</sup> Consistent with this provision, on November 16, 2012, the Secretary of the Treasury issued a determination that exempts FX swaps and FX forwards from the definition of swap under the CEA.<sup>7</sup> As so exempted, FX swaps and FX forwards remain subject to business conduct, regulatory reporting, anti-fraud and anti-manipulation provisions of the CEA relating to swaps, as well as to the CFTC’s existing jurisdiction over retail transactions under Section 2(c)(2) of the CEA.<sup>8</sup>

The CEA, as amended by Dodd-Frank, defines a foreign exchange forward as follows:

The term ‘foreign exchange forward’ means 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.<sup>9</sup>

In the release jointly adopting the final rules defining “swap,” the CFTC and the Securities and Exchange Commission (the “*SEC*” and, collectively with the CFTC, the “*Commissions*”) stated

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<sup>5</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, tit. VII, 124 Stat. 1376, 1641 (2010).

<sup>6</sup> See Section 1a(47)(E) of the CEA (7 U.S.C. § 1a(47)(E)).

<sup>7</sup> Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, (Nov. 16, 2012) (the “*Treasury Determination*”), available via link at [www.treasury.gov/press-releases/pages/tg1773.aspx](http://www.treasury.gov/press-releases/pages/tg1773.aspx). Page reference herein to the text of the Treasury Determination are to this version, as posted on the Treasury’s website.

<sup>8</sup> See Sections 1a(47)(E) (7 U.S.C. § 1a(47)(E)) and 1a(47)(F)(ii) (7 U.S.C. § 1a(47)(F)(II)) of the CEA.

<sup>9</sup> Section 1a(24) of the CEA ((7 U.S.C. § 1a(24)).

that NDFs do not meet this statutory definition and therefore cannot qualify for Treasury's proposed exemption.<sup>10</sup> In the Treasury Determination, the Treasury Secretary determined that NDFs meet neither of the definitions of FX swap nor FX forward under the CEA, and thus the Treasury Secretary did not possess the authority to also exempt NDFs pursuant to §1a(47)(E) of the CEA. The Treasury Determination noted, however, that the CFTC is authorized to further define the term "swap" under the CEA, and "Treasury does not intend that the Commissions' joint rules in respect of the status of NDFs as swaps be affected by [the Treasury Determination] . . . ."<sup>11</sup>

As we discuss in greater detail below, we believe NDFs should receive the same regulatory treatment as FX forwards. An NDF is economically and functionally the same transaction as an FX forward. Many market participants with cross border businesses, including energy, natural resource and telecommunications companies, as well as U.S. funds that are regulated under the Investment Company Act of 1940 (including mutual funds and closed-end funds) and non-U.S. regulated funds publicly offered to investors (such funds being referred to collectively as "*Regulated Funds*") legitimately seek to hedge the currency risks associated with their underlying economic or investment activities. Market participants use FX forwards to hedge this currency risk when both of the relevant currencies are freely traded and therefore both are available to exchange at settlement of the trade. Market participants cannot use FX forwards in restricted markets when one of the relevant currencies is incapable of delivery or impracticable to deliver. Instead, these market participants use an NDF to achieve the same economic result as an FX forward and close out the trade at maturity by delivering the net value of the underlying exchange denominated in a pre-determined deliverable currency. Facilitating hedging of deliverable currencies by exempting deliverable FX forwards while increasing the costs of hedging restricted currencies by not similarly exempting NDFs serves no discernible public policy purpose. In addition, we note that neither NDFs nor deliverable FX forwards are

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<sup>10</sup> Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48,208, 48,255 (July 18, 2012) ("*Final Product Definitions Release*") ("[T]he Commissions have determined that NDFs do not meet the definitions of 'foreign exchange forward' or 'foreign exchange swap' set forth in the CEA. NDFs do not involve an 'exchange' of two different currencies (an element of the definition of both a foreign exchange forward and a foreign exchange swap); instead, they are settled by payment in one currency (usually U.S. dollars)." (footnotes omitted)), available at [www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister071012c.pdf](http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister071012c.pdf).

<sup>11</sup> Treasury Determination at fn. 89. This passage refers to the joint rulemaking authority of the Commissions, and is included, we believe, in part as a response to the statement by the CFTC in the Final Product Definitions Release that discussion of a Section 4(c) exemption with respect to NDFs was beyond the scope of that rulemaking. Final Product Definitions Release, 77 Fed. Reg. at 48,256 fn. 555.

products that contributed to the recent financial crisis. This experience further supports the proposition that these products should be regulated in a similar manner.

Treating NDFs differently from FX forwards will result in unequal regulatory treatment of functionally identical products. To date, these products have been viewed as indistinguishable by central banks and regulators globally. This shift will potentially lead to distortions of existing markets, and create incentives for market participants to direct NDF transactions to offshore jurisdictions they perceive to be preferable from a regulatory (and thus economic) point of view. It will also lead to increased costs in hedging currency risk in restricted markets, to the detriment of U.S. market participants that invest in the economies of countries with restricted currencies. Accordingly, as we discuss in more detail in this petition, we believe that the requested relief is justified on a cost-benefit basis.

We therefore respectfully request that the CFTC use its Section 4(c) authority to exempt NDFs from certain aspects of swap regulation under the CEA so that they are regulated in the same manner as FX forwards and FX swaps.<sup>12</sup>

## II. Authority Under CEA Section 4(c)

Section 4(c) of the CEA permits the CFTC to “exempt any agreement, contract, or transaction” from the provisions of the CEA, with certain exceptions not relevant here,<sup>13</sup> “[i]n

