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`Commodity Exchange Act Sections 1(a)49; 1(a)24; 1a(31); 1a(11); 1(a)(12); 6(s)(a)(1)
Commission Regulations Parts 1.3, Swap dealer, paragraph (4)(i)(A);
7 U.S.C. 6s(a)(1)

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Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Center
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Re: *De Minimis Exception to the Swap Dealer Definition 83 Fed. Reg. 27444 (June 12, 2018), RIN 3038-AE68 and Non-Deliverable FX Forwards*

Ladies and Gentlemen:

Covington & Burling LLP is pleased to submit this comment letter in respect of the above-cited proposed rule and request for comment (the "*Proposed Rule*") on behalf of a client that participates in the foreign exchange markets. For the reasons outlined below, we urge the Commodity Futures Trading Commission (the "*Commission*" or "*CFTC*") to amend the *de minimis* exception in paragraph (4) of the "swap dealer" definition in § 1.3(ggg) of the Commission's regulations by excepting non-deliverable foreign exchange forwards ("*NDFs*") from consideration when calculating the aggregate gross notional amount ("*AGNA*") of swap dealing activity for purposes of the *de minimis* threshold, which when exceeded, triggers Swap Dealer registration. As noted in the Proposed Rule, excepting NDFs would result in a more equivalent regulatory treatment for these transactions when compared with foreign exchange swaps and deliverable foreign exchange forwards, which under no circumstances trigger Swap Dealer registration.

As we discuss below, for reasons similar to excluding NDFs from consideration for Swap Dealer registration, transactions in NDFs should also be excluded from consideration for a market participant or intermediary's determination of whether it is required to register with the Commission as a Futures Commission Merchant ("*FCM*"), Commodity Trading Advisor ("*CTA*"), or Introducing Broker ("*IB*").

The Legislative History Supports Equivalent Treatment of NDFs and FX Forwards. Dodd-Frank amended the Commodity Exchange Act ("*CEA*") to, among other

things, include foreign exchange ("*FX*") forwards in the definition of "swap."[1] The CEA defines "FX Forward" as "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."[2] NDFs are FX forwards involving one currency that is subject to local law that either prohibits, or makes impractical, physical delivery of the currency outside of the home jurisdiction. Therefore, in an NDF, one counterparty makes a one-way payment to the other denominated in the deliverable currency (usually in U.S. Dollars) representing the exchange rate movements of the two currencies between trade date and maturity. As such, the CEA definition of "FX Forward" could be interpreted to exclude NDFs because they cannot physically settle by "the exchange of 2 different currencies" since one currency is non-deliverable.

During the Dodd-Frank legislative process, the Department of Treasury objected to the regulation of FX forwards (and FX swaps) as swaps, due to, among other factors, the widespread use of these products by central banks as monetary policy tools and the low level of market risk inherent in such products.[3] Others advocated for inclusion of FX forwards and FX swaps in the definition of swap.[4]

As a result of the differences in approach to the regulatory treatment of FX forwards and FX swaps under the CEA, Congress included in Dodd-Frank a provision authorizing the Secretary of Treasury to make a written determination as to whether FX forwards and FX swaps would be excluded from the definition of "swap" under the CEA. On November 16, 2012, then-Secretary Timothy Geithner issued a determination that FX swaps and deliverable FX forwards should be so excluded.[5] Further, he stated that, due to the statutory language described above, he did not possess the authority to determine that NDFs should be accorded the same treatment as deliverable FX forwards under the CEA.[6]

However, as noted in the Proposed Rule, in a footnote, then-Secretary Geithner stated that the Treasury did not intend for its written determination to affect the CFTC's authority to further define the term "swap" under the CEA. The footnote states, "Under section 712(d)(1) of the Dodd-Frank Act, 15 U.S.C. 8302(d)(1), the Commissions are authorized to further define the term "swap" under the CEA, and the Treasury does not intend that the Commissions' joint rules in respect of the status of NDFs as swaps be affected by this written determination issued under other provisions of the CEA."[7] To date, the CFTC has not exercised this authority or otherwise interpreted the application of NDFs under the Commission's rules. However, as explained in

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[1] CEA, 7 U.S.C. at §§1a(24), 1a(47).

