

MEMO# 28621

December 23, 2014

CFTC Global Markets Advisory Subcommittee on FX Markets Issues Report on Clearing Non-Deliverable Forwards

[28621]

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TO: DERIVATIVES MARKETS ADVISORY COMMITTEE No. 92-14

ICI GLOBAL MEMBERS No. 60-14

ICI GLOBAL TRADING & MARKETS COMMITTEE No. 7-14

INTERNATIONAL MEMBERS No. 52-14

INVESTMENT ADVISER MEMBERS No. 32-14

REGISTERED FUND CPO ADVISORY COMMITTEE RE: CFTC's GLOBAL MARKETS ADVISORY
SUBCOMMITTEE ON FX MARKETS ISSUES REPORT ON CLEARING NON-DELIVERABLE
FORWARDS

On December 22, 2014, the Subcommittee on Foreign Exchange Markets ("Subcommittee") of the Commodity Futures Trading Commission's ("CFTC") Global Markets Advisory Committee ("GMAC") submitted a report to the GMAC regarding the Subcommittee's views on a prospective clearing mandate for foreign exchange ("FX") non-deliverable forwards ("NDFs"). [\[1\]](#) The Report was requested by Commissioner Mark Wetjen, sponsor of the GMAC, at an October public meeting at which the GMAC discussed the possibility of a clearing mandate for NDFs. [\[2\]](#) The Report is summarized below.

The Report provides some background on the NDF market and the current status of NDF clearing, and then addresses three questions that were raised at the CFTC public meeting regarding a possible NDF clearing mandate.

Question 1: Is an NDF Clearing Mandate Appropriate?

The Subcommittee does not specifically make a recommendation whether the CFTC should mandate clearing of NDFs. The Subcommittee recommends that if the CFTC decides to proceed with a clearing mandate for NDFs, the mandate should contain a clear timeline and method of implementation to ensure that market participants have the opportunity to address the issues the Subcommittee has identified in the Report. In responding to this question, the Subcommittee makes the following points:

- NDFs are not subject to the liquidity and settlement risk issues associated with clearing deliverable products such as FX options.
- Because the NDF market is used by corporations, investors, banks and others, it is critical to consider the impact of a clearing mandate on market access for such users. A failure to do so could lead to segmentation, such that some market users cannot access the existing broad pool of liquidity, and instead may be faced with two or more smaller/shallower pools with less competitive pricing.
- Critical infrastructure issues remain outstanding and must be addressed by regulators and/or market participants in order to provide support for cleared NDFs. The schedule for solving these issues is a critical input for the CFTC in adopting a timeline for NDF clearing.

Question 2: What is the Best Way for the CFTC to Implement a Clearing Mandate?

Harmonization Across Major Geographies

In light of the recent proposal on NDF clearing by the European Securities and Markets Authority (“ESMA”), the Subcommittee suggests harmonization between US and European regulators with respect to an NDF clearing mandate in the following respects:

- Harmonization of products to be cleared (e.g., currency pairs and tenors) – the Subcommittee recommends 12 standard currency pairs, and recommends referencing the Emerging Markets Trade Association (“EMTA”) templates going forward. The Subcommittee recommends that any clearing mandate should apply to outstanding maturities not greater than 12 months.
- Harmonization of counterparty categories – to maintain broad consistency between the CFTC and ESMA, the Subcommittee recommends keeping the implementation of the clearing mandate for Category 1 and Category 2 counterparties close together.
- Harmonization of the timeline for mandatory clearing – the Subcommittee suggests a phase-in schedule that would be consistent with prior phase-in periods of the US and European regulators, but would align the clearing mandates as closely as possible in order to minimize any market liquidity fragmentation. Under this proposed schedule:
 - The ESMA clearing mandate could enter into force on May 1, 2015, with:
 - Category 1 participants subject to the clearing mandate on November 1, 2015;
 - Category 2 participants subject to the clearing mandate on May 1, 2016;
 - Category 3 participants subject to the clearing mandate on November 1, 2016; and
 - Category 4 participants subject to the clearing mandate on February 1, 2018.
 - CFTC clearing determinations could be proposed no later than August 1, 2015 and the CFTC mandate finalized on November 1, 2015, with:
 - Category 1 participants subject to the clearing mandate on February 1, 2016;

- Category 2 participants subject to the clearing mandate on May 1, 2016; and
- Category 3 participants subject to the clearing mandate on August 1, 2016.