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<sup>12</sup> While the Final Product Definitions Release is a joint release of the Commissions, and certain conclusions contained therein that are described in this petition are expressed as conclusions of the Commissions, we believe that the CFTC possesses sole authority to address this petition. Section 2(a)(1)(A) of the CEA (7 U.S.C. § 2(a)(1)(A)), as amended by Section 722(a) of Dodd-Frank, provides that the CFTC has exclusive jurisdiction with respect to accounts, agreements and transactions involving swaps, while the SEC has corresponding exclusive jurisdiction with respect to security-based swaps (*see* Section 2(a)(1)(G)(i) of the CEA (7 U.S.C. § 2(a)(1)(G)(i)); *see also* Section 772(a) of Dodd-Frank, adding new sub-section (c) to Section 36 of the Securities Exchange Act of 1934 (the “*Exchange Act*”) to provide the SEC with exemptive authority with respect to security-based swaps, but not swaps). The products at issue in this petition are not security-based swaps, and thus do not fall within the SEC’s exclusive authority under Section 2(a)(1)(G)(i) of the CEA and Section 36(c) of the Exchange Act. Further, this petition seeks an exemption with respect to certain requirements involving swaps, not from the definition of swap, and thus is not a topic over which the CFTC and SEC have joint authority under Section 712(d)(1) of Dodd-Frank. Therefore, this petition is properly within the ambit of the CFTC’s exclusive jurisdiction over swaps under Section 2(a)(1)(A) of the CEA. We believe that the CFTC’s authority to issue the requested exemptive relief is unaffected by the Treasury Determination for the same reasons that the Commissions’ authority to further define the term “swap” in respect of NDFs is not affected. *See* footnote 89 to the Treasury Determination.

order to promote responsible economic or financial innovation and fair competition.”<sup>14</sup> The CFTC may not grant relief under Section 4(c) unless it determines, among other things, that (1) the exemption is in the public interest, (2) the exempted agreement, contract, or transaction will be entered into solely by appropriate persons and (3) the exemption will not have a materially adverse effect on the CFTC’s regulatory duties. In addition, in order to grant a Section 4(c) petition, the CFTC also must undertake a cost-benefit analysis.

For the reasons described below, we believe that an exemption framed as we propose above will meet each of these statutory requirements:

- This petition is in the public interest. The market for NDFs is an important component of the FX market, which is a market on which U.S. companies, Regulated Funds and other investors and market participants rely on a daily basis. If NDFs are not exempted as requested herein, U.S. companies, Regulated Funds and other investors and market participants will find it more costly, and difficult, to hedge exposures to non-deliverable currencies. Yet NDFs are arguably less risky than deliverable FX forwards for reasons we describe below, and NDFs did not contribute to the recent financial crisis. As described more fully in Part III.E. below, we respectively submit that preventing that result is in the public interest.
- Our members (Regulated Funds and financial institutions) are active participants in the NDF market, and are appropriate persons as defined under the CEA. We believe that an exemptive order could easily be framed that would incorporate the same preservation of the CFTC’s authority with regard to retail FX transactions as applies to the exemption of FX swaps and FX forwards.

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<sup>13</sup> We recognize that there is ambiguous language in Section 4(c)(1)(A)(i)(I) of the CEA (7 U.S.C. § 6(a)(1)(A)(i)(I)) that arguably could be read to limit the CFTC’s authority to issue exemptive relief with respect to, among other provisions, Section 1a(24) (the definition of “foreign exchange forward”) and Section 1a(47) (the definition of “swap”) of the CEA. Even assuming, *arguendo*, that the CFTC’s authority to issue exemptive relief with respect to such definitions might be limited under the CEA, any such potential limitation is not relevant to this request. We seek exemptive relief *not* from the definitions of “foreign exchange forward” or “swap,” but *rather* from the application of certain swap regulations to NDFs.

<sup>14</sup> Section 4(c)(1) of the CEA (7 U.S.C. § 6(c)(1)).

- FX swaps and FX forwards remain subject to three important provisions of the CEA notwithstanding the exemption from the definition of “swap” pursuant to the Treasury Determination. The ongoing regulatory oversight afforded by these provisions will enable the CFTC to continue to perform its regulatory duties under the CEA with respect to those products. A determination by the CFTC to treat NDFs in the same manner as FX swaps and FX forwards will result in NDFs remaining subject to the following provisions of the CEA:
  - Regulatory reporting -- This will enable the CFTC to monitor use of NDFs generally, and will also support the anti-fraud/anti-manipulation authority noted below.
  - Business conduct rules -- Investors utilizing NDFs will benefit from the protections afforded by the business conduct rules adopted for swap dealers and major swap participants in the swaps markets pursuant to Dodd-Frank.<sup>15</sup>
  - Anti-fraud and anti-manipulation rules -- NDFs would remain subject to the CFTC’s broad anti-fraud and anti-manipulation authority. This would enable the CFTC to protect the markets from transactions entered into in bad faith or on a fraudulent basis.

We also believe that recent precedent supports our request. For example, the CFTC has used its Section 4(c) authority (1) to provide exemptive relief from certain swaps regulations on multiple occasions in order to ensure an orderly transition to the post-Dodd-Frank regulatory regime;<sup>16</sup> (2) to provide exemptive relief from certain swap regulations for non-U.S.

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<sup>15</sup> This includes the ability of the CFTC to examine NDF practices of market participants to ascertain compliance with these business conduct rules. In addition, the National Futures Association’s delegated authority to examine member firms would encompass evaluation of compliance of NDF practices engaged in by such firms.

<sup>16</sup> See, e.g., Second Amendment to July 14, 2011 Order for Swap Regulation, 77 Fed. Reg. 41,260 (July 13, 2012) (providing exemptive relief for agreements, contracts, and transactions, and persons offering, entering into, or rendering advice or other services with respect to any such agreement, contract, or transaction, from provisions of the CEA, as added or amended by Dodd-Frank, that reference one or more terms subject to further definition); Amendment to July 14, 2011 Order for Swap Regulation, 76 Fed. Reg. 80,233 (Dec. 23, 2011) (same); Effective Date for Swap Regulation, 76 Fed. Reg. 42,508 (July 19, 2011) (same).

persons that register with the CFTC as swap dealers or major swap participants;<sup>17</sup> and (3) to propose exemptive relief on its own volition from the mandatory clearing requirement for financial entity cooperatives hedging or mitigating risks related to member loans.<sup>18</sup> In the Treasury Determination, the Treasury Secretary expressly stated that Treasury does not intend the Treasury Determination to affect the Commissions' authority with respect to the status of NDFs as swaps.<sup>19</sup> In the preamble to its final rules defining "swap," the CFTC deferred a determination of whether Section 4(c) relief is appropriate for NDFs.<sup>20</sup> In the discussion of these rules at the CFTC's open meeting on July 10, 2012, in response to queries from Commissioners O'Malia and Sommers regarding the proposed treatment of NDFs, CFTC staff stated that exemptive relief under Section 4(c) could be provided.<sup>21</sup>

Finally, we further respectfully suggest that granting the requested exemptive relief requested herein would be consistent with the general policy goals underlying Congress's broad grant of exemptive authority to the CFTC<sup>22</sup> and, as described more fully in Part III.F. below, is justified from a cost-benefit point of view.