[2] *Id.* at § 1a(24).

[3] Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, Final Determination, 77 Fed. Reg. 69694, 69698 (Nov. 20, 2012) (the "*Treasury Determination").*

[4] *See id.*

[5] *See id.* Notwithstanding this determination, deliverable FX forwards and FX swaps remain subject to the business conduct rules (when an SD is involved), regulatory reporting, anti-fraud and anti-manipulation provisions of the CEA relating to swaps.

[6] *See id.*

[7] *Id.* at 69704 n. 89.

this letter, excepting NDFs from consideration when calculating the *de minimis* threshold for Swap Dealers would address certain market distortions that have arisen from the divergent regulatory treatment currently afforded two functionally and economically identical products.

NDFs and FX Forwards Are Functionally and Economically Identical Products. An NDF is functionally and economically the same product as a deliverable FX forward. The sole difference between these two products is that in a deliverable FX forward, the trade closes out at maturity upon delivery by each party to the transaction of the gross notional amount of the respective currency specified in the contract. In comparison, in an NDF, the trade closes out at maturity upon delivery of the net value of the underlying exchange, denominated in a predetermined currency. In each structure, the net value transferred is exactly the same and the counterparty initiating the transaction can achieve exactly the same economic outcome, whether it be to hedge a particular asset or liability or to speculate in a given currency. Virtually all FX forwards (deliverable and non-deliverable) mature in one year or less, and a significant majority mature in three months or less. We are not aware of any meaningful difference in average maturities of deliverable FX forwards as compared with NDFs.

While in theory NDFs could be used in lieu of physically settled FX forwards with respect to any unrestricted currency pair, it is our understanding that in practice this rarely occurs in the market.[8] NDFs are used almost exclusively to effect the substance of a deliverable FX forward when one of the underlying currencies cannot be physically delivered as a matter of local law or is, as a practical matter, not deliverable due to local law or other local requirements.[9]

We respectfully submit that the fact of net settlement of NDFs versus gross notional settlement at maturity for deliverable FX forwards is neither dispositive nor relevant from a regulatory policy point of view. In other words, the structural difference in the products is insignificant compared to their functional and economic equality. In fact, were one to simultaneously enter into a deliverable FX forward and NDF with identical underlying currencies, notional amount and maturity date, the value of the transactions would be identical throughout their tenor. Whether the product is a deliverable FX forward or an NDF, it is the net value of the trade that is the fundamental economic component of any FX forward transaction, and that value is not known until maturity. Thus, the distinction in settlement processes is not a sufficient basis upon which to base disparate regulatory treatment, including with respect of the *de minimis* threshold for Swap Dealers, of otherwise identical instruments.

Given the functional and economic congruity between the two products, sound regulatory policy compels comparable treatment. We respectfully submit that no reason for

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[8] This is primarily due to the fact that the Staff of the Commission has taken the position that a FX forward involving two deliverable currencies that settles net rather than gross would not be entitled to the exemption from the definition of swap afforded by the Treasury Determination. Product Definitions Release (77 Fed. Reg. 48207, 48255 at n. 539 (Aug. 13, 2012), n. 539.

[9] Non-deliverability is a feature of many emerging market currencies and of virtually no developed market currencies. Thus, NDFs are in effect an emerging market product. Many of these currencies are important to the global financial markets and therefore proper treatment of NDFs is important to the markets. NDFs continue to represent about a fifth (19%) of outright forward trading, and about a 40th (2.6%) of overall FX trading. Robert McCauley & Chang Su, *Non-deliverable Forwards: Impact of Currency Internationalisation and Derivatives Reform*, BIS QUARTERLY REVIEW 81 (Dec. 2016), https://www.bis.org/publ/qtrpdf/r_qt1612h.pdf .

divergent treatment exists and that the market already treats the products as comparable in many ways. We thus support excluding both deliverable FX forwards and NDFs from the calculation for the Swap Dealer *de minimis* threshold.

