

MEMO# 25354

July 25, 2011

ICI - ABASA Joint Letter on Definitions of Swap and Foreign Exchange Forward

[25354]

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 57-11
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 29-11
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 32-11
ETF ADVISORY COMMITTEE No. 50-11
EQUITY MARKETS ADVISORY COMMITTEE No. 46-11
FIXED-INCOME ADVISORY COMMITTEE No. 56-11
SEC RULES MEMBERS No. 90-11
SMALL FUNDS MEMBERS No. 52-11 RE: ICI - ABASA JOINT LETTER ON DEFINITIONS OF SWAP AND FOREIGN EXCHANGE FORWARD

As we previously informed you, pursuant to Sections 712, 721 and 761 of the Dodd-Frank Act, the Commodity Futures Trading Commission and the Securities and Exchange Commission (together "Commissions") have proposed to further define the term "swap," and to clarify the status of foreign exchange ("FX") forwards, FX swaps, and non-deliverable FX forwards ("NDFs") within that definition. [\[1\]](#) ICI filed a joint comment letter with the ABA Securities Association [\[2\]](#) addressing the solitary issue of whether the term FX forwards includes both deliverable and non-deliverable products ("Joint Letter"). The Joint Letter, which states that deliverable FX forwards and NDFs are economically and functionally equivalent, is attached and briefly summarized below.

Summary

The Commissions' proposal would clarify that the definition of "swap" includes FX swaps and forwards unless the Department of the Treasury ("Treasury") issues a final determination pursuant to the Dodd-Frank Act that such products would no longer be considered swaps. [\[3\]](#) The proposal would further clarify that the swap definition explicitly 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 Commodity Exchange Act ("CEA").

The Joint Letter states that the proposed 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. It recommends that the Commissions coordinate with the Treasury to interpret the definition of FX forwards to include deliverable and non-deliverable forwards because they are functionally and economically indistinguishable.

The Joint Letter explains that NDFs should be exempt from the definition of swap for the same reasons that the Treasury has proposed to exempt deliverable FX forwards, including that an exemption for NDFs from the trading and clearing requirements in the Dodd-Frank Act would not create systemic risk, lower transparency, or threaten the financial stability of the United States. To the contrary, the costs associated with regulating NDFs as swaps would outweigh the benefits and likely would harm the NDF market and threaten practices that help limit risk and ensure that it functions effectively. The Joint Letter specifically identifies many of the similarities between deliverable FX forwards and NDFs, including their purpose, limited settlement risk, short-term duration and high liquidity.

In addition, the Joint Letter notes that NDFs are not expressly included in the definition of swap in the CEA and there is no indication that Congress intended to distinguish such products from deliverable FX forwards. Consequently, the Treasury and the Commissions could interpret reasonably the term FX forward to include both deliverable and non-deliverable products because the products are economically equivalent, 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.

Finally, the Joint Letter explains that separate treatment of deliverable FX forwards and NDFs could create confusion for market participants resulting in negative consequences for the FX forwards market and the derivatives markets as a whole. For example, it would result in operational difficulties for market participants when assessing their swaps activity for purposes of certain CFTC rules. [4] In addition, splitting up FX forwards and NDFs would increase 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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[Attachment](#)

endnotes

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

[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] 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. In May 2011, the Treasury issued a proposed determination that would exempt FX swaps and forwards from the definition of swap. See Determination of Foreign Exchange Swaps and Foreign Exchange Forwards under the Commodity Exchange Act, 76 FR 25774 (May 5, 2011). ICI supported the proposed written determination. See [Letter](#) from Karrie McMillan, General Counsel, Investment Company Institute, to Mary J. Miller, Assistant Secretary for Financial Markets, U.S. Department of the Treasury, dated June 6, 2011.

[4] 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 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.

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