### III. Analysis

#### A. The Treasury Determination Demonstrates That Exempting NDFs from Certain Aspects of Swap Regulation is Warranted

In the Treasury Determination, the Treasury Secretary relied on several factors supporting the position that FX swaps and FX forwards do not warrant the same new

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<sup>17</sup> Final Exemptive Order Regarding Compliance with Certain Swap Regulations; Further Proposed Guidance, RIN 3038-AD85 (Dec. 20, 2012).

<sup>18</sup> Clearing Exemption for Certain Swaps Entered Into by Cooperatives, 77 Fed. Reg. 41,940 (July 17, 2012) (to be codified at 17 C.F.R. pt. 39).

<sup>19</sup> Treasury Determination at fn. 89.

<sup>20</sup> See Final Product Definitions Release, 77 Fed. Reg. at 48,256 fn. 555 (noting that commenters' request for a Section 4(c) exemption with respect to NDFs was beyond scope of that rulemaking).

<sup>21</sup> Our counsel, Covington & Burling LLP, has prepared a transcript of this meeting, which we can provide upon request.

<sup>22</sup> See, e.g., H.R. Rep. No. 102-978 (1992) (Conf. Rep.), reprinted in 1992 U.S.C.C.A.N. 3179, 3213 ("The goal of providing the Commission with broad exemptive powers . . . is to give the Commission a means of providing certainty and stability to existing and emerging markets so that financial innovation and market development can proceed in an effective and competitive manner.").

comprehensive regulatory structure that is warranted for other swaps. We respectfully submit that these factors, which we briefly summarize below, apply similarly to NDFs.

*First*, Treasury concluded that mandatory clearing of FX forwards, which would be required for NDFs if the proposed exemption is not granted, would not reduce risk to the same degree in the market for FX forwards as would be the case for other derivatives. Dodd-Frank's clearing mandate is designed to address counterparty credit risk.<sup>23</sup> In Treasury's view, FX forwards pose less counterparty credit risk than other derivatives because they typically are of short duration.<sup>24</sup> Rather than counterparty credit risk, the primary risk of FX forwards is settlement risk, which would not be mitigated by central clearing. In addition, central clearing would introduce new challenges and risks into a well-functioning market.<sup>25</sup>

These considerations are similarly applicable to NDFs. Like FX swaps and FX forwards, NDFs are predominantly short-term in duration.<sup>26</sup> Imposing central clearing on NDFs

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<sup>23</sup> See, e.g., Clearing Requirement Determination under Section 2(h) of the CEA, at 9 ("The Commission believes that a clearing requirement will reduce counterparty credit risk and provide an organized mechanism for collateralizing the risk exposures posed by swaps."), available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister072412.pdf>.

<sup>24</sup> See Treasury Determination, Part IV.A.(i) at pp. 13-14 (noting that "over 98 percent of foreign exchange swaps and forwards mature in less than one year, and 68 percent mature in less than one week" and that "Since counterparty credit risk increases as the term of a contract increases, foreign exchange swaps and forwards carry significantly lower levels of counterparty credit risk, relative to other swaps and derivatives.").

<sup>25</sup> See *id.* at Part III.A.(iii) at pg. 19 (noting that requiring central clearing of FX swaps and FX forwards may lead to combining clearing and settlement in one facility, which would create large currency and capital needs for that facility due to the sheer size of these markets and the fact that the central clearing party would be effectively guaranteeing both settlement and market exposure to replacement cost). We recognize that CME Group Inc ("CME") lists certain NDF products for clearing. We understand that, notwithstanding these products being listed by CME, relatively few market participants currently clear NDFs. For the reasons set forth above, requiring clearing of NDFs would introduce new risks and challenges and would continue to not be viewed as an efficient or attractive option by market participants.

<sup>26</sup> Based on discussions with our members and a number of market participants, we believe that NDFs, like FX swaps and FX forwards, are also predominantly short-term in duration. We note that the Bank for International Settlements ("BIS") data cited by the Treasury Secretary in support of the proposition that FX swaps and FX forwards are predominantly short-term in nature include NDFs in that data. See Treasury Determination at fn. 31. As we discuss below, BIS does not distinguish between deliverable and non-deliverable FX forwards. Because this is true for many market regulators and central banks, we have not been able to identify empirical data analyzing average maturities for NDFs. See Part III.B., *supra*.

would introduce similar challenges as with the FX swaps and FX forwards markets -- adding capital costs to a market that is short-term in nature and functioning efficiently. Further, unlike deliverable FX forwards, NDFs only involve the delivery of the net change in value between the time the trade was entered into and the time it is settled. Therefore, as a pure financial instrument, NDFs entail significantly less credit risk than a deliverable FX forward, where gross amounts are delivered at settlement.<sup>27</sup>

*Second*, Treasury concluded that Dodd-Frank's exchange-trading requirement was not needed to the same degree in the market for FX forwards. The exchange-trading requirement aims to improve transparency.<sup>28</sup> Treasury determined, however, that mandatory exchange trading would not significantly improve price transparency or reduce trading costs in the FX swaps and FX forwards markets.<sup>29</sup> According to Treasury, market participants have access to readily available pricing information for FX forwards through multiple sources. FX forwards already trade across a range of electronic platforms and the use of such platforms has been steadily increasing in recent years. Like swap execution facilities to be implemented under Dodd-Frank, "the use of electronic trading platforms provides a high level of pre- and post-trade transparency within the foreign exchange swaps and forwards market."<sup>30</sup>

NDF pricing data is also widely available to institutional investors via a variety of publicly-available price sources. Like FX forwards, NDFs trade across various electronic platforms. Standardized transaction infrastructure (including the Emerging Markets Trading Association's NDF templates) facilitates high rates of straight-through processing and electronic confirmation practices for NDFs, comparable to those of deliverable FX forwards. We thus believe that the NDF market is similarly transparent, on both a pre- and post-trade basis, to the FX swaps and FX forwards markets.

*Third*, Treasury noted that, unlike participants in the market for other derivatives, "[t]he predominant participants in the foreign exchange swaps and forwards market are banks

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<sup>27</sup> Market participants may, but are not required to, reduce this credit risk by settling FX forwards through CLS Bank International ("*CLS Bank*").

