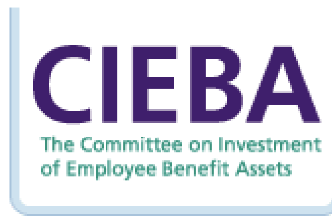

July 22, 2011

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: **Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping – File No. S7-16-11**

Dear Mr. Stawick and Ms. Murphy:

The Committee on Investment of Employee Benefit Assets ("***CIEBA***") appreciates this opportunity to provide comments to the Commodity Futures Trading Commission (the "***CFTC***") and the Securities and Exchange Commission (the "***SEC***" and, together with the CFTC, the "***Commissions***") regarding the proposed rule regarding product definitions (the "***Proposed Rule***")[1] which is proposed under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "***DFA***" or the "***Act***").[2]

CIEBA represents more than 100 of the country's largest private pension sponsors. Its members manage more than $1 trillion of defined benefit and defined contribution plan assets on behalf of 15 million plan participants and beneficiaries. CIEBA members are generally the senior corporate financial officers who manage and administer The Employee Retirement Income Security Act of 1974 ("***ERISA***")[3]-governed corporate retirement plan assets. CIEBA's recent annual survey of members showed an increased emphasis on managing and reducing plan risks and a corresponding increase in the usage of swaps and security-based swaps ("***SB swaps***") to address those risks.

SUMMARY

As further discussed below, we believe that non-deliverable foreign exchange forwards ("***NDFs***") are functionally and economically indistinguishable in many ways from Foreign Exchange Forwards (as defined in the DFA).[4] Because Congress explicitly allowed Foreign

[1] Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 Fed. Reg. 29818 (published May 23, 2011).

[2] The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

[3] The Employee Retirement Income Security Act of 1974, Pub. L. 93-406, 88 Stat. 829 (enacted September 2, 1974).

[4] The CEA, as amended by the Dodd-Frank Act, defines the foreign exchange contracts, agreements and transactions eligible for the Determination as:

Exchange Forwards to be exempted from the definition of a "swap" in the DFA, we believe that it would be in keeping with Congressional intent for the Commissions to also exempt NDFs from the definition of a swap so long as certain conditions are met. We also believe that the CFTC is authorized to make such an exemption for NDFs under Section 4(c) of the Commodity Exchange Act (the "***CEA***"). As with Foreign Exchange Forwards, we believe that NDFs should only be exempt from clearing and trading requirements and not other requirements of the DFA.[5] Likewise, a currency swap that consists of two NDFs should be subject to the same exemption and the same conditions as Foreign Exchange Swaps.[6] If the Commissions and the Secretary are unwilling to give a broad exemption for foreign exchange NDFs, we believe it would be consistent with Congressional intent and in the public interest to authorize this exemption for ERISA pension plans that enter into such transactions primarily for hedging and mitigating risks directly associated with the operation of their plans.

DISCUSSION

(1) Congress Recognized That Foreign Exchange Forwards and Foreign Exchange Swaps Differ in Significant Ways from Many Other Swaps and Derivatives

Congress granted the Secretary of Treasury (the "***Secretary***") the authority to make a determination that Foreign Exchange Forwards and Foreign Exchange Swaps should not be considered swaps and should not be regulated as swaps.[7] This was one of the few exemptions from regulation that Congress granted for transactions that are in the nature of swaps, and it required the Secretary to base its determination on the fact that Foreign Exchange Forwards are "qualitatively different from other classes of swaps. . . ."[8]

The Secretary indeed made such a determination, finding that Foreign Exchange Forwards "have a very short average length and, therefore, relative to other swaps and derivatives, create significantly lower levels of counterparty credit risk."[9] Furthermore, foreign

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(24) FOREIGN EXCHANGE FORWARD.—The term 'foreign exchange forward' means a transaction that solely involves the exchange of 2 different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange.

(25) FOREIGN EXCHANGE SWAP.—The term 'foreign exchange swap' means a transaction that solely involves — (A) an exchange of 2 different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange; and (B) a reverse exchange of the 2 currencies described in subparagraph (A) at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange.

CEA § 1a(24), (25). To distinguish Foreign Exchange Forwards and Foreign Exchange Swaps from other instruments that are not specifically defined in the CEA and may be included in the definition of a "swap", we refer to these instruments as capitalized terms - Foreign Exchange Forwards and Foreign Exchange Swaps.

