

**MEMO# 28474**

October 21, 2014

## **CFTC Global Markets Advisory Committee Holds Public Meeting on Non-Deliverable Forwards**

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TO:

REGISTERED FUND CPO ADVISORY COMMITTEE  
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 71-14  
ICI GLOBAL MEMBERS No. 45-14  
INVESTMENT ADVISER MEMBERS No. 30-14  
INTERNATIONAL MEMBERS No. 35-14

RE:

CFTC GLOBAL MARKETS ADVISORY COMMITTEE HOLDS PUBLIC MEETING ON NON-DELIVERABLE FORWARDS

On October 9, 2014, the Global Markets Advisory Committee (“GMAC”) of the Commodity Futures Trading Commission (“CFTC”) held a public meeting to discuss issues related to clearing non-deliverable forwards (“NDFs”) and the digital currency bitcoin. [\[1\]](#) This memorandum summarizes the session of the meeting focused on NDFs.

### **Background**

The focus of the session on NDFs was on whether the CFTC should propose mandatory clearing for NDFs. Panelists included Brian O’Keefe, Deputy Director, Division of Clearing and Risk, CFTC; David Bailey, Director, Financial Market Infrastructure, Bank of England; Rodrigo Buenaventura, European Securities and Markets Authority (“ESMA”); and the GMAC Subcommittee on Foreign Exchange Markets (“Subcommittee”), comprised of foreign exchange (“FX”) experts. Commissioner Wetjen has asked the Subcommittee to prepare a written recommendation regarding a clearing mandate for NDFs. [\[2\]](#)

In his opening statement, Chairman Massad enumerated the factors the CFTC must consider in making a swap clearing determination. He clarified that this GMAC meeting

represented an opportunity to learn more about the NDF market so that the CFTC can consider whether to

proceed with a proposed clearing determination. In that connection, he emphasized the importance of resolving the cross-border issues on clearinghouse regulation and supervision that currently exist between the United States and Europe. He believes that the existing U.S. system of dual regulation of clearinghouses has worked well and that Europe should recognize U.S. clearinghouses as equivalent. He stated that U.S. and European regulators have agreed to determine whether they can further harmonize their rules and regulatory approach.

Commissioner Wetjen also addressed the discussions between U.S. and European regulators regarding clearinghouse equivalency, noting his belief that both sides are interested in pursuing agreement on “equivalency within a dual-registration framework.” He believes that a substituted compliance approach makes the most sense and urged negotiators to seek practical, outcome-based solutions.

With respect to NDFs, Commissioner Wetjen said that although the settlement characteristics and standardization of NDFs appear to make them clearable, other factors are also important to consider in the analysis, including the market-structure issues involving clearinghouse, futures commission merchant (“FCM”) and service-provider risk management, and issues related to trade execution. He expects the CFTC will rely heavily on the recommendation of the Subcommittee in determining whether and when a clearing mandate is appropriate and that any such mandate must be aligned with any comparable mandate overseas.

## **Discussion**

Mr. O’Keefe of the CFTC provided a presentation regarding the CFTC’s anticipated proposal regarding an NDF clearing mandate, which was described as follows:

- 12 reference currency pairs, settled in USD
- Tenors ranging from 3 days-2 years
- Specifications would be intended to cover NDFs executed according to the standardized templates published by the Emerging Markets Trade Association (“EMTA”) and would not include non-standard NDFs
- Any mandate would be expected to be subject to the same implementation schedule the CFTC used for prior clearing mandates (i.e., interest rate swaps (“IRS”), credit default swaps)

Mr. Buenaventura of ESMA discussed ESMA’s approach to clearing, and its recent clearing proposal for NDFs. [\[3\]](#) He believes the three primary factors ESMA must consider as part of its clearing determination – standardization, availability of pricing, and liquidity – appear to be met. He noted, however, that with respect to liquidity, cleared volumes are low, compared to traded volumes, and ESMA is watching this element more closely. He also noted that most NDF trades (90%) are below three months, 30% are below 30 days, and 10% are below seven days, a theme that came up later in the meeting as well.

Mr. Bailey of the Bank of England discussed the Bank’s perspective as supervisor of the clearinghouses. He raised concerns about the capacity of clearinghouses to manage the expected clearing volumes and defaults of clearing members if they occur. He said these

problems are raised particularly in the NDF market because most NDFs currently are uncleared, and because of the size and scale of positions that would need to be closed out if a clearinghouse member defaults. Another factor he believes should be considered in the analysis is liquidity available in the market, including average daily volume, number of dealers, and positions in the market. He noted that there is not as much market data available for NDFs as for other asset classes.

Mr. Bailey believes the market structure generally exists for NDF clearing, but that the indicators weaken as maturities extend beyond a year (although it depends on the currency pair). He noted that, at longer maturities, positions tend to be more concentrated and spreads are larger. These characteristics may make it more difficult for a clearinghouse to close out an NDF with a longer maturity, but the flip side is that such positions may be smaller. He also noted, however, that if the clearing mandate were placed only on shorter maturity NDFs, market participants might choose to voluntarily clear longer maturity NDFs to take advantage of netting opportunities.

Following these presentations, the meeting participants discussed key issues regarding NDF clearing:

What are the benefits of NDF clearing? Why hasn't there been more clearing of NDFs?