<sup>28</sup> See, e.g., CFTC, Open Meeting on the Eighth Series of Proposed Rulemakings Under the Dodd-Frank Act, Transcript at 9:16-20 (Dec. 16, 2010) (statement of Chairman Gensler) ("The bill promotes pre-trade transparency in the swaps market by requiring that the standard part of the market — what I'll call standardized swaps, other than block trades — be traded on regulated exchanges or swap execution facilities.").

<sup>29</sup> Treasury Determination, Part III.A.(v) at pp. 21-22.

<sup>30</sup> *Id.*

which have long been subject to prudential supervision.”<sup>31</sup> In addition, Treasury considered whether FX market participants were already subject to regulation “materially comparable to that established by the CEA for other classes of swap,” and concluded that, since the 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.”<sup>32</sup> Dealers in NDFs are, as in the case of FX swaps and FX forwards, primarily banks, so prudential regulation is similarly common in these transactions.

*Fourth*, Treasury observed that businesses that rely on FX forwards to hedge risk would bear significant new costs associated with mandatory clearing, margin and capital requirements if such products were subject to comprehensive swap regulation. In this regard, market participants believed such additional costs could potentially “reduce [end users’] incentives to manage foreign exchange risks”; “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”; or “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 Bank in light of the additional costs associated with central clearing.”<sup>33</sup>

We note similar concerns with respect to imposing central clearing, and the attendant collateral, margin and capital requirements, on participants in the NDF market. NDFs are commonly used by U.S. companies, Regulated Funds and other institutional investors and market participants (including pension funds) to hedge currency risk involving restricted currencies. NDFs are the only product available to efficiently and effectively hedge that risk. Counterparties include Regulated Funds with investments in emerging markets and financial institutions and multinational companies that are active in emerging markets. If NDFs become unduly costly to execute, these entities would be forced to select from the following options, none of which are attractive: (i) forego the protections afforded by these products (which

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<sup>31</sup> *Id.* (“[N]early 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.”).

<sup>32</sup> *Id.* at 25,780. We acknowledge that central banks of developing countries would not necessarily support the NDF market, as those transactions may be viewed as inconsistent with these countries’ efforts to maintain exchange or other controls on their currencies. As discussed below, however, G20 central banks have historically included NDFs in their evaluations of the FX forward market, and thus monitor and evaluate this aspect of the market on an ongoing basis. See Part III.B., *supra*.

<sup>33</sup> *Id.* at Part III.B.(i) at pg. 27 (footnotes omitted).

introduces the risks that the hedge was otherwise meant to address); (ii) reduce their participation in the emerging markets (thus foregoing a strategy otherwise viewed by management as attractive); or (iii) in some cases, seek to execute NDFs in markets outside the U.S., for counterparties that are not otherwise subject to CFTC regulation (to the detriment of economic activity and job creation in the U.S. economy). None of these options is attractive from a policy point of view, unless the benefits of central clearing clearly outweigh these costs. And, as noted above, the amount of the net payment in an NDF is far smaller than the aggregate amount of the two separate payments required for gross settlement in a deliverable FX forward, which further ameliorates settlement risk.

We note there is one difference between FX forwards and NDFs that is pointed out in the Treasury Determination that is relevant to this discussion. NDFs would not use the payment-versus-payment process of CLS Bank, as that system is designed to address Herstatt Risk, a form of settlement risk that is unique to FX forwards and FX swaps.<sup>34</sup> Because a net settled trade, by definition, involves only a single transmission of funds at settlement, Herstatt Risk is not present, and thus the payment-versus-payment process utilized by CLS Bank is not necessary, and cannot be utilized, with respect to NDFs.<sup>35</sup>

B. There is No Policy Reason to Treat NDFs Differently from FX Forwards

As noted above, an NDF is economically and functionally the same transaction as an FX forward. The sole difference between these two transactions is that, in an FX forward, the trade closes out at maturity upon delivery by each party to the transaction of the gross amount of the respective currencies specified in the contract. When compared with an FX forward, the only difference is that an NDF involves a currency that is either not deliverable or impracticable to

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<sup>34</sup> “Herstatt Risk” refers to the risk that only one of two payments made to settle a single trade may be received. In 1974, German regulators forced Herstatt Bank, a privately owned German bank, into liquidation. That day, a number of banks had released payments denominated in Deutsche Marks to Herstatt Bank in Frankfurt in exchange for U.S. Dollars that were to be delivered by Herstatt Bank in New York. Because of time-zone differences, Herstatt ceased operations after receipt of the DM payments but prior to transmission of the U.S.\$ payments, so the counterparty banks did not receive their U.S.\$ payments and could not retrieve their DM payments. The payment-versus-payment process utilized by CLS Bank protects against this risk.

<sup>35</sup> CLS Bank does provide settlement functionality for NDFs. This is not a payment-versus-payment process. Instead, CLS Bank can compress multiple payments in a single currency on a single day between two counterparties to a single net payment across all such trades, thus further reducing settlement risk across such trades. Unlike an FX forward, in which CLS’s payment-versus-payment settlement service reduces risk for the specific trade, for an NDF, CLS’s settlement service affords no risk mitigation with respect to a specific trade, but instead provides risk mitigation across multiple trades by allowing for compression as noted above.

deliver due to local law restrictions — in an NDF, the trade closes out at maturity upon delivery of the net value of the underlying exchange, denominated in a pre-determined deliverable currency. In all of these structures, the net value transferred is exactly the same, and the counterparty initiating the transaction can achieve exactly the same economic outcome.

We note that the Treasury Secretary and the CFTC have pointed to the fact that the net settlement amount to be received or paid at maturity of an NDF is not known at the outset of the trade, whereas in an FX forward, each counterparty's gross closing payment obligation is known at trade date. Both the Treasury Secretary and the CFTC point to this distinction to support the position that NDFs should not be afforded the same regulatory treatment as FX forwards. We respectfully submit that this distinction does not justify different outcomes for economically identical products of very short duration. As noted above, the economic values of the trades are identical whether gross or net settled, and the net settlement amount payable upon maturity of an NDF will, by definition, be far smaller than the aggregate amount of crossing payments required at the maturity of a gross-settled FX forward. The short-term nature of NDFs further reduces the potential that any movement in final net settlement amount will be of sufficient magnitude so as to create risk for the U.S. financial system. We have searched for any suggestion in the record that Congress perceived a policy risk in NDFs such that the definition of FX forward was intended to distinguish NDFs from FX forwards as a regulatory matter in the United States, and have been unable to find any evidence of such an intent.