We note the following examples of such comparable treatment:

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

- 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." The Federal Reserve Bank of New York has long recognized NDFs as a viable means by which to engage in forward transactions in non-deliverable currencies.[10]

- The Bank for International Settlements ("*BIS*") treats NDFs as a component of the outright forward category.[11]

- Standard FX market documentation structures do not distinguish between FX forwards and NDFs.[12]

- FX forwards are subject to special rules under the U.S. tax code that apply equally to physically settled and cash settled transactions.[13]

The Commission's failure to interpret "foreign exchange forward" to include NDFs is inconsistent with these precedents, and also, as described below, has introduced distortions into the market.

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[10] Sam Y. Cross, *Main Instruments: Over-the-Counter Markets*, *in* ALL ABOUT THE FOREIGN EXCHANGE MARKET IN THE UNITED STATES 31, 39 (Fed. Res. Bank of N.Y., 1998), MED. http://www.spytrdr.com/ForeignExchangeMarket.pdf.
"Outright forward" as used in this publication means FX forwards, including NDFs. *See also* Laura Lipscomb, Federal Reserve Bank of New York, *An Overview of Non-Deliverable Foreign Exchange Forward Markets* (May 2005), https://www.bis.org/publ/cgfs22fedny5.pdf.

[11] Monetary and Economic Department, Bank for International Settlements, *Triennial Central Bank Survey of Foreign Exchange and OTC Derivatives Markets: Reporting Guidelines for Turnover in April 2019,* at 2 (Draft May 2018), https://www.bis.org/statistics/triennialrep/2019survey_guidelinesturnover.pdf. *See also* Committee on Payment and Settlement Systems, BIS, *A Glossary of Terms Used in Payments and Settlement Systems,* https://www.bis.org/dcms/glossary/glossary.pdf?scope=CPMI&base=term.

[12] *See, e.g.,* International Swaps and Derivatives Association, Inc. ("*ISDA*"), 1998 FX AND CURRENCY OPTION DEFINITIONS §§ 1.12 and 1.15 (ISDA 1998) (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)); The Foreign Exchange Committee, *The 1997 International Foreign Exchange Master Agreement* § 1 (1997) (the "*IFEMA*"), (definition of "FX Transaction") (definition of FX Transaction includes both physically settled and net settled transactions; no separate mention of non-deliverable transactions in the IFEMA).

[13] *See* 26 U.S.C. § 1256(g)(2).

In the past the Commission has attempted to distinguish NDFs from instruments that fall outside the definition of "swap" by stating that NDF markets are driven in large part by speculation and hedging.[14] However, deliverable FX forwards are also used to hedge and to speculate. NDFs and deliverable FX forwards are functionally and economically indistinguishable and can be used to effectuate economically identical transactions[15]—whether that transaction is a hedge or a speculative position.[16] We therefore respectfully submit that hedging and speculation cannot be used to rationalize the divergent regulatory treatment of NDFs and deliverable FX forwards.

Further, NDFs are primarily institutional products. As is the case with the exemption of FX swaps and FX forwards, the relief discussed 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 deliverable 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 acknowledge that, if modification of the proposed rule as it relates to NDFs is to be implemented, 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 are non-deliverable. We believe that limiting such an exemption to a specified list of currencies would prevent the potential risk of the exemption being used to evade the regulation of products that are in fact swaps and not entitled to any exemption.

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[14] Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 Fed. Reg. 29818, 29836, 29836 nn. 134-35 (May 23, 2011) Proposing Release, supra note 6.

[15] To the extent a party to a deliverable FX forward was using the transaction to speculate and did not wish to receive gross payment in a currency that was due to it, the FX trading desk with which it had entered into the transaction would convert the gross proceeds to the currency of such party's choice. As the transactions are economically equivalent, any difference in the extent to which NDFs are used for speculation relative to deliverable FX forwards relates to speculators' views regarding the currencies underlying the transactions rather than to differences between NDFs and deliverable FX forwards themselves. Again, 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 deliverable FX forwards. In summary, if FX forwards are excepted from the calculation for the swap dealer *de minimis* threshold, so too should NDFs.

