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ABA SECURITIES ASSOCIATION
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July 22, 2011

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Product Definitions Contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (RIN 3235-AL14; File No. S7-16-11)

Dear Ms. Murphy and Mr. Stawick:

The Investment Company Institute[1] and the ABA Securities Association[2] welcomes the opportunity to provide comments to the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC," together "Commissions") regarding their proposed product definitions under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "Act").[3] Pursuant to Sections 712, 721 and 761 of the Act, the

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs) (collectively "funds"). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $13.3 trillion and serve over 90 million shareholders.

[2] ABASA is a separately chartered affiliate of American Bankers Association, representing those holding company members of ABA that are actively engaged in capital markets, investment banking, and broker-dealer activities.

[3] *See* Product Definitions Contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 FR 29818 (May 23, 2011) ("Release"), available at http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-11008a.pdf.

Commissions have proposed to further define the term "swap," and to clarify the status of, among other products, foreign exchange ("FX") forwards, FX swaps, and non-deliverable FX forwards ("NDFs") within that definition.[4] As participants in the swaps markets, including the FX forwards and swaps markets, ICI and ABASA members have a strong interest in ensuring that these markets are suitably regulated to maintain highly competitive, transparent and efficient operations and do not threaten the financial stability of the United States.

The Commissions' proposal would clarify that NDFs are not FX forwards or swaps as those terms are defined in the Commodity Exchange Act ("CEA"). This clarification would ignore domestic and international market practice with respect to NDFs and also threaten the viability of the NDF market in the United States through a series of unintended consequences, as discussed below. We therefore recommend that the Commissions coordinate with the Department of the Treasury ("Treasury") to interpret the definition of FX forwards to include both deliverable and non-deliverable forwards because they are functionally and economically indistinguishable.

I. Background

The Dodd-Frank Act provides the Commissions with the authority to further define the term "swap."[5] In addition, Section 721(a)(21) of the Act would allow the Treasury to issue a written determination that either FX swaps, forwards or both should not be regulated as swaps.[6] In May 2011, the Treasury issued a proposed determination that would exempt FX swaps and forwards from the definition of swap.[7]

The Commissions' proposal would clarify that the definition of "swap" includes FX swaps and forwards. It would incorporate into the rules a provision that FX swaps and forwards would no longer be considered swaps if the Treasury issues a final determination pursuant to the Dodd-Frank Act, although such products would remain subject to certain reporting requirements and anti-fraud and business conduct standards. The proposal would further clarify that the swap definition explicitly

[4] In this letter we will confine our remarks to the single issue of the categorization of NDFs as FX forwards.

[5] *See* Sections 712, 721 and 761 of the Dodd-Frank Act.

[6] *See* Section 1a(47)(E) of the Commodity Exchange Act, as amended by the Dodd-Frank Act.

[7] *See* Determination of Foreign Exchange Swaps and Foreign Exchange Forwards under the Commodity Exchange Act, 76 FR 25774 (May 5, 2011) ("Notice"). ICI and ABA supported the proposed written determination. *See* Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Mary J. Miller, Assistant Secretary for Financial Markets, United States Department of the Treasury, dated June 6, 2011 ("Treasury Letter") and Joint Letter from ABASA, The Financial Services Roundtable, and the Institute for International Bankers to the Office of Financial Markets, United States Department of the Treasury, dated June 3, 2011.

includes NDFs and other products involving foreign currency, regardless of whether the Treasury finalizes its determination to exempt FX forwards or swaps. It also would clarify that NDFs are neither FX forwards nor FX swaps as those terms are defined in the CEA.

II. Treasury's Proposed Determination

The Treasury's proposed determination would provide a narrow exemption from the Dodd-Frank Act's clearing and exchange-trading requirements for FX swaps and forwards. The Treasury has proposed to issue its determination because the "unique characteristics and oversight of the FX swaps and forwards market[s] already reflect many of Dodd-Frank's objectives for reform – including high levels of transparency, effective risk management, and financial stability."[8] In reaching its conclusion, the Treasury was required by the Dodd-Frank Act to consider the following factors:

- Required trading and clearing of FX swaps and forwards would not create systemic risk, lower transparency, or threaten the financial stability of the United States;
- FX swaps and forwards are already subject to a regulatory regime that is materially comparable to that established by the CEA for other classes of swaps;
- Participants in the FX market are adequately supervised;
- Payment and settlement systems for FX swaps and forwards are adequate, particularly due to the role of the CLS Bank International ("CLS"); and
- An exemption for FX swaps and forwards could not be used for evasions from otherwise applicable regulatory requirements.

ICI and ABASA concur with the Treasury's analysis in its Notice regarding each of these factors and believe that sufficient safeguards already exist in the FX swaps and forwards markets.

As discussed in ICI's Treasury Letter, we are concerned that imposing central clearing and exchange trading requirements on the FX swaps and forwards markets could threaten practices in this market that help limit risk and ensure that it functions effectively.[9] For example, requiring central clearing could increase systemic risk by concentrating risk in one or more clearinghouses. Imposing trading requirements could inhibit transparency if there was insufficient information to support quotes for customized trades and for the markets to determine an appropriate market price. Such a quote

[8] *See* Notice, *supra* note 7.

[9] *See* Treasury Letter, *supra* note 7.

could grow stale sitting on an exchange waiting to attract a bidder. Further, the increased difficulty and costs for market participants to manage their currency exposures, if they generally are limited to using standardized FX swaps and forwards because of clearing and trading requirements, likely would translate to increased risk to the financial system.

Moreover, central clearing and exchange trading are unlikely to meaningfully lower settlement risk in these markets. Banking regulators have a long history and extensive experience in monitoring the FX swaps and forwards market and its major market participants. If necessary, the Federal Reserve Board of Governors could exercise authority to enhance the workings of the CLS or other payment-versus-payment ("PVP") settlement systems.[10] In addition, the FX swaps and forwards markets are highly transparent, with much of the markets trading across electronic platforms. These platforms provide market participants with a high level of pre- and post-market transparency, enhancing pricing information, liquidity and efficiency in these markets. Ultimately, the risks and operational challenges of adopting central clearing and trading practices would significantly outweigh the benefits by undermining the safety and efficiencies of the existing FX swaps and forwards markets.

In its Notice, the Treasury explained that its proposed determination would not include NDFs because they do not meet the statutory definition of FX forward set forth in the CEA. Under Title VII of the Dodd-Frank Act, an FX forward is a transaction that solely involves the exchange of two different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange.[11] As discussed below, ICI and ABASA believe that a reasonable interpretation of the definition of FX forward should not be limited to deliverable trades because of the economic equivalence of deliverable and non-deliverable forward trades. Further, mention of "exchange" in the definition should be satisfied by the economic exchange that occurs in net settlement rather than being narrowly read as the physical "exchange" of two different currencies. ICI and ABASA therefore recommend that the Treasury modify its proposed determination to clarify that the term "foreign exchange forwards" includes both deliverable and non-deliverable FX forwards.

III. Definition of FX Forwards Should Include Deliverable and Non-Deliverable FX Forwards

In the Release, the Commissions state that an NDF "generally is similar" to an FX forward but that "the NDF markets are driven in large part by speculation and hedging, which features are more characteristic of swap markets than forward markets." In fact, NDFs are functionally and economically identical to deliverable FX forwards, and thus are no more or less prone to be used to speculate or to hedge, and should be accorded equivalent treatment by the Treasury and the Commissions. For this

[10] Under Title VIII of the Dodd-Frank Act, the Board of Governors has the authority to enhance the regulation and supervision of systemically important financial market entities. *See* Section 802 of the Dodd-Frank Act.

[11] *See* Section 1a(24) of the Commodity Exchange Act, as amended by the Dodd-Frank Act.

reason, we recommend that the Commissions amend their proposal to clarify that, if the Treasury determines to exempt FX forwards from the definition of swap, NDFs would be exempt from the definition of swap because the category of FX forwards would include both deliverable and non-deliverable FX products.

A. Deliverable and Non-Deliverable FX Forwards are Functionally and Economically Equivalent

NDFs are economically and functionally identical to deliverable FX forwards despite the fact that they are cash settled in just one currency and do not involve the exchange of underlying currencies because of currency controls or local law restrictions in certain foreign jurisdictions.[12] Because of these restrictions, market participants use NDFs to access emerging markets and currencies.[13] NDFs and deliverable FX forwards require the same net value to be transferred between counterparties. Furthermore, the purpose for using the FX forward is the same – to cover foreign currency exchange risk. The primary use of NDFs is to hedge investments in non-dollar jurisdictions against moves in that currency. Whether the FX forward is deliverable or non-deliverable is irrelevant to the market participant's investment decision.[14]

As with deliverable FX forwards, NDFs can be settled through the CLS system. The CLS system is capable of settling an increasing number of NDF transactions and the industry trend appears to include a growing number of such settlements.[15] Instead of its PVP system, CLS settles NDFs using bilateral end of day netting in the same currency, reducing settlement and counterparty risk through a single payment.[16] Consequently, the risk-related distinction between the way in which NDFs and

[12] NDFs settle in cash, based on the difference between a price agreed upon at the inception of the contract and the spot price for the currency determined one or two days before the date of settlement.

[13] In its recommendations to the Treasury and the Commissions regarding classifying NDFs as a subset of FX forwards, ICI and ABASA are speaking only to those NDFs for which delivery is not possible or practical because of existing currency controls, local law or other restrictions. At this time there are approximately 17 currencies where capital movements are restricted and thus investors are forced to use NDFs to hedge the currency exposure: Taiwan, Korea, Philippines, China (outside of Hong Kong), India, Indonesia, Malaysia, Thailand, Vietnam, Pakistan, Brazil, Chile, Russia, Argentina, Columbia, Peru and Romania.

[14] The difference in deliverability becomes relevant to the market participant at settlement for operational purposes.

[15] We note that the presence and operation of CLS plays a large role in the Treasury's proposed determination to exempt FX forwards from the swap definition. Use of the CLS system, however, is voluntary, and neither Treasury or the CFTC or SEC has proposed to mandate that FX forwards settle through the system.

[16] Some banks and brokers execute NDFs on behalf of their clients. These NDFs are settled internally and thereby minimize settlement risk.

deliverable FX forwards are settled through CLS is negligible and may even provide additional protections to the NDF holder.

Also similar to deliverable FX forwards, most NDFs are short-term, settling in less than one year. Indeed, a large percentage of them settle in three months or less. In addition, the market for NDFs is liquid and transparent. NDFs can be executed using well-established documentation structures, such as ISDA or IFEMA Master Agreements. Arguably, NDFs present less risk to market participants and the financial system than deliverable FX forwards, because the principal amounts are never exchanged.

Regulatory and market practice domestically and internationally has been to treat NDFs and FX forwards as the same product. A recent comment letter from Covington & Burling LLP identified a series of examples supporting this contention:

- 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).

- 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 New York Fed has long recognized NDFs as a viable means by which to engage in offshore forward transactions in non-deliverable currencies.

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

- International regulators do not distinguish between FX forwards and NDFs.

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

- FX forwards are subject to special rules under the U.S. tax code that apply equally to physically settled and cash settled transactions.[17]

For all of these reasons, NDFs should not be treated differently from deliverable FX forwards.

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[17] *See* Letter from Bruce C. Bennett, Covington & Burling LLP, to Office of Financial Markets, Department of the Treasury, dated June 6, 2011.

B. Treasury Factors Supporting Exemption for Deliverable FX Forwards Support Exemption for NDFs

The justification underlying the Treasury's proposed exemption for deliverable FX forwards applies equally to NDFs. In proposing to exempt FX forwards from the definition of swap, the Treasury concluded that the risk profile for the FX forwards market is "markedly different" from other derivatives markets and therefore warrants the proposed exemption. As identified by the Treasury, the primary differences in the risk profile stem from the fact that FX forwards have fixed payment obligations because they are physically settled by exchange of principal at maturity, and are predominantly short-term instruments – features which mitigate risk and help ensure stability. These differences exist for both deliverable and non-deliverable FX forwards, except for physical delivery. However, without physical delivery, NDFs arguably are less risky to the U.S. financial system and market participants than deliverable FX forwards because, as discussed above, delivery at maturity is a netted amount typically settled in U.S. dollars and the principle amounts are never exchanged.

In its proposed determination, the Treasury concluded that the costs associated with regulating FX forwards as swaps would outweigh the benefits. As with FX forwards more broadly, the minimal benefits to overseeing systemic risk from including NDFs within the central clearing and exchange trading regime do not justify the costs of narrowly interpreting the definition of FX forward in the CEA to exclude NDFs. In fact, the costs are even more misplaced with respect to the systemic risk associated with NDFs versus deliverable FX forwards. The NDF market is small to begin with and only likely to get smaller as restrictions on emerging currencies are lifted. It comprises approximately 1.5% of the $4 trillion daily volume in the FX market.

Further, if the Treasury determined to exempt FX forwards from the definition of swap, as a subset of FX forwards, and if our interpretation is accepted, NDFs would remain subject to the trade reporting requirements, business conduct standards for swap dealers and major swap participants, and enhanced anti-fraud and anti-manipulation rules. This division of regulatory oversight would strike the appropriate balance in light of the existing regulatory regime, transparency and operation of the entire FX forwards market. Further, by providing only limited relief, the exemption should restrict the ability of market participants to evade regulatory requirements imposed by the CEA. For example, imposition of the reporting requirements would permit the CFTC to surveil the FX forwards market, including monitoring risks, to pursue additional regulatory action at a future date, if required, without unnecessarily disrupting the derivatives markets.[18]

[18] With respect to financial stability and systemic risk, we strongly disagree with the assertion that FX markets almost collapsed" during the recent financial crisis as some commenters have contended. Instead, the FX markets functioned smoothly during the financial crisis, and any disruption in the FX swap markets was related to the global U.S. dollar liquidity squeeze and increased concern about counterparty risk that occurred in money markets more generally. This impact on the FX swaps market was discussed in detail by the Bank for International Settlements ("BIS"). *See* BIS Quarterly Review, March 2008. The BIS cites no structural imperfection in FX swap markets to explain what occurred, and instead

C. No Statutory Mandate for Separate Treatment of NDFs

In the Release, the Commissions acknowledge that NDFs are not expressly enumerated in the definition of swap but then state NDFs satisfy clause (A)(iii) of the definition because there is a transfer of financial risk associated with a future change in an exchange rate that is not accompanied by a transfer of an ownership interest in any asset or liability. We agree with the Commissions that NDFs satisfy the definition of swap. FX forwards also satisfy the definition of swap in the CEA. Yet the Treasury has been provided with the authority to exempt FX forwards from the definition of swap.

While the definition of FX forward includes the "exchange" of two different currencies, nothing in the Dodd-Frank Act mandates that the Commissions or the Treasury treat deliverable FX forwards differently from NDFs. There is no indication that Congress intended the proposed division of deliverable and non-deliverable forwards and there is no reason to make this distinction. We believe the Treasury and the Commissions have the authority to interpret reasonably the term FX forward to include both deliverable and non-deliverable products because the products are economically equivalent,[19] and the proposed clarification by the Commissions limiting the definition to deliverable trades simply because the definition mentions the "exchange" of two different currencies takes a too restrictive reading.

D. Separate Treatment Will Produce Unintended Negative Consequences

Failure to clarify that NDFs are within the definition of FX forwards could create confusion for market participants regarding the treatment of the two types of FX forwards. This, in turn, could create systemic risk or lower transparency in contravention of the objectives of the Dodd-Frank Act. Specifically, it would result in operational difficulties for market participants when assessing their swaps activity for purposes of certain CFTC rules.[20] It also would create operational difficulties for clearinghouses with respect to meeting their performance obligations if the underlying currency for the NDF is non-deliverable. In addition, splitting up FX forwards and NDFs would increase

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discusses how increased counterparty and liquidity risk likely explain any deviations from covered interest rate parity and movements in the bid-ask spreads.

[19] We also note that a literal interpretation of the definition of a Contract for Difference ("CFD") proposed by the CFTC in the Release could lead to the conclusion that an NDF is a CFD. *See* Release, *supra* note 3, at 29838. Again, because NDFs are economically and functionally equivalent to FX forwards, but functionally distinguishable from CFDs, we do not advocate such an interpretation and, if the Commissions agree that NDFs fall within the definition of FX forwards, the Commissions should also clarify that NDFs are not CFDs.

[20] For example, market participants engaging in NDF and FX forward transactions will be faced with the unnatural bifurcation of ensuring that NDF activity complies with the full panoply of new regulatory requirements imposed by the Dodd-Frank Act while FX forwards remain subject to existing regulatory requirements and certain limited requirements imposed by the Act.

fragmentation in the currency markets as NDFs would be subject to clearing and trading requirements. Finally, it could allow for potential arbitrage between the two types of FX forwards and between different jurisdictions, which continue to treat NDFs as a type of FX forward.

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If you have any questions on our comment letter, please feel free to contact Karrie McMillan directly at (202) 326-5815, Cecelia Calaby at (202) 663-5325, or Heather Traeger at (202) 326-5920.

Sincerely,

/s/ Karrie McMillan

Karrie McMillan
General Counsel
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/s/ Cecelia Calaby

Cecelia Calaby
Executive Director and General Counsel
ABA Securities Association

cc: The Honorable Mary L. Schapiro, Chairman
The Honorable Kathleen L. Casey, Commissioner
The Honorable Elisse B. Walter, Commissioner
The Honorable Luis A. Aguilar, Commissioner
The Honorable Troy A. Paredes, Commissioner
U.S. Securities and Exchange Commission

The Honorable Gary Gensler, Chairman
The Honorable Michael V. Dunn, Commissioner
The Honorable Jill E. Sommers, Commissioner
The Honorable Bart Chilton, Commissioner
The Honorable Scott D. O'Malia, Commissioner
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