NDFs exist solely to address a unique attribute of a limited number of currencies -- physical delivery outside of the home jurisdiction is either impossible or impracticable due to local law or other local requirements. For non-deliverable currencies, an NDF is the only viable means by which to effect a forward transaction. Non-deliverability is a feature of many emerging market currencies and of virtually no developed market currencies. Accordingly, NDFs are, in effect, an emerging market product. Many of these currencies are important to the global financial markets.<sup>36</sup>

Given the economic and functional congruity between the two products, there is already substantial market and regulatory precedent in the United States and globally for treating NDFs and FX forwards comparably. We note the following additional examples:

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

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<sup>36</sup> Among currencies that are widely traded as NDFs (and not traded as FX forwards) are South Korean Won, Taiwanese Dollars, Brazilian Reals, Indonesian Rupiahs and Chinese Yuan. As noted below, currency controls in China have recently been relaxed to permit physical delivery of Yuan in Hong Kong, so there is a Yuan market in FX forwards, but only in Hong Kong. In the rest of the world, the Yuan trades on a forward basis solely as an NDF.

- In a 1998 publication regarding the FX markets, the Federal Reserve Bank of New York described an NDF as “an instrument similar to an outright forward, except that there is no physical delivery or transfer of the local currency.”<sup>37</sup> The New York Fed has long recognized NDFs as a viable means by which to engage in forward transactions in non-deliverable currencies.
- BIS treats NDFs as a component of the outright forward category.<sup>38</sup>
- Leading international regulators do not distinguish between deliverable forwards and NDFs.<sup>39</sup>
- Standard FX market documentation structures do not distinguish between deliverable forwards and NDFs.<sup>40</sup>
- FX forwards are subject to special rules under the U.S. tax code that apply equally to physically settled and cash settled transactions.<sup>41</sup>

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<sup>37</sup> Sam Y. Cross, *Main Instruments: Over-the-Counter Markets*, in THE FOREIGN EXCHANGE MARKETS IN THE UNITED STATES 31, 39 (Fed. Res. Bank of N.Y., 1998), available at <http://www.newyorkfed.org/education/addpub/usfxm/>. “Outright forward” as used in this publication means FX forwards, including NDFs.

<sup>38</sup> *Triennial Central Bank Survey — Report on Global Foreign Exchange Market Activity in 2010* (BIS, Monetary and Econ. Dep’t, Basel, Switz.) Dec. 2010, at 32. BIS also uses the term “outright forward” to mean FX forwards, including NDFs.

<sup>39</sup> See, e.g., European Commission’s Markets in Financial Instruments Directive, or “*MiFID*,” Directive No. 39/2004, Annex I, § C(4), 2004 O.J. (L 145) 1, 58 (EC); see also U.K. Financial Services Authority’s (“*FSA*”) regulations implementing MiFID, Financial Services and Markets Act 2000 (Markets in Financial Instruments) Regulations 2007, 2007/126, sched. 7, tbl. 3 (U.K.).

<sup>40</sup> See, e.g., ISDA, 1998 FX AND CURRENCY OPTION DEFINITIONS (ISDA, Inc. 1998) §§ 1.12 and 1.15 (a “Non-Deliverable FX Transaction” is defined as a subset of FX Transactions that settles net (pursuant to §2.2(b) of the FX and Currency Option Definitions) as opposed to gross (pursuant to § 2.2(a) thereof)); 1997 INTERNATIONAL FOREIGN EXCHANGE MASTER AGREEMENT (Foreign Exch. Comm. 1997) (the “*IFEMA*”), § 1 (definition of “FX Transaction”) (definition of FX Transaction includes both physically settled and net settled transactions; there is no separate mention of non-deliverable transactions in the IFEMA).

<sup>41</sup> See 26 U.S.C. § 1256(g)(2).

Treating deliverable FX forwards differently from NDFs would not only be inconsistent with these precedents, it would introduce disparate regulatory treatment, and concomitant inefficiency, when none should exist.

Because FX forwards and NDFs serve the same economic purpose, neither transaction lends itself to speculation more than the other, and therefore NDFs are no more risky, from a speculative use point of view, than FX forwards.<sup>42</sup> While it may be accurate to say that certain emerging market currencies in the NDF market can be more volatile than the deliverable currencies comprising the FX forward market, that does not make NDFs a riskier product than an FX forward. The amount of risk will depend on how the instrument is used. If anything, this analysis demonstrates the important role that NDFs play in facilitating risk amelioration by market participants. Facilitating rather than restricting the use of such products serves to reduce the risk faced by market participants in the U.S. financial system.

#### C. NDFs are Easy to Identify

We acknowledge that, if the proposed relief is to be granted, it should only apply to those transactions that are commonly viewed as NDFs in the FX markets. We believe this can easily be accomplished. As noted above, NDFs are utilized solely with respect to currencies that are subject either to exchange controls that preclude delivery outside of the home jurisdiction or to other legal or regulatory requirements that make delivery of the currency outside of the home jurisdiction effectively impracticable. We believe there is clear consensus in the market as to the list of currencies that trade on a forward basis using NDFs. The CFTC could consult with organizations such as BIS or the Foreign Exchange Chief Dealers Working Group of the Federal Reserve Bank of New York to develop and maintain a list of currencies that, when traded on a forward basis, would trade as NDFs and thus be entitled to the relief requested herein. We believe that limiting such an exemption to a specified list of currencies would prevent the exemption from being used to evade the regulation of products that are in fact swaps and not entitled to any exemption.<sup>43</sup>

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<sup>42</sup> We also note that, with respect to funds that are regulated under the Investment Company Act of 1940, their ability to “speculate” is limited as they are subject to strict capital and asset coverage requirements intended to limit risk associated with leverage. Section 18 of the Investment Company Act of 1940 (15 U.S.C. §80a-18).

<sup>43</sup> We also believe that the CFTC’s broad anti-evasion authority would provide a basis for enforcement actions against market participants that may try to use an NDF exemption to improperly execute non-exempt swaps without complying with the CEA. *See, e.g.* Section 1a(47)(E)(i)(II) of the CEA (7 U.S.C. § 1a(47)(E)(i)(II)), providing that any transaction claiming exemption as an FX forward must not in fact be a different substantive transaction structured so as to avoid regulation under Dodd-Frank.