- NDF clearing will result in lower capital requirements once the margin requirements for uncleared swaps apply in 2015. So few NDFs are being cleared right now because there is no clearing mandate and because there is no capital impetus (i.e., the margin requirements for uncleared swaps are not yet applicable). (Gavin Wells, LCH.Clearnet)
- NDFs are only 2.5% of the overall FX market, yet roughly 70% of the price formation occurs outside the United States and Europe (e.g., China, India, Korea) – U.S. investors need to be able to access that liquidity pool in some way. U.S. investors tend to be price takers in this market, and they need access to as much liquidity as possible. It is also important to ensure what we are doing is consistent with other jurisdictions. (Jason Vitale, Deutsche Bank AG)
- The very short-dated nature of this market is why we haven't seen more clearing – there hasn't been the capital efficiency you'd otherwise gain from clearing. (Chris Allen, Barclays)

Has the NDF class been sufficiently defined? The right currency pairs?

- The benefit to clearing FX is portfolio correlation – margin is reduced because of correlations within the portfolio, and the clearinghouse is better able to manage its risk. It would be best to include 11 or 12 currency pairs. (Gavin Wells, LCH.Clearnet)
- Limiting the scope of currency pairs from the outset would just isolate risk further. It is important to discuss how we will deal with disruption events in these markets. (Jason Vitale, Deutsche Bank AG)
- Like to see more liquid currency pairs in the first phase. Need to be able to trade these currency pairs in the time zone where they are most liquid. BlackRock views a clearing mandate as the key driver for clearing NDFs. Would also like the swap execution facilities ("SEFs") to permit electronic trading of NDFs when a mandate goes into effect. (Superna Vedbrat, Blackrock)

Timing of U.S. clearing mandate, including relative to Europe

- It is more important to focus on the timing of any trading mandate than to ensure that different jurisdictions' clearing mandates are implemented on a lock-step basis. (Kim Taylor, CME)
- If the United States were to issue a made available to trade ("MAT") determination for NDFs before Europe mandated trading for NDFs, there is a real possibility that trading could move away from the United States -- this should be avoided. (Adam Cooper, Citadel)
- Concern regarding the bifurcation of liquidity/fragmentation that would result once there is a MAT determination in the United States (Troy Rohrbaugh, J.P. Morgan)
  - This concern is heightened by phased implementation. (Chris Allen, Barclays)
- These concerns potentially could be addressed by delaying the clearing mandate or preventing a trading mandate from going into effect. (Commissioner Wetjen)
- Where trading mandates have been implemented, we have seen liquidity fragmentation, which has detrimental effects in times of crisis. (David Bailey, Bank of England)
- The earliest a trading mandate could take place in Europe is January 2017. (Rodrigo Buenaventura, ESMA)

#### Costs and risks

- If Europeans are unable to clear through third-country clearinghouses because of lack of resolution of cross-border recognition issues, this will create additional risk in this market (Kim Taylor, CME)
- The cost of capital is increasing as a result of Basel III, and the benefits of netting are decreasing – concern that some of these markets may become too expensive for participants. (Jason Vitale, Deutsche Bank AG)
- It is not cost effective for SEFs to trade NDFs right now, at least until clearing is mandated. (Phil Weisberg, FXall)

#### Package transactions involving NDFs

- Package transactions are not an immediate issue with NDFs. (Jason Vitale, Deutsche Bank AG)
- Two participants noted that there is a potential issue of package transactions where non-deliverable options are traded with an NDF delta hedge, although another participant believes the same issue is raised with IRS and that the solutions that have been proposed there could similarly be implemented in the NDF context before mandatory clearing is implemented.

#### Reporting and connectivity issues for NDFs

- The infrastructure exists now for the reporting of NDF transactions. (Jill Sigelbaum, Traiana)
- The build-out that is necessary for an FCM to connect to the clearinghouses to clear NDFs is significant, and the FCMs are facing limited resources, as are clients. It therefore is very important to clarify the timing of these events, and address existing capital issues. (Mike Dawley, Goldman Sachs)
- We agree that there are very few FCMs willing to clear NDFs. It is very difficult for us to just clear a few trades and not look at our whole book of business. Another important issue to focus on is the ability to terminate positions and have orderly unwinds. Right now, you can mitigate the risk, but it isn't possible to exit the trade. This should be addressed prior to the imposition of a clearing mandate. (Superna Vedbrat, BlackRock)

- The connectivity to clear NDFs does exist, and we have FCMs signed up to clear NDFs by the first quarter of 2015. (Gavin Wells, LCH.Clearnet)
- Very interested in the concerns expressed regarding the difficulties of unwinding positions – this issue should be studied more. Also very interested in the appropriate maturities for NDFs – it is important to get this right. (David Bailey, Bank of England)

Sarah A. Bessin  
Senior Counsel

#### **endnotes**

[1] The webcast of the meeting is available at:  
<http://www.youtube.com/watch?v=uwe-RQAPN9I&feature=youtu.be>.

[2] The current list of Subcommittee members is available at:  
[http://www.cftc.gov/About/CFTCCcommittees/GlobalMarketsAdvisory/gmac\\_femmembers](http://www.cftc.gov/About/CFTCCcommittees/GlobalMarketsAdvisory/gmac_femmembers).

[3] See ICI Memorandum No. 28439, October 8, 2014, available at  
[http://www.ici.org/my\\_ici/memorandum/memo28439](http://www.ici.org/my_ici/memorandum/memo28439).

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