[5] *See, e.g.*, CEA § 1(a)(47)(E)(iv) ("Notwithstanding a written determination by the Secretary pursuant to clause (i), any party to a foreign exchange swap or forward that is a swap dealer or major swap participant shall conform to the business conduct standards contained in section 4s(h).").

[6] *See id*.

[7] *See* DFA § 721(a)(21) (amending CEA § 1a(47)(E)). We further discuss the exemption applicable to Foreign Exchange Swaps in this letter below in Section 6.

[8] *See* DFA § 722(h) (adding CEA § 1b(b)(1)).

[9] Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 76 Fed. Reg. 25774, 25776 (published May 5, 2011) (the "***Determination***").

exchange rates, upon which the risk of a Foreign Exchange Forward is based, have historically been far less volatile (and thus less risky) than other underlying markets such as equities. As such, their "risk profile is largely concentrated on settlement risk" which is controlled by settlement procedures established by CLS Bank International,[10] and that key players in the foreign exchange market are already subject to oversight.[11] As such, the Secretary proposed to exempt Foreign Exchange Forwards from the definition of a swap because they "differ in significant ways from other swaps and derivatives."[12]

(2) Non-Deliverable Foreign Exchange Forwards (NDFs) Are the Functional Equivalent of Foreign Exchange Forwards

The Secretary arguably did not have authority to exempt NDFs from the definition of a swap because the DFA only permits a Treasury exemption for Foreign Exchange Swaps and Forwards, which terms arguably do not include NDFs under the definitions provided in the Act.[13] However, we believe that the CFTC can and should exempt NDFs from that definition because NDFs are very much the functional and economic equivalent of Foreign Exchange Forwards. The only difference between the two is that parties to a Foreign Exchange Forward exchange U.S. dollars (U.S. currency) for, for example, British Pounds (non-U.S. currency), and in a NDF the paying party pays the difference between the agreed upon exchange rate for two currencies (e.g, US dollars/Pounds) and the spot rate at settlement.. Obviously, because most commonly-traded non-U.S. currencies are very liquid and very easily convertible into U.S. currency at any given time, the distinction becomes highly artificial and arbitrary. *Ironically, NDFs pose less risk than Foreign Exchange Forwards because, in a NDF, only party is required to make payment and such payment is based on the net difference between two currencies as compared to the full notional amount of the transaction.*

As a result, we do not believe that there is any policy reason to subject NDFs, and not Foreign Exchange Forwards, to clearing and execution requirements and we believe that exempting NDFs would be in keeping with Congressional intent as demonstrated through its authorization of the Foreign Exchange Forward and Foreign Exchange Swap exemption.

A Foreign Exchange Forward contract is "an obligation to purchase or sell a specific currency on a future date (settlement date) for a fixed price set on the date of the contract (trade date)."[14] The Commissions recognized that an NDF "generally is similar to a forward foreign exchange contract, except that at maturity, the NDF does not require physical delivery of currencies"[15]. Both of these types of transactions involve the same market risks. As the Commissions correctly pointed out, in an NDF transaction, "[i]f the spot market exchange rate

[10] *Id.*

[11] *Id.* at 25777.

[12] *Id.* at 25776.

[13] *See supra*, note 4, at 2 (providing definition of Foreign Exchange Forward and Foreign Exchange Swap). NDFs arguably do not satisfy either the definition of a Foreign Exchange Forward or a Foreign Exchange Swap because, by definition, there is not an exchange of two different currencies in an NDF.

[14] Laura Lipscomb, "Federal Reserve Bank of New York, An Overview of Non-Deliverable Foreign Exchange Forward Markets," 1 (May 2005) (citation omitted) ("Fed NDF Overview").

[15] Proposed Rule, 76 Fed. Reg. at 29836 (citation omitted).

on the settlement date is greater (in foreign currency per dollar terms) than the previously agreed forward exchange rate, the party to the contract that is long the emerging market currency must pay its counterparty the difference between the contracted forward price and the spot market rate, multiplied by the notional amount."[16] Similarly, in a Foreign Exchange Forward contract, if the spot market exchange rate of Currency A has risen relative to Currency B between the trade date and settlement date, the "seller" of Currency A will receive less of the Currency B on the settlement date than it could receive by simply exchanging the currencies on the settlement date. In this way, both NDFs and Foreign Exchange Forwards involve the same risk that the currency market will move against them.