D. Regulatory Oversight of NDFs will be Achieved through the CEA Requirements that Apply to FX Forwards and FX Swaps

In requesting that NDFs receive the same regulatory treatment as FX forwards, we are not proposing that NDFs be unregulated. Notwithstanding the exemption of FX swaps and FX forwards from the definition of swap, the CEA still requires that (1) FX swaps and FX forwards be reported to either a swap data repository or the CFTC (if there is no swap data repository accepting such swaps or forwards), and (2) swap dealers or major swap participants entering into FX swaps and FX forwards comply with applicable business conduct standards.<sup>44</sup> In addition, new anti-fraud and anti-manipulation provisions will apply to these transactions.<sup>45</sup> Our request proposes the same treatment for NDFs under each of these provisions of the CEA. These significant protections will ensure that there will not be a material adverse effect on the CFTC's ability to discharge its regulatory duties under the CEA.

Imposing margin, capital, central clearing and exchange trading requirements, among other new requirements, on NDFs is unwarranted given their functional and economic congruity with physically settled FX forwards, and the combination of a net payment settlement structure and short duration trades. Imposing these requirements would also create operational difficulties for FX market participants engaging in both NDFs and FX forward transactions in deliverable currencies. These market participants would be forced unnaturally to bifurcate their FX forward business to address the different regulatory treatment of NDFs and FX forwards.

NDFs are primarily institutional products. As is the case with the exemption of FX swaps and FX forwards, the relief requested herein would not limit the CFTC's existing regulatory authority with respect to certain retail transactions in foreign exchange. We therefore do not believe that it is necessary to distinguish between FX forwards and NDFs as a matter of regulatory policy in order for the CFTC to effectively regulate the retail markets for these transactions. We further note that providing exemptive relief for NDFs in the same manner as FX forwards would continue to allow for flexibility and financial innovation among U.S. companies, Regulated Funds and other institutional investors and market participants to address the need to monitor and manage currency risk in the U.S. financial markets.

E. Providing Exemptive Relief for NDFs Will Serve the Public Interest

Although NDFs constitute a small part of the overall FX market -- comprising approximately 1.5% of the U.S.\$4 trillion daily volume in the global FX market -- NDFs have a

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<sup>44</sup> See Section 1a(47)(E)(iii)-(iv) of the CEA (7 U.S.C. § 1a(47)(E)(iii)-(iv)). These standards will benefit unregistered counterparties that face registered swap dealers or major swap participants in NDF transactions that are subject to CFTC jurisdiction under Dodd-Frank.

<sup>45</sup> See Section 1b(c) of the CEA (7 U.S.C. § 1b(c)).

significance to the global FX markets that exceeds their overall share of those markets. NDFs are a key component of the FX markets in non-deliverable currencies, as physically settled FX forwards are not capable of being executed in those markets (or, in some markets, it is sufficiently impractical to physically deliver the local currency that would be traded on a forward basis). For that reason, proper regulatory treatment of NDFs takes on enhanced regulatory policy significance. We summarize below factors (several of which we have discussed above in other contexts) that we believe support the proposition that granting the request relief for NDFs will serve the public interest, as required by Section 4(c) of the CEA.

**1. Procedures Already Exist in the NDF Markets to Minimize Risk and Help Ensure Stability**

As the Secretary of the Treasury has explained, the risk profile of FX forwards is different from that of other derivatives, and mechanisms are already in place in the FX market to minimize risk and ensure stability.<sup>46</sup> We believe that NDFs are similarly distinguishable from other derivatives, and are in one important respect favorably distinguishable from FX forwards from a risk profile point of view.

*First*, as the Treasury Secretary noted, the principal risk with respect to FX forwards is settlement risk. NDFs pose less risk to the U.S. financial system than FX forwards due to the lower settlement and counterparty risk posed by net settlement as opposed to the gross notional settlement at maturity of FX forwards. For a short-term product, the net settlement amounts are likely small as a percentage of notional amount, since there is not sufficient duration to allow for significant divergences in value. Widespread netting and payment compression practices (including as provided by CLS Bank) further mitigate any risks in the NDF market.

We acknowledge that an entire settlement system has been developed for FX forwards (payment-verses-payment settlement at CLS Bank) to address the significant settlement risk posed by the gross payment structure of FX forwards. As noted above, NDFs are not capable of being settled via a payment-versus-payment settlement structure, although CLS Bank does provide payment compression functionality for NDFs to reduce the number of net payments made between counterparties on a given day. We also note that a significant amount of NDFs settle across a single bank's books for its clients. As noted by the Treasury Secretary, transactions that settle in this manner are not subject to settlement risk.<sup>47</sup> U.S. companies, Regulated Funds and other institutional investors are significant users of NDFs. In many instances, these and other market participants trade NDFs with a single custody bank, which settles the trades across its own books on behalf of the client, thus removing settlement risk for

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<sup>46</sup> See Treasury Determination, Part III.A., pp. 11-22.

<sup>47</sup> *Id.* at Part III.A.(ii) at p. 18.

those transactions.<sup>48</sup> We thus note that a significant portion of NDF trading volumes are, like FX forwards, transacted so as to eliminate settlement risk. As noted above, to the extent NDFs do not settle so as to eliminate settlement risk, the net settlement structure significantly mitigates this risk.

*Second*, FX forwards have less counterparty credit risk than other derivatives. Counterparty credit risk increases with the length of time during which a counterparty could suffer from adverse developments, but FX forwards typically have very short durations. The same is true of NDFs.<sup>49</sup> Virtually all FX forwards and NDFs mature in one year or less, and a significant majority mature in three months or less. Because NDFs, like FX forwards, present less counterparty credit risk than other derivatives, the benefits of mandatory central clearing are necessarily lower than for other derivatives.

*Third*, banks are the key players in the FX forward market. According to the Treasury, roughly 95% of FX swaps and FX forward transactions occur between banks acting either on their own behalf or on behalf of their clients.<sup>50</sup> We believe that the NDF market is similarly institutional in nature and subject to comparable comprehensive bank regulatory oversight.

*Finally*, the FX forward market is already transparent. According to the Treasury Secretary, market participants have access to readily available pricing information through multiple sources. Approximately 41% of FX swaps and 72% of FX forwards already trade across a range of electronic platforms, and the use of such platforms has been steadily increasing.<sup>51</sup> We understand that NDF pricing information is also broadly available on the market and NDFs trade across various electronic platforms. Accordingly, mandatory clearing and exchange-trading would not appreciably improve pre- and post-trade transparency of NDFs.

2. FX Forward and FX Swap Markets Play an Important Role in Helping Businesses Manage Their Everyday Funding and Investment Needs, and Market Disruption Could Have Serious Negative Economic Consequences

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<sup>48</sup> We are not aware of data measuring how much NDF volume settles in this manner, but based on discussions with our members and other market participants, we believe that a significant component of the institutional NDF market settles in this manner.

<sup>49</sup> See *ISDA OTC Derivatives Market Analysis Mid-Year 2012* at p. 3 (“ISDA believes that FX contracts differ meaningfully from other OTC derivatives contracts. FX contracts typically reach maturity within a few months while other OTC derivatives mature over much longer time periods.”)(citing BIS data that includes NDFs within the definition of FX transactions).

<sup>50</sup> Treasury Determination, Part III.A.(iv) at pp. 20-21.

<sup>51</sup> *Id.* at Part III.A.(v) at p. 21.

In the Treasury Determination, the Treasury Secretary noted that end-users of FX swaps and FX forwards had expressed concern that requiring centralized clearing would substantially increase the costs of hedging FX risks, resulting in potentially lower cash flows or earnings, thus limiting the growth of U.S. businesses.<sup>52</sup>

As noted above, NDFs are widely used by U.S. companies, Regulated Funds and other institutional investors and market participants that invest in markets with restricted currencies, as NDFs are the most effective and efficient means by which to hedge their exposure to the currencies of those markets. Regulating NDFs as swaps would significantly increase the cost of hedging these exposures. In other words, treating NDFs differently from FX forwards would, in addition to having other unintended consequences, put U.S. companies, Regulated Funds and other institutional investors and market participants that seek to hedge exposure to emerging markets at a disadvantage relative to those doing business or investing solely in developed markets. For Regulated Funds and pension funds that use NDFs to hedge exposure to emerging market equity or debt securities, regulation of NDFs would increase hedging costs, and those increased costs would be borne primarily by the Regulated Fund investors and pension fund beneficiaries on behalf of whom these investments are made. At the same time, to the extent any end user elected to refrain from entering into these hedges rather than incur the added costs to maintain them, additional risk would be introduced into the U.S. financial system. To the extent that the U.S. regulatory approach to NDFs differs from that of other jurisdictions, U.S. banks that transact in NDFs could see this business migrate to other jurisdictions that may be perceived to be preferable from a regulatory (and thus economic) point of view.<sup>53</sup> This could impair the competitiveness of U.S. financial institutions that trade in NDFs and risk the loss of jobs in this country. We believe these outcomes are unwarranted with respect to NDFs for the same reasons as with respect to FX forwards.

Accordingly, for the foregoing reasons, we respectfully submit that granting this petition would serve the public interest.

F. The Benefits of Exemptive Relief for NDFs Outweigh the Costs

Before promulgating a regulation under the CEA or issuing an order, the CFTC must evaluate the costs and benefits of the action to be taken<sup>54</sup> in light of five considerations

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<sup>52</sup> *Id.* at Part III.B.(i) at p. 27.

<sup>53</sup> We understand that market participants outside of the United States have used the absence of comparable regulatory provisions in their home markets to seek to gain a competitive advantage over their U.S.-based competitors since the adoption of Dodd-Frank and the development of implementing regulations, so this is not a hypothetical concern.

<sup>54</sup> *See* Section 15(a) of the CEA (7 U.S.C. § 19).

specified by the CEA.<sup>55</sup> We briefly discuss below why we believe that the proposed exemptive relief would satisfy the cost/benefit analysis required under each of these considerations.

**1. Considerations of Protection of Market Participants and the Public<sup>56</sup>**

As noted in more detail earlier in this petition, our proposal that NDFs receive the same regulatory treatment as FX forwards and FX swaps ensures that market participants and the public will be protected in the same manner as is the case with FX forwards and FX swaps. A determination to exempt NDFs will result in these products remaining subject to the following provisions of the CEA:

- Regulatory reporting -- This will enable the CFTC to monitor use of NDFs generally, and will also support the anti-fraud/anti-manipulation authority noted below.
- Business conduct rules -- Investors utilizing NDFs will benefit from the protections afforded by the business conduct rules adopted for swap dealers and major swap participants in the swaps markets pursuant to Dodd-Frank.
- Anti-fraud and anti-manipulation rules -- NDFs would remain subject to the CFTC's broad anti-fraud and anti-manipulation authority. This would enable the CFTC to protect the markets from transactions entered into in bad faith or on a fraudulent basis.

Therefore, NDFs, if exempted as proposed, will be subject to the same provisions as FX forwards, an economically identical product. We respectfully submit that this will afford market participants and the public precisely the same protection as Congress determined to be appropriate with respect to FX forwards.

Also, as noted above, the market for NDFs is primarily institutional. The relief requested herein would not limit the CFTC's existing regulatory authority with respect to certain retail transactions in FX.

From a cost point of view, the costs to the market of imposing clearing on NDFs far outweigh any benefits that would be achieved. As noted earlier in this petition, the CFTC has stated that clearing will reduce counterparty credit risk.<sup>57</sup> Treasury determined that FX forwards

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<sup>55</sup> See Section 15(a)(2) of the CEA (7 U.S.C. § 19(a)(2)).

<sup>56</sup> Section 15(a)(2)(A) of the CEA (7 U.S.C. § 19(a)(2)(A)).

<sup>57</sup> See note 23, *supra*.

pose less counterparty risk than other derivatives due to their short duration. The same is true of NDFs, which are equally predominantly short-term in duration. Finally, Treasury noted that businesses that rely on FX forwards to hedge risk would bear significant new costs associated with mandatory clearing, margin and capital requirements, which could potentially reduce these market participants' incentives to manage foreign exchange risks.<sup>58</sup> Reducing risk-mitigation activities would impose new risks, and potential costs, on these market participants and on the public in general that Treasury determined were not warranted with respect to FX forwards. An NDF is the sole means by which a business that has cash flows in a non-deliverable currency may hedge the risk of that currency. Imposing comprehensive swap regulation on this product is likely to result in precisely the same costs with respect to NDFs, while producing equally insubstantial benefits.