Standardization via Use of EMTA Currency Templates

The Subcommittee explains that there is a lack of uniform adoption of templates providing the standardized terms under which NDFs are traded. The Subcommittee recommends that any FX NDF contract that does not use a currency template, in the form developed and published by EMTA in close consultation with market participants, is not sufficiently standardized to be suitable for a clearing mandate.

Market Readiness for Client Clearing

The Subcommittee explains that not all clients and futures commission merchants (“FCMs”) are operationally ready for NDF clearing in the United States. Specifically, operational processes such as the following still need to be enhanced and standardized to support any clearing mandate for FX NDFs: clearing and allocation of voice trades; pre-allocated and bunched order trades on swap execution facilities (“SEFs”); and voice block trade, package trades, and others. The Subcommittee believes its recommended timeline provides adequate time for these issues to be resolved.

Preparation to Support Trade Certainty and CFTC Rule 1.73 Compliance

The Subcommittee notes that, under current rules, if NDFs become subject to a clearing mandate, they would be required to comply with CFTC Rule 1.73 requirements for pre-trade risk checking and certainty of clearing. The Subcommittee describes the disruptions that occurred beginning in October 2013 as pre-trade checks were required for SEF trades, and states that the readiness of SEFs and their participants for compliance with Rule 1.73 pre- and post-trade processes, including FCM credit checks, pre-allocated trades and post-clearing allocations, should be considered in implementing the Subcommittee’s timeline for NDF clearing.

Question 3: Are There Likely to be Any Execution Issues in Light of the Made Available to Trade Determination Filings?

The Subcommittee agrees with participants at the CFTC’s October public meeting that systemic risks could be raised if a made available to trade (“MAT”) determination for NDFs followed too closely after a mandatory clearing determination. The Subcommittee believes that market participants should be given adequate time to prepare for mandatory trading of NDFs.

Handling of Package Transactions

In the NDF market, package transactions take the form of NDF swaps and strips-of-forwards. The Subcommittee recommends that the GMAC advise the CFTC to proactively address package transactions in any clearing determination, and recommend consistent treatment of an interest rate swap or credit derivative package transaction and a FX package transaction.

Prime Brokerage

The Subcommittee states that market participants are waiting for guidance from the CFTC regarding the treatment of prime-brokered transactions on SEFs. There are inconsistencies

between SEF practices and the role that prime brokers have long played in the FX markets. The Subcommittee urges the GMAC to advise the CFTC to consider the feedback that has been provided by the industry on this issue, and provide guidance regarding its views on prime-brokered SEF transactions.

Outstanding Areas under No-Action Relief

The Subcommittee notes that there are several outstanding issues that are currently benefitting from no-action relief or have not yet been addressed by the CFTC, and any MAT determinations for NDFs would exacerbate the fact that these issues remain unaddressed. The Subcommittee provides the example of SEF confirmations and the CFTC's interpretation of footnote 195 of the SEF rules, which requires a SEF to obtain physical paper copies of each bilateral master agreement signed by a counterparty to a non-cleared trade executed on a SEF. These documentation requirements have raised difficulties for SEFs in practice.

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endnotes

[1] Memorandum to Global Markets Advisory Committee, CFTC, from Foreign Exchange Markets Subcommittee, dated December 5, 2014, available at http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/gmac_fxndfmandate122214.pdf ("Report").

[2] The webcast of the meeting is available at: <http://www.youtube.com/watch?v=uwe-RQAPN9I&feature=youtu.be>. For a summary of the meeting, please see ICI Memorandum No. 28474 (Oct. 21, 2014), available at <http://www.ici.org/iciglobal/pubs/memos/memo28474>.