[16] For example, NDFs are commonly employed by U.S. corporations that use the U.S. Dollar as their functional currency to hedge exposure to a non-deliverable emerging market currency (by taking the short side of an NDF transaction involving the emerging market currency). The same trade enables a mutual fund to hedge exposure to a portfolio of emerging market equities or debt denominated in a non-deliverable currency. Deliverable FX forwards (as well as spot transactions) are used in the same manner (e.g., to hedge downside risk in U.S. equities by going long Japanese Yen or another currency that is viewed as inversely correlated to the U.S. Dollar, or to hedge downside risk in European equities by going short the Euro).

NDFs Do Not Pose Systemic Risk Warranting Swap Dealer Registration. NDFs likely pose less risk to the U.S. financial system than deliverable FX forwards in similar aggregate notional amounts due to the lower settlement and counterparty risk. NDFs, by definition, net settle whereas deliverable FX forwards settle on a gross notional basis at maturity. As noted, divergent settlement processes cannot justify divergent regulatory treatment between the products. Nevertheless, we posit that the settlement structure of NDFs supports the claim that they do not pose systemic risk great enough to warrant swap dealer registration. In addition, as noted above, NDFs comprise a very small portion of the overall FX market.

A widely-used payment and settlement system currently exists for the net settlement payment at maturity structure that is inherent in NDFs. [17] CLS Bank, a settlement system that is regulated by the Federal Reserve Bank of New York, can be utilized to settle NDFs that are executed in one of the currencies currently settled through the CLS system. [18] Bilateral cross-product settlement of NDFs and other FX transactions denominated in the same currency is offered by CLS Bank. By netting NDFs with other products involving the same counterparties, counterparty risk is reduced.[19] In addition, many of these transactions are settled internally pursuant to existing collateral or other arrangements. Such internal settlement eliminates settlement risk. We believe all of these features of NDFs support the conclusion that NDFs likely pose less risk to the US financial system than deliverable FX forwards and therefore should be equally excepted from consideration when calculating the AGNA of swap dealing activity for purposes of the *de minimis* exception.

In addition, a significant amount of NDF transactions are executed by banks or brokers with clients. These bank and broker entities are generally subject to extensive regulation, including capital requirements, which enhance the protections afforded to the counterparty. To the extent Swap Dealers are involved, similar obligations are imposed.

According to the 2016 BIS Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity (the "*Triennial*"), global NDF turnover amounted to $134 billion in April 2016, up 5.3% since April 2013. The NDF share in the categories reported to the Triennial has stayed broadly stable over the prior three years: NDFs continue to represent about a fifth (19%) of outright forward trading, and about a 40th (2.6%) of overall FX trading. Therefore, we believe it is fair to view the NDF market as a small market when compared to the overall FX market, and also in effect a finite market that will continue to be important, but will not develop

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[17] CLS Bank currently offers its settlement service for all currencies that are commonly viewed by the FX market as non-deliverable.

[18] Jürg Mägerle & David Maurerh, *The Continuous Linked Settlement foreign exchange settlement system* (CLS) (Nov. 9), *available at* https://www.snb.ch/en/mmr/reference/continuous_linked_settlement/source/continuous_linked_settlement.en.pdf

CLS Bank offers a settlement service for deliverable FX forwards that addresses Herstatt risk inherent in the product, thus mitigating counterparty risk. The Commission has noted that this service is used by many market participants. The CEA does not, however, mandate use of this settlement service for deliverable FX forwards. *See* 77 Fed. Reg. at 69698 ("The extensive use of CLS and privately negotiated PVP settlement arrangements between banks, financial intermediaries, and their clients largely addresses settlement risk in the market for foreign exchange swaps and forwards, and, as a result, constitutes an important, objective difference between foreign exchange swaps and forwards and swaps that otherwise are subject to regulation under the CEA.").

into a significantly larger market presenting risks to the U.S. financial system different than those being evaluated today. [20] This view is supported by the data put forth in the 2016 Triennial. Under these circumstances, it is difficult to conclude that NDFs warrant different regulatory treatment than deliverable FX forwards.