The Secretary, however, emphasized that an important distinction between Foreign Exchange Forwards and NDFs is that parties to a Foreign Exchange Forward know at the beginning of the contract what they will owe on the settlement date.[17] We believe that this is a distinction without a difference because parties to a Foreign Exchange Forward do not know the *value* of the currency that they will owe on the settlement date. Foreign Exchange Forward parties are therefore assuming the same risk that the currency market will move against them as are parties to any NDF.

Because NDFs and Foreign Exchange Forwards are equivalent from a risk and any other economic perspective, they are used to hedge and speculate in the same manner and for the same reasons. For example, a company with operations in an emerging market would use an NDF to hedge against the risk of the non-deliverable currency depreciating, while a company with operations in a market without capital controls could use a Foreign Exchange Forward for the same purpose.

Another example is a pension plan that holds non-base currency denominated assets (such as equities or bonds). In this instance, the pension plan is exposed to the translation (*i.e.*, mark-to-market) risk that the currency in which the assets are denominated will depreciate against the base currency. The NDF is then used to offset the translation risk of the non-base currency assets; a pension plan would use an NDF instead of a Foreign Exchange Forward since there is no need to exchange physical currencies, only to hedge the potential loss of market value due to currency translation.

Importantly, some NDFs exist because of the capital controls imposed by certain emerging markets which make Foreign Exchange Forwards impossible, not because of any greater risk or benefit associated with NDFs. As the Federal Reserve Bank of New York explained, "Major NDF market trading began in the early 1990's, initially as a means for companies to hedge their exposure to currency fluctuations of emerging market countries with actual or potential foreign exchange convertibility restrictions."[18] The use of NDFs for this purpose has continued, as evidenced by the fact that "NDF markets in currencies of countries that have allowed increased capital convertibility, to the point where currency hedging is fully

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[16] *Id.* at 29836.

[17] *See* Determination, 76 Fed. Reg. at 25776 ("In contrast to other derivatives, including [NDFs], parties' ultimate payment obligations on a foreign exchange swap or forward are known and fixed from the beginning of the contract and involve the actual exchange of a predetermined amount of principal at settlement.").

[18] Fed NDF Overview, 2.

available onshore, have dissipated and/or disappeared."[19] This further demonstrates that NDFs and Foreign Exchange Forwards are functionally equivalent to one another.

In this way, we respectfully disagree with an implication that the Commissions made regarding the differences between NDFs and Foreign Exchange Forwards. In the Proposed Rule, the Commissions stated that "NDF markets appear to be driven in large part by speculation and hedging, which features are more characteristic of swap markets than forward markets."[20] The implication of this is that Foreign Exchange Forwards are *not* driven in large party by speculation and hedging. We do not believe that this is true.

This implication appears to be based on the CFTC's "historical understanding that a forward contract is a commercial merchandising transaction,"[21] which "is deferred for reasons of commercial convenience or necessity."[22] However, the Commissions noted in the Proposed Rule that this "historical understanding" applies to *non-financial* forwards.[23] As explained above, this "historical understanding" does not apply to Foreign Exchange Forwards any more than it does to NDFs. But Congress and the Secretary determined to exempt Foreign Exchange Forwards from the definition of a swap for many reasons that are entirely divorced from the CFTC's "historical understanding."

As explained below, the reasons for the Secretary's exemption of Foreign Exchange Forwards apply equally to NDFs.

(3) <u>NDFs Pose Similar Counterparty Credit Risk and Less Settlement Risk than Foreign Exchange Forwards</u>

In determining to exempt Foreign Exchange Forwards from the swap definition, the Secretary placed great emphasis on the fact that Foreign Exchange Forwards "have a very short average length and, therefore, relative to other swaps and derivatives, create significantly lower levels of counterparty credit risk"[24] and that they have "a risk profile that is largely concentrated on settlement risk."[25] We believe that these factors also apply to NDFs.

First, NDFs are typically of a short duration, just like Foreign Exchange Forwards. As the Secretary correctly explained, "[c]ounterparty credit risk increases with the length of a contract because that increases the length of time during which a counterparty could suffer from adverse developments."[26] We believe that this point also supports the low degree of

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[19] *Id.*

[20] Proposed Rule, 76 Fed. Reg. at 29836.

[21] *See id.* at 29828.

[22] Statutory Interpretation Concerning Forward Transactions, 55 Fed. Reg. 39188, 39190 (published Sept. 25, 1990).

[23] *See* Proposed Rule, 76 Fed. Reg. at 29828.

[24] Determination, 76 Fed. Reg. at 25776.

[25] *Id.*

[26] *Id*.

counterparty credit risk posed by NDFs because NDFs typically mature in much less time than many other types of derivatives.[27]

Second, we believe that NDFs have even *less* settlement risk than Foreign Exchange Forwards. Settlement risk in the context of a Foreign Exchange Forward is the risk assumed by one party, when that party delivers the currency it owes, that its counterparty will not deliver the currency it owes or that such delivery will be delayed.[28] While both parties to a Foreign Exchange Forward are required to deliver the entire sum of currency to the other party, only *one* party to an NDF transaction is obligated to pay the other party, and even then the obligation is only for the net settlement amount. Both of these factors (one payor versus two and net settlement) reduce the settlement risk of NDFs. The Secretary argued that the settlement risk associated with Foreign Exchange Forwards has been largely addressed through settlement procedures provided by CLS Bank International.[29] We note that CLS Bank also provides settlement procedures for NDFs.[30]

(4) The Other Factors Relied Upon By the Secretary Also Apply to NDF Transactions

The Secretary also based the Determination on the facts that "key players" in the Foreign Exchange Forwards market are already regulated, that Foreign Exchange Forwards are highly transparent and frequently exchange-traded, and that Foreign Exchange Forwards will be subject to additional oversight under the CEA.[31] "Key players" in the NDF market are also subject to significant regulation. In particular, we note that all NDFs entered into by ERISA-regulated plans are already subject to the highest fiduciary standards under United States law.

Regardless of the *current* state of the NDF market, we note that NDFs would be highly transparent and would remain subject to regulation even if the Commissions were to exempt them from the definition of a swap. Just as the DFA did not permit the Secretary to exempt Foreign Exchange Forwards from DFA requirements pertaining to reporting, anti-evasion, and business conduct standards,[32] we would expect that the Commissions would require NDFs to

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[27] *Compare* Sangita Misra and Harendra Behera, "Non Deliverable Foreign Exchange Forward Market: An Overview," 30 (Winter 2006) ("for most of the [Asian NDF] currencies, there is limited liquidity in contracts with a maturity over one year."), *with* Determination, 76 Fed. Reg. at 25777 (explaining that interest rate swaps generally have a maturity between two and thirty years).

[28] *See* Determination, 76 Fed. Reg. at 25776.

[29] *See id.* at 257760.

[30] *See* CLS Settlement for Non-Deliverable Forwards: Cutting Costs and Enabling Growth, *available at* http://www.cls-group.com/Publications/NDF.pdf.

[31] *See* Determination, 76 Fed. Reg. at 25777.

[32] *See* CEA § 1a(47)(E). The CEA's business conduct standards include, among other things, standards relating to fraud, manipulation, or abusive practices, diligent supervision, position limits, responsibilities with special entities, responsibilities when acting as an advisor, and disclosure requirements. The CFTC has proposed several rules implementing these duties. *See* Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, 75 Fed. Reg. 80638 (published Dec. 22, 2010); Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 6715 (published Feb. 8, 2011); Orderly Liquidation Termination Provision in Swap Trading Relationship Documentation for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 6708 (published Feb. 8, 2011); Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants, 75 Fed. Reg. 81519 (published Dec. 28,

comply with the same DFA requirements. Because NDFs would be subject to reporting requirements, they would be highly transparent.

(5) The CFTC Has Authority to Exempt NDFs from the Swap Definition

As the CFTC recently noted, "Section 4(c)(1) of the CEA authorizes the CFTC to exempt any transaction or class of transactions . . . from any of the provisions of the CEA (subject to certain exceptions)."[33] Section 4(c)(2) requires the CFTC, before making such determination, to determine that:

i. The exemption is appropriate and consistent with the public interest;
ii. The exemption is consistent with the purposes of the CEA;
iii. The agreements subject to the exemption will be entered into by "appropriate persons," which include pension plans with more than a net worth exceeding $1,000,000 or total assets exceeding $5,000,000; and
iv. The exemption will not have a material adverse effect on the CFTC's ability to discharge its duties under the CEA.[34]