## **2. Considerations of the Efficiency, Competitiveness and Financial Integrity of Futures Markets<sup>59</sup>**

Regulating economically equivalent products in the same manner is a fundamental tenet of an efficient market. Imposing different regulatory treatment on functionally identical products introduces inefficiency into markets, and impairs competitiveness as market participants inevitably seek to arrange their affairs so as to be able to avail themselves of the most efficient regulatory structure. To the extent markets outside of the U.S. are perceived as regulating a product in a more efficient and effective manner, the competitiveness of the U.S. markets are impaired. For the reasons noted above, we believe that these consequences could very well occur if NDFs are regulated differently from FX forwards, given the economic congruence of the products.

We also note that regulating NDFs as swaps will deter innovation in the U.S. market involving NDFs, as the incremental costs imposed by these new regulations will, by definition, increase the benefits that must be realized to make any innovative structure economically attractive to market participants. Deterring innovation impairs efficiency and competitiveness, and thus should only occur when the benefits outweigh these costs. For the reasons described herein, we believe that regulating NDFs as swaps creates benefits that are, at the best, negligible, and that would clearly be outweighed by these costs.

## **3. Considerations of Price Discovery<sup>60</sup>**

NDF pricing data is widely available to the institutional market participants that comprise the NDF market via a variety of publicly-available price sources. Like FX forwards

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<sup>58</sup> See note 33, *supra*, and accompanying text.

<sup>59</sup> Section 15(a)(2)(B) of the CEA (7 U.S.C. § 19(a)(2)(B)).

<sup>60</sup> Section 15(a)(2)(C) of the CEA (7 U.S.C. § 19(a)(2)(C)).

and FX swaps, NDFs trade across various electronic platforms, utilizing standardized transaction infrastructure that facilitates high rates of straight-through processing and electronic confirmation practices. Regulating NDFs as swaps has never been justified on the basis of improving price discovery.

#### **4. Considerations of Sound Risk Management Practices<sup>61</sup>**

In the context of its final determination to exempt FX forwards and FX swaps from the definition of swap, Treasury noted that, unlike participants in the market for other derivatives, the predominant participants in the FX forward and FX swap markets are banks, which have long been subject to prudential supervision. Dealers in NDFs are, as in the case of FX forwards and FX swaps, primarily banks, so prudential regulation is similarly common in these transactions. We also note that the CFTC's business conduct rules for swaps will apply to NDFs if exempted as proposed herein, which will further promote sound risk management practices.

#### **5. Other Public Interest Considerations<sup>62</sup>**

As noted above in this petition, FX market practice has, historically, not distinguished between FX forwards and NDFs, and leading U.S. and international regulators also do not distinguish between these economically identical products.<sup>63</sup> Maintaining regulatory consistency with international regulators is an important consideration in seeking to develop effective and efficient regulations of financial products. More generally, as discussed above, regulating NDFs differently from FX forwards relies upon an artificial distinction -- that FX forwards settle on a gross basis, whereas NDFs settle on a net basis. While we acknowledge that the statutory language suggests such a distinction, we do not believe it dictates a substantive difference in regulation. As noted above, there has been no explanation of a compelling policy reason to base disparate regulatory treatment of economically identical products solely upon this difference in settlement structure. In fact, as noted above, the net settlement structure inherent in NDFs facilitates greater efficiency and risk management than FX forwards, as the amounts of cash required to be moved to settle a transaction is far smaller in an NDF. Historically, counterparty risk imposed by the FX forward structure was sufficiently significant that, unlike NDFs, sound risk management practices led to the development of a product-specific settlement structure utilizing CLS Bank. We readily acknowledge that, when utilized, CLS Bank effectively mitigates settlement risk for FX forwards (and FX swaps). In comparison, the NDF

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<sup>61</sup> Section 15(a)(2)(D) of the CEA (7 U.S.C. § 19(a)(2)(D)).

<sup>62</sup> Section 15(a)(2)(E) of the CEA (7 U.S.C. § 19(a)(2)(E)).

<sup>63</sup> See notes 37-41, *supra*, and accompanying text.

settlement structure involves far lower settlement risk, and thus the benefits of mandatory clearance are negligible, and far outweighed by the costs described above.

For the reasons summarized above, we respectfully submit that the exemption of NDFs that we propose herein is fully justified on a cost/benefit basis under each of the considerations set forth in Section 15(a)(2) of the CEA.

In addition, the CFTC must consider the public interest protected by the antitrust laws and “endeavor to take the least anticompetitive means of achieving the objectives of [the CEA].”<sup>64</sup> These factors also weigh in favor of granting the requested exemptive relief for NDFs. Regulating NDFs as swaps, and thus treating them differently from FX forwards, would put market participants (including U.S. companies, Regulated Funds and other investors and market participants) at a competitive disadvantage relative to market participants doing business or otherwise investing solely in developed markets. Regulating NDFs as swaps would significantly increase the cost of hedging exposure to FX risk associated with non-deliverable currencies, to the detriment of the competitiveness of these market participants. This result is inconsistent with requirement of Section 15(b) of the CEA that the CFTC “take the least anticompetitive means of achieving the objectives of the [CEA]”. The proposed exemptive relief would preserve existing competition between market participants doing business (or investing) in developed and developing markets by placing both groups of investors on equal footing from a regulatory policy (and thus cost) point of view.

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In light of the considerations listed above, we respectfully request that the CFTC issue an order providing that NDFs will be treated in the same manner as FX forwards and FX swaps for purposes of swap regulation under the CEA. Exemptive relief for NDFs would promote responsible economic and financial innovation by allowing this important market to continue to use and develop market infrastructure designed specifically to meet the unique needs of FX transactions. For the reasons we have identified, we respectfully suggest that providing exemptive relief for NDFs would be in the public interest, could be tailored to appropriate persons, and would not have a materially adverse effect on the CFTC’s regulatory duties.

We appreciate the CFTC’s consideration of this petition. If we can be of any further assistance regarding these important issues, please feel free to contact Karrie McMillan ((202) 326-5815) or Sarah Bessin ((202) 326-5835) of ICI, Dan Waters (44-203-009-3101) or Giles Swan (44-203-009-3103) of ICI Global, Timothy Keehan ((202) 663-5479) of ABA, Cecelia Calaby ((202) 663-5325) of ABASA or our counsel at Covington & Burling LLP (Bruce C. Bennett, (212) 841-1060, bbennett@cov.com).

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<sup>64</sup> See Section 15(b) of the CEA (7 U.S.C. § 19(b)).

Ms. Melissa Jurgens  
February 26, 2013  
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Very truly yours,

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