We note that if NDFs are excluded from the *de minimis* calculation, NDF activity will still be subject to all of the other requirements imposed on swaps, including reporting, margin and centralized clearing (as applicable). These controls will minimize any systemic risk NDFs pose even if the entity trading such products is not a Swap Dealer.

The NDF market, for the reasons noted above, does not pose a significant systemic risk to financial markets and in fact, likely pose less risk to the U.S. financial system than deliverable FX forwards. If follows that if deliverable FX forwards need not be counted toward the *de minimis*, neither should NDFs.

The Financial Crisis Did Not Reveal that FX Forwards or NDFs Pose Undue Systemic Risk. Addressing systemic risk more broadly, empirical evidence supports the view that the FX market in general functioned smoothly during the financial crisis.[21] Detailed studies of the impact of the financial crisis on the FX market demonstrate that the disruptions were limited to the FX swap market; other aspects of the FX market were not disrupted in any material way. The FX swap market was affected by an unprecedented shortage in U.S. dollar-denominated funding for non-U.S. financial institutions.[22] This shortage, which dates back at least a decade, largely stemmed from a sharp growth in the U.S. dollar assets of European, Asian and other non-U.S. banks and financial institutions. Traditional U.S. dollar funding from banks, non-banks and depositors historically only covered part of this structural shortage, so non-U.S. institutions became increasingly reliant upon the FX swap market to make up this shortfall.

During the financial crisis, due to increasing concern over counterparty risk, U.S. banks curtailed lending and money market mutual funds effectively withdrew from the commercial paper markets. Inter-bank lending of U.S. dollars and money market mutual fund purchases of

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[20] It is, of course, possible that the NDF market will grow in absolute terms if trading volumes in currently non-deliverable currencies increase. However, we believe that is unlikely that any currently deliverable currency that is widely traded in the FX market will become non-deliverable. Instead, we believe that it is more likely that one or more currently non-deliverable currencies will shed their restrictions in the future. Any such shift would reduce the size of the NDF market and correspondingly increase the size of the deliverable FX forward market on a dollar-by-dollar basis. Thus, while the NDF market will continue to be an important component of the FX market, and an indispensable market for hedging or speculating in non-deliverable currencies, it will not encounter growth such that our analysis of the potential risks to the U.S. financial system would cease to be accurate over time.

[21] Michael R. King & Dagfinn Rime, *supra* note 15, at 32. *See e.g.* Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, Final Determination, 77 Fed. Reg. 69694, *69701* (Nov. 20, 2012).

[22] *See generally*, Randall S. Kroszner & William Melick, *The Response of the Federal Reserve to the Recent Banking and Financial Crisis* (Dec. 2009), *available at* http://faculty.chicagobooth.edu/randall.kroszner/research/pdf/KrosznerMelickFedCrisisResponse.pdf; Patrick McGuire & Götz von Peter, T*he U.S. Dollar Shortage in Global Banking and the International Policy Response*, BIS WORKING PAPERS NO. 291 (Oct. 2009), *available at* http://www.bis.org/publ/work291.htm; Naohiko Baba & Frank Packer, *From Turmoil to Crisis: Dislocations in the FX Swap Market Before and After the Failure of Lehman Brothers*, BIS WORKING PAPERS NO. 285 (July 2009), available at http://www.bis.org/publ/work285.htm.

U.S. dollar-denominated commercial paper were significant sources of U.S. dollar funding for non-U.S. banks and financial institutions. As a result of these shifts, the availability of U.S. dollar funding to banks and other financial institutions was reduced.[23] At the same time, these factors caused the effective maturity of non-U.S. financial institutions' U.S. dollar funding to shorten, as lenders tended to reduce the duration of their transactions with borrowers, or as particular credit tools ceased to be available. As a result, the effective maturity of their U.S. dollar assets lengthened as those assets became increasingly illiquid, thus exacerbating the issue. As demand for U.S. dollar funding by non-U.S. financial institutions far outstripped a decreasing supply, one-sided order flow in the FX swap market resulted, causing a severe impairment of liquidity in that market. This, in turn, introduced volatility to the international market for U.S. dollars, which impaired the ability of the Federal Reserve to conduct monetary policy by maintaining a targeted Federal Funds rate.