We believe that an exemption for NDFs would satisfy all of these factors. First, exempting NDFs from the definition of a swap would permit companies with operations in emerging markets, who have no other effective way of managing local currency risks, to continue managing those risks in a cost effective manner. Second, the exemption is consistent with the CEA because, as described above, NDFs are the functional equivalent of Foreign Exchange Forwards which are permitted to be exempted under the DFA. Third, the CFTC could limit the use of NDFs to "appropriate persons" by regulation. If the CFTC does so, we request that the CFTC explicitly identify ERISA-regulated plans as "appropriate persons." Finally, we do not believe that the exemption of NDFs would adversely affect the CFTC's ability to discharge its duties under the CEA because NDFs could remain subject to certain regulations in order to ensure the transparency of these transactions. Moreover, the CFTC would maintain jurisdiction over NDFs even after exempting NDFs from the swap definition.[35]

(6) Foreign Exchange Swaps Are Essentially Two Foreign Exchange Forwards

A Foreign Exchange Swap, as defined in the DFA, is essentially a combination of two Foreign Exchange Forwards.[36] Typically, however, a Foreign Exchange Swap may be of a

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2010); Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants, 75 Fed. Reg. 71397 (published Nov. 23, 2010).

[33] Effective Date for Swap Regulation, 76 Fed. Reg. 35372, 35376 (published June 17, 2011).

[34] *See* CEA § 4(c)(2).

[35] *See* CEA § 4(d) ("The granting of an exemption under this section shall not affect the authority of the Commission under any other provision of this Act to conduct investigations in order to determine compliance with the requirements or conditions of such exemption or to take enforcement action for any violation of any provision of this Act. . . .").

[36] *See* CEA § 1a(25) ("Foreign Exchange Swap. – The term "foreign exchange swap" means a transaction that solely involves – (A) an exchange of 2 different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange; and (B) a reverse exchange of the 2 currencies described in

longer duration than a Foreign Exchange Forward and, in addition to the exchange of currencies, would typically involve also an exchange of periodic payments to account for the interest rate differential between the two underlying currencies. These exchanges may be in one net currency, in two currencies, or even in some other third currency.

For example, on day one, commercial counterparties may enter into a Foreign Exchange Swap whereby they would exchange U.S. dollars for British pounds and, on the termination date (for example, six months from the execution date), they would reverse exchange British pounds for U.S. dollars. Each month the parties will be obligated to pay each other LIBOR on the British pounds and U.S. Treasury rate on the U.S. dollars. The periodic settlement can be calculated in either currency and will be paid as the difference between the two amounts at a then-prevailing spot exchange rate. For convenience, the counterparties may simply exchange the difference between the two payments and settle in one currency, such as U.S. dollars, or British pounds or Swiss francs, instead of transferring two different currencies.

This example illustrates that drawing a rigid regulatory jurisdictional line without taking into account business practices may artificially and unintentionally disrupt these established business practices. Because the counterparties can accomplish their risk mitigation objectives by using either a Foreign Exchange Swap (as defined in the DFA and further expanded in the Proposed Rule) or, instead, two NDFs or a currency and an interest swap (in either U.S. dollars or any other foreign currency), the proposed distinction becomes that of form over substance.

Even recognizing the specific language of the DFA defining Foreign Exchange Forwards and Foreign Exchange Swaps, the CFTC has regulatory tools to ensure that economically similar instruments are regulated similarly.

As described above,[37] we caution against making the presumption that an entity that exchanges both currencies is hedging, while an entity that exchanges a net payment at settlement is speculating. We do not believe that this presumption is supported by empirical evidence. An entity such as an ERISA-regulated pension fund that has an articulated need to hedge its exposure in foreign currency either by using NDFs, Foreign Exchange Forwards or Foreign Exchange Swaps, should not be forced to prefer one instrument over another purely on the basis of arbitrarily drawn jurisdictional lines.

Accordingly, we respectfully request that the CFTC exempt NDFs (and Foreign Exchange Swaps that essentially consist of two NDFs) from the definition of a swap pursuant to its authority under CEA Section 4(c)(1) provided that: (i) one of the counterparties enters into such contract for hedging purposes; and (ii) such transaction is consistent with the CFTC's long-standing interpretation of forward contracts.

If the Commissions and the Secretary are unwilling to give a broad exemption for foreign exchange NDFs as requested above, we believe it would be consistent with Congressional intent and in the public interest to authorize this exemption for ERISA pension plans that enter into

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subparagraph (A) at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange").

[37] *See supra*, section 2.

such transactions primarily for hedging and mitigating risks directly associated with the operation of their plans.

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We thank the Commissions for the opportunity to comment on the proposed definition of “swap,” “foreign exchange forward,” and “foreign exchange swap.”

Committee on Investment of Employee Benefit Assets