



August 9, 2018

Mr. Christopher J. Kirkpatrick
Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, D.C. 20581

Re: De Minimis Exception to the Swap Dealer Definition; Notice of Proposed Rulemaking

Dear Mr. Kirkpatrick:

Northern Trust¹ respectfully submits these comments with respect to the Notice of Proposed Rulemaking dated June 12, 2018, entitled “De Minimis Exception to the Swap Dealer Definition” (the “Proposal”). The Proposal requests comments on whether non-deliverable forwards (“NDFs”) should be excepted from the aggregate gross notional amount (“AGNA”) for purposes of determining whether the *de minimis* exception applies to an entity’s swap dealing activity. For the reasons discussed below, we support excepting NDFs from consideration in calculating AGNA.

A. NDFs are economically equivalent to physically settled foreign exchange forwards and should therefore be treated consistently by regulations.

While a typical spot or forward foreign exchange (“FX”) transaction is physically settled at maturity by an exchange of the notional amounts of the two currencies, an NDF is net settled at maturity with a single amount payable in a reserve currency (usually U.S. dollars) by one party to the other. NDFs are essentially contracts for the payment of the difference between an agreed exchange rate and the actual spot rate at maturity for the relevant currency pair. They perform an important function by allowing hedging of investments in non-dollar jurisdictions against movements in a currency without requiring funding in that currency. Market participants use NDFs to access emerging markets and currencies, allowing them to take positions in currencies that are subject to official controls and restrictions in cases where a foreign central bank limits offshore access to its domestic cash markets.

¹ Northern Trust is a leading provider of investment management, asset servicing and fund administration, banking solutions and fiduciary services for corporations, institutions and affluent individuals worldwide. Founded in Chicago in 1889, Northern Trust has offices in the United States in 19 states and Washington, D.C., 23 international locations in Canada, Europe, the Middle East and the Asia-Pacific region. As of June 30, 2018, Northern Trust Corporation had assets under custody/administration of \$10.7 trillion and assets under management of \$1.1 trillion. The Northern Trust Company is provisionally registered with the CFTC as a swap dealer and is a dealer in foreign exchange through its trading desks in Chicago, London and Singapore.

The difference in settlement mechanics should not override the fact that FX forwards and NDFs are otherwise “economically and functionally identical.”² Both FX forwards and NDFs are:

- traded on the FX trading desk of a bank or broker;
- eligible for settlement through CLS Bank International (“CLS”);
- characterized by short-term maturities (usually settling within one year, with a significant percentage settling in three months or less);
- priced primarily based on each currency’s interest rate and spot exchange rate; and
- traded in a highly liquid and transparent market.

The purpose for entering into an NDF is often the same as the purpose for entering into a deliverable FX forward – to hedge exposure to market and foreign currency risk. For example, a U.S. pension fund investing in securities denominated in a non-U.S. currency may, depending on the capital controls and currency restrictions placed on the non-U.S. currency, enter into either a deliverable FX forward or an NDF to hedge or mitigate the associated foreign currency risk, and the net result will be the same.

FX forwards and NDFs share most characteristics except that delivery at maturity for NDFs is a netted amount and the principal amounts are never exchanged. That difference does not justify the disparate treatment between the two types of FX transactions with respect to the *de minimis* exception. Counting NDFs toward AGNA and not counting FX forwards results in disproportionate regulatory oversight over NDFs relative to other types of FX products, with a requirement that an entity acting as a dealer in a higher volume of NDFs register as a swap dealer even if it does not transact in other types of swaps, while a similarly situated entity transacting in FX forwards is not required to register. This difference in regulatory treatment has contributed to market fragmentation, increased costs and confusion in the market regarding the treatment of the deliverable and non-deliverable types of FX forwards.

B. NDFs do not pose any particular systemic risk distinct from FX forwards, and pose less counterparty credit risk and settlement risk than FX forwards.

NDFs fulfill the same economic purpose as, and share most characteristics of, FX forwards and therefore they share a similar risk profile in terms of systemic risk. However, because NDFs represent a smaller proportion of the overall FX market, the systemic risks posed by NDFs are arguably smaller than FX forwards.

NDF settlement with a single payer delivering a net amount in a reserve currency reduces both counterparty credit risk and settlement risk of NDFs relative to deliverable FX forwards. By exchanging a net amount, as opposed to the full notional amounts in each currency at settlement, NDFs can almost eliminate settlement risk,³ posing less risk to market participants and the financial system overall. Settlement via CLS, though voluntary, further reduces settlement risk, as CLS settles NDFs on a payment-versus-payment (“PVP”) basis.

² See The Investment Company Institute comment letter to the U.S. Department of the Treasury’s Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the CEA, 77 Fed. Reg. 69,694 (Nov. 2012), at 5.

³ The Foreign Exchange Committee, *An Issue Paper: Foreign Exchange, Difference Settled (FXDS)* August 1998, available at: <https://www.newyorkfed.org/medialibrary/microsites/fxc/files/fxds.pdf>.

The FX markets and NDFs did not cause the failure of any systemically risky entity or banking institution during the 2008-2009 financial crisis, and FX markets functioned relatively well, with deliverable FX forwards used to support global liquidity and access to funding. While liquidity was impaired at times in the forward FX markets, those effects were felt mostly in the deliverable FX forward market rather than the NDF market.⁴ The PVP settlement of NDFs with bilateral netting reduces settlement risk relative to deliverable FX forwards and potentially facilitates a more orderly settlement of transactions during a bankruptcy or a period of market stress.

C. There is no material benefit to the market in requiring participants transacting in NDFs to register with the Commission, while not imposing similar obligations on participants that transact in deliverable FX forwards.

The Department of the Treasury's determination that FX forwards and FX swaps should not be regulated as swaps under the Commodity Exchange Act ("CEA")⁵ was based on a number of factors that also apply to NDFs, including the effective mitigation of settlement risk, decreased counterparty credit risk owing to the short average length of the contracts, that the FX market is highly transparent, trading is done over electronic platforms, and the fact that FX transactions are effected through banks that are already subject to extensive and coordinated oversight. In addition, non-spot FX products, including FX forwards and NDFs, are already subject to reporting requirements and anti-fraud rules under the CEA. Therefore, requiring banks that transact in high volumes of NDFs to register with the Commission provides no further material benefit to the U.S. financial market and only increases the costs associated with providing liquidity in the NDF market to investors.

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We appreciate the opportunity to present this recommendation to the Commission. We applaud the Commission's efforts to better understand the important market function that NDFs provide and we are in support of amending the *de minimis* exception in the "swap dealer" definition to except NDFs from consideration when calculating the AGNA of swap dealing activity.

We would be happy to discuss our comments at greater length with the Commission or its staff. If there are any questions, please contact the undersigned at (312) 444-5947.

Respectfully Submitted,



Jennifer L. Roman
Senior Legal Counsel
The Northern Trust Company

⁴ See the London Foreign Exchange Joint Standing Committee's "FXJSC Paper on the Foreign Exchange Market" at p. 21, (providing that "FX counterparty settlement risk resulting from the physical exchange of principal is a major source of risk in the FX market.") (Sept. 2009).

⁵ See Determination of Foreign Exchange Forwards and Foreign Exchange Swaps Under the Commodity Exchange Act, 77 Fed. Reg. 69,694 (Nov. 2012).