In response, the Federal Reserve opened up reciprocal currency arrangements (also referred to as "swap lines") with 14 European and Asian central banks pursuant to which the Fed swapped U.S. dollars for the home currency of the respective central bank. The recipient central banks would, in turn, auction the U.S. dollars to financial institutions in their respective jurisdictions.[24] The opening of these lines (which have historical precedent dating back to the early 1960s and were most recently opened in 2001 in response to the terrorist attacks) significantly increased the supply of U.S. dollars in the international markets, and thus eased pressures on those markets, including the market for FX swaps, that provided U.S. dollar funding to financial institutions located outside of the United States.

It is important to note that these disruptions were not caused by the FX swap market (or any other aspect of the FX market). Instead, the disruption of the FX swap market was an effect of the shortage of U.S. dollars outside of the United States, an unrelated cause. The disruption affected not just the FX swap market, but the offshore market for U.S. dollars generally, as the shortage compromised the supply and demand equilibrium that would be present when the market is functioning smoothly.[25] When demand so completely outstrips supply, markets can be disrupted.[26] In fact, it can be argued that the FX swap market

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[23] Commentators have also noted that allegations of flawed reporting of LIBOR rates during the crisis could have contributed to difficulties in accurately pricing U.S. dollar lending to non-U.S. financial institutions during this period.

[24] This supplemented the Federal Reserve's concurrent Term Auction Facility program, which provided U.S. depositary institutions with access to longer-term U.S. dollar denominated federal funds, and also avoided any perceived stigma associated with borrowing from the Fed's discount window.

[25] As an indication of the extent of the disruption caused by the shortage of U.S. dollars outside of the United States, U.S. financial institutions reportedly sought to utilize the FX swap market to procure U.S. dollars during the crisis, using non-U.S. currencies as a source for U.S. dollar funding. This would be a highly unusual, perhaps unprecedented, phenomenon.

[26] Another example of market distortions caused by mismatches in supply and demand is the volatility experienced in the market for longer-dated U.S. treasury bonds when the U.S. government announced, on October 31, 2001, that it had decided to discontinue the issuance of 30-year treasury bonds. The announcement caused the yields on 30-year treasury bonds (which move inversely to the price of the bonds) to immediately drop 30 basis points and the yields on 10-year treasury bonds to immediately drop 12 basis points. These changes, which massively disrupted the markets for these securities, were not caused by any structural flaw in the markets for, or structure of, U.S. treasury bonds, but instead by a massive shift in supply and demand.

behaved appropriately in the face of unprecedented volatility in the broader market for U.S. dollars — market participants adjusted pricing and availability to protect themselves rather than incurring inappropriate risk by continuing to transact at traditional levels notwithstanding the troubles evident in the market.[27] Thus, the Federal Reserve's action in opening the reciprocal currency arrangements was taken not to stabilize the FX swap market, but instead to stabilize the broader market for U.S. dollars outside of the United States, of which the FX swap market was but a part. We do not believe that this episode should be construed as support for any argument that FX swaps or FX forwards (deliverable or not) pose undue systemic risk to financial markets. If anything, the impact of the financial crisis on the FX market demonstrate that the disruptions that occurred were limited to the FX swap market; other aspects of the FX market were not disrupted in any material way.

The Diverging Treatment of NDFs and Deliverable FX Forwards Has Negatively Impacted the FX Market. Regulating NDFs differently than deliverable FX forwards has led to market distortions and a decline in liquidity for NDFs in the U.S. Certain market participants, including some of those for whom Swap Dealer registration would be triggered solely by the volume of NDFs traded, have directed NDF transactions to offshore jurisdictions or exited the U.S. market, which they perceive to be preferable from a regulatory (and thus economic) point of view as compared with the costs of transacting in NDFs in the United States. For American businesses that utilize NDFs to hedge commercial risks this resulted in fewer choices of market participants to transact with and the resultant increased costs due to the decreased market competition.

If businesses elect to refrain from entering into hedges, they would face increased risks. If they elect to enter into transactions overseas they would face inefficiencies and potential risks of offshore execution, including the costs associated with the resolution of any disputes which would shift to venues outside of the U.S. or were to be resolved under local law. We therefore believe, by excluding NDFs from calculation of the *de minimis* threshold for Swap Dealers, the Commission would facilitate a return to the U.S. market of at least a portion of the volume that has migrated away due to perceptions of regulatory or execution advantage in dealing in NDFs outside the U.S. This in turn would create a more robust and competitive market, from which American business will benefit.

Commissioner Behnam's Dissent Does Not Provide an Imminent Solution. We respectfully disagree with the approach set forth in Commissioner Behnam's dissent to the proposal to exclude NDFs from Swap Dealer *de minimis* calculations. Commissioner Behnam believes that the issue of whether the Commission should consider an exception for NDFs from consideration when calculating the AGNA of swap dealing activity for purposes of the *de minimis* threshold is inappropriate. He argues that such an exception ignores that the Swap Dealer definition is activities-based and that the real issue that should be addressed is whether NDFs are swaps and, if so, whether they ought to be excluded from consideration in the Swap Dealer definition. He further posits that instead of attempting to begin a conversation through use of its *de minimis* exception authority, the Commission should use its relationships with the Secretary of the Treasury, the SEC and prudential regulators and engage in a meaningful dialogue regarding the appropriate categorization and consideration of NDFs outside of the Proposed Rule.

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[27] *See* Michael Melvin & Mark P. Taylor, *The Crisis in the Foreign Exchange Market*, CESIFO WORKING PAPER NO. 2707 (July 2009), at 14, *available at* http://www.ifo.de/portal/pls/portal/docs/1/1186164.PDF.

While we do believe that NDFs should be excluded from the definition of swaps, we also believe the prolonged divergent regulatory treatment of NDFs and FX forwards has led to market distortions that need to be addressed imminently. If NDFs were excluded from the calculation of the Swap Dealer *de minimis* threshold, it would afford market participants more options for executing NDF transactions, resulting in greater competition and lower prices for American businesses. This would occur without any undue, additional systemic risk to American markets because NDF transactions will be disclosed, margined and possibly cleared. Compared to deliverable FX forwards, NDFs present no greater systemic risks, therefore there is no reason the market should be pushed offshore as a function of regulation. Further, NDFs still comprise only a small portion of the overall FX market. As noted above, empirical evidence supports the view that FX markets in general functioned smoothly during the financial crisis.

Given the need to allocate scarce regulatory resources as effectively and efficiently as possible, ensuring American businesses are given greater access to NDFs while not increasing the Commission's regulatory burden to monitor more registered Swap Dealers (when NDFs pose little or no systemic risks) reflects sound regulatory policy.

Responses to Questions in the Proposed Rule. We submit the following responses to the specific requests for comment in the Proposed Rule.

(1) Should the Commission except NDFs from consideration when calculating the AGNA of swap dealing activity for purposes of the *de minimis* exception? Why or why not?

Yes. As noted above, both to ensure that two similar products receive more consistent regulatory treatment and to create a more robust NDF market within the U.S. (without engendering additional systemic risk), the Commission should except NDFs from consideration when calculating the AGNA of swap dealing activity for the purpose of the *de minimis* exception.

(2) Are there other foreign exchange derivatives that the Commission should except from consideration for counting towards the *de minimis* threshold?

We are aware that there may be other products (such as window FX forwards) which may have similarly/inadvertently been impacted by the definition of an FX forward and therefore may also benefit from an exception from being counted toward the *de minimis* proposal. However, whether those other products should also be excluded from the *de minimis* calculation should have no bearing on whether excluding NDFs is appropriate.

(3) Do NDFs pose any particular systemic risk in a manner distinct from foreign exchange swaps and foreign exchange forwards?

No. As outlined above, it is evident that NDFs do not pose any particular systemic risk in a manner distinct from deliverable FX forwards. If anything, NDFs likely pose less risk to the U.S. financial system than deliverable FX forwards in similar aggregate notional amounts due to the lower settlement and counterparty risk that the net settlement structure of NDFs as compared to the gross notional settlement structure of deliverable FX forwards.

(4) If the Commission were to except NDFs from consideration when calculating the AGNA for purposes of the *de minimis* exception, are there particular limits that the Commission should consider in connection with this exception?

We do not believe that it would be necessary, or appropriate, for additional limits to be imposed on NDFs as part of a determination to exclude NDFs from Swap Dealer *de minimis* calculations. As described above, we believe that economically identical products should be regulated in a consistent manner, and no such limitations are imposed on deliverable FX forwards.

(5) What would be the market liquidity impact if the Commission were to except NDFs from counting towards the *de minimis* threshold?

From discussions with market participants, we understand that a meaningful portion of NDF transaction volume that moved to offshore jurisdictions due to the regulatory burdens imposed by their treatment as swaps under Dodd-Frank would return to the U.S. market, creating greater market liquidity. We are not able to quantify this impact.

(6) Is there material benefit to the market in requiring participants that transact in NDFs to register with the Commission, while not imposing similar obligations on participants that transact in deliverable foreign exchange forwards? If so, what benefits accrue from imposing such registration obligations?

No. As noted above, we believe that NDFs and deliverable FX forwards are functionally and economically equivalent products and as such no benefits accrue from imposing registration obligations on market participants dealing in one product and not the other. Due to the small portion of the FX market comprised by NDFs, the absence of systemic risk they pose and the transition the market is making towards swap data reporting, margining and possibly clearing we do not believe the Commission should require registration solely due to NDF transactions. As noted above, this would only take scant resources away from entities and products that actually require monitoring because of the systemic risks they pose to U.S. markets.

(7) Please provide any relevant data that may assist the Commission in evaluating whether to except NDFs from counting towards the *de minimis* threshold.

In our response above, we have discussed, and referred to, empirical analysis of the behavior of FX forwards (including NDFs) during the crisi.

(8) Please provide any additional comments on other factors or issues the Commission should consider when evaluating whether to except NDFs from counting towards the *de minimis* threshold.

There are market participants that are active in the FX markets, but not active in other aspects of the swaps and derivatives markets, that may become obligated to register with the Commission not only as a Swap Dealer but also as a FCM, CTA or IB solely by virtue of transacting in NDFs.[28] Considering the arguments we have set forth advocating FX forwards and NDFs receive the same regulatory treatment, we would respectfully request that NDFs be excepted from consideration when determining whether an entity needs to register with the CFTC as an FCM, CTA or IB as well. Comparable treatment is the best way to resolve the market distortions that have arisen from the divergent regulatory treatment of FX forwards and NDFs, and transacting in deliverable FX forwards does not trigger any of these registration requirements, as deliverable FX forwards are not "swaps" for these purposes. Further, given the

[28]CEA §§1(a)(49) (Swap Dealer definition), 1(a)(28) (FCM definition), 1a(12) (CTA definition), 1a(31) (IB definition).

need to allocate scarce regulatory resources as effectively and efficiently as possible, it follows that the Commission's regulatory burden to monitor registered entities should not increase solely because certain entities transact in NDFs, which pose little to no systemic risk.

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Based upon the foregoing, we respectfully request that the Commission to amend the *de minimis* exception in paragraph (4) of the "swap dealer" definition in § 1.3(ggg) of the Commission's regulations by excepting NDFs from consideration when calculating the AGNA of swap dealing activity for purposes of the *de minimis* threshold. We also respectfully request that NDFs be excepted from consideration when determining whether an entity needs to register with the CFTC as an FCM, CTA or IB as well. We appreciate your consideration of this request and stand ready to provide any additional information or assistance that you might find useful. Should you have any questions, please do not hesitate to contact the undersigned.

Very truly yours,

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cc: Honorable Christopher Giancarlo, Chairman
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