

MEMO# 25340

July 18, 2011

ICI Draft Comment Letter on Definitions of Swap and Foreign Exchange Forward; Comments Due July 21

[25340]

July 18, 2011

TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 35-11
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 27-11
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 30-11
ETF ADVISORY COMMITTEE No. 47-11
EQUITY MARKETS ADVISORY COMMITTEE No. 44-11
FIXED-INCOME ADVISORY COMMITTEE No. 54-11
SEC RULES COMMITTEE No. 64-11
SMALL FUNDS COMMITTEE No. 28-11 RE: ICI DRAFT COMMENT LETTER ON DEFINITIONS OF SWAP AND FOREIGN EXCHANGE FORWARD; COMMENTS DUE JULY 21

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, among other products, foreign exchange (“FX”) forwards, FX swaps, and non-deliverable FX forwards (“NDFs”) within that definition. [1] The ICI has drafted a comment letter addressing the solitary issue of whether the term FX forwards includes both deliverable and non-deliverable products. ICI’s draft comment letter, which states that deliverable FX forwards and NDFs are economically and functionally equivalent, is attached and briefly summarized below.

Comments are due to the SEC no later than this Friday, July 22. If you have any comments on the draft letter, please contact Heather Traeger by email at htraeger@ici.org or by phone at 202-326-5920 by Thursday, July 21.

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. [2] The proposal would further clarify that the swap definition explicitly

includes NDFs and other products involving foreign currency, regardless of whether the Treasury issues a final 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 draft letter 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 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. It also states that the proposed clarification to separate deliverable FX forwards from NDFs would ignore domestic and international market practice with respect to NDFs. The draft 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 required trading and clearing of NDFs would not create systemic risk, lower transparency, or threaten the financial stability of the United States. It emphasizes that the costs associated with regulating NDFs as swaps would not outweigh the benefits and likely would harm the NDF market and threaten practices that help limit risk and ensure that it functions effectively.

In addition, the draft letter explains that there is no statutory mandate for separate treatment of NDFs from deliverable forwards. It states that NDFs are not expressly included in the definition of swap in the CEA. It also states that there is no indication that Congress intended to distinguish NDFs from deliverable FX forwards. Consequently, the letter concludes that the proposed clarification by the Commissions limiting the definition of FX forwards to deliverable trades simply because the definition mentions the “exchange” of two different currencies takes a too restrictive reading.

Finally, the draft 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. [3] 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.

Heather L. Traeger
Associate Counsel

[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] Section 721(a)(21) of the Act allows 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) (“Notice”). 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.

[\[3\]](#) 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 requirements.

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.