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TO:

Mr. Christopher J. Kirkpatrick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

September 30, 2016

Re: Filing IF 16-003 - Swap clearing requirements pursuant to section 2(h)(2)(D) of the Commodity Exchange Act

Dear Mr. Kirkpatrick,

The Global Foreign Exchange Division ("GFXD") of the Global Financial Markets Association appreciates the opportunity to provide comments to the Commodity Futures Trading Commission ("CFTC") on the swap clearing submissions the CFTC has received over the past several years from registered derivatives clearing organizations ("DCOs") pursuant to section 2(h)(2)(B) of the Commodity Exchange Act (CEA) and CFTC regulation 39.5(b).

The GFXD was formed in co-operation with the Association for Financial Markets in Europe (AFME), the Securities Industry and Financial Markets Association (SIFMA) and the Asia Securities Industry and Financial Markets Association (ASIFMA). Its members comprise 24[1] global foreign exchange (FX) market participants collectively representing around 85%[2] of the FX inter-dealer market. The GFXD and its members are committed to ensuring a robust, open and fair marketplace and welcome the opportunity for continued dialogue with global regulators.

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[1] Bank of America Merrill Lynch, Bank of New York Mellon, Bank of Tokyo Mitsubishi UFJ, Barclays, BNP Paribas, Citigroup, Crédit Agricole, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan, Lloyds Bank, Mizuho, Morgan Stanley, Nomura, Royal Bank of Canada, Royal Bank of Scotland, Société Générale, Standard Chartered Bank, State Street, UBