

## **AGC Americas Focus Committee Communication; Subject to Supplemental Commentary**

August 10, 2018

Christopher Kirkpatrick  
Secretary of the Commission  
Commodity Futures Trading Commission  
Three Lafayette Center  
1155 21st Street, NW  
Washington, DC 20581

**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:

The Association of Global Custodians is a group of 12 financial institutions that provide securities safekeeping services and asset-servicing functions to primarily institutional cross-border investors worldwide. As a non-partisan advocacy organization established in 1996, the Association represents members' common interests on regulatory and market structure matters through comment letters, white papers and interaction with legislative and regulatory authorities and financial industry organizations. The member banks, see [www.theagc.com](http://www.theagc.com), are competitors, and the Association does not involve itself in member commercial activities or take positions concerning how members should conduct their custody and related businesses. Baker & McKenzie LLP acts as the Association's Secretariat and Counsel.

This communication was developed by members of the Association's Americas Focus Committee.

The Americas Focus Group of the Association of Global Custodians 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 its members that are active participants 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.

We also urge that NDFs should 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").

This matter is particularly important to the global custodial industry, in which U.S. banks play a major role. In the role as global custodian, U.S. banks are required on an agency basis to enter into FX trades to facilitate the movement of moneys associated with the administration of cross border investment and the hedging of international investment to the home currencies of a broad range of U.S. institutional investors, including U.S. registered investment companies,

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pension plans and insurance companies. FX forward contracts are the tools by which appropriate administration and management of cross-border investments may be accomplished.

Although we acknowledge that much of what needs to be done in the administration and hedging of cross-border investments for global custodial clients may be (and is) accomplished via deliverable forwards, deliverable forwards are not, and cannot be, the only solution. This is because deliverable forwards are not available in all markets where US banks provide custody and administration (including, but not limited to, Brazil, China (CNY), India and Indonesia, collectively, the “NDF markets”), where the local currency is not deliverable or is impracticable to deliver by reason of exchange controls or related rules governing foreign investment in a given local market. Market participants therefore use NDFs as the functional equivalents of deliverable forwards to support administration and hedging of assets where deliverable forwards are not available.

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. This would appear likely to be due to the Commission staff position that a FX forward involving two deliverable currencies that *by its terms* settles net rather than gross would not be entitled to the exemption from the definition of swap afforded by the Treasury Determination.

Finally, even if the requested relief is granted, NDFs will remain subject to the CFTC’s anti-fraud and anti-manipulation provisions, among other requirements.

Please accept the following in support of your consideration.

**A. The CFTC May Exclude NDFs from the Definition of Swaps for the Purposes set forth in this Letter.**

As noted in the Proposed Rule, in a footnote, the Secretary of the Treasury in construing the term “Swap” for purposes of the CEA, did not intend for its written determination to affect the CFTC’s authority to further define the term. Specifically, the Secretary stated that:

“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.”<sup>1</sup>

We would also note that there is no compelling public policy not to exclude NDFs as described herein:

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<sup>1</sup> Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, Final Determination, 77 Fed. Reg. 69704, (Nov. 20, 2012).

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- NDFs undertaken by global custodians support institutional products.
- Market participants continue to use NDFs but we note that other commentators have reported that, due to the CFTC's current treatment of NDFs for purposes of various eligibility tests like Swap Dealer status, some have moved this business outside of the United States, reducing liquidity in the US to the detriment of US investors and US end users of derivatives like industrial companies.

## **B. Economic Equivalence of NDFs and Deliverable Forwards.**

An NDF is functionally and economically the same transaction as a deliverable FX forward. The difference is administrative rather than economic in that in a deliverable FX forward, the trade closes out at maturity upon delivery by each party to the transaction of the gross amount of the respective currency specified in the contract. 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 of the exposure to the currency is the same and the counterparty initiating the transaction can achieve exactly the same economic outcome, whether via deliverable or non-deliverable FX forward contract.

Given this functional and economic equivalence, it is anomalous from a policy perspective to treat NDFs different from deliverable forwards. Indeed, the market, in many contexts, treats the two products as equivalent:

- 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 forward transactions in non-deliverable currencies.
- The Bank for International Settlements treats NDFs as a component of the outright forward category.
- Standard FX market documentation structures do not distinguish between FX forwards and NDFs.

## **C. The Disparate Treatment of NDFs versus Deliverable Forwards Puts US FX Market at a Disadvantage**

As indicated above, the use of NDFs in connection with the NDF markets is particularly important to the global custody industry and the unnecessary complication of such use puts the U.S. venue for foreign exchange at a disadvantage to non-U.S. markets in NDF dealings with non-U.S. clients by encouraging offshore processing of NDFs with foreign counterparties. This applies to both U.S. banks and U.S. branches or subsidiaries of

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non-U.S. banks. It also has the potential effect of increasing the cost and decreasing the efficiency of currency administration for large institutional investors located in the U.S. who were affected by the current rule whether or not the transaction is processed offshore.

**D. Address of Herstatt Risk and the Confluence of Administrative Settlement of NDFs and Deliverable Forward Contracts.**

As a result of the lessons learned in 2008 and before, the Bank for International Settlements and other international institutions and national banking regulators have encouraged the development of means for reducing settlement risk attendant to foreign exchange transactions. This has led to two major developments:

- As a matter of addressing counterparty settlement risk, foreign exchange desks will often agree to close out the countervailing gross delivery requirements of deliverable forwards by means of a net payment (meaning that the two currencies are not actually exchanged); and,
- The markets have evolved multilateral FX settlement systems that entail net movements between counterparties to FX contracts that are deliverable according to their terms. The prime example of this is the operation of CLS Bank, which is regulated in the United States. Forward FX contracts deliverable in gross according to their terms are nonetheless processed on a net basis by virtue of CLS participants adopting the CLS participant rules.

As noted above, these developments, which are strongly encouraged by banking and other regulators address liquidity needs and credit exposure to counterparties in the market.

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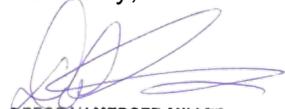
Based upon the foregoing, we respectfully request that the Commission amend the *de minimis* exception in paragraph (4) of the “swap dealer” definition in § 1.3(ggg) of the Commission’s regulations by excepting NDFs from consideration when calculating the AGNA of swap dealing activity for purposes of 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 as the same arguments and observations noted above apply to FCM, CTA or IB status.

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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.

Sincerely,



Deborah Mercer-Miller  
Co-Chair, Americas Focus Committee  
Association of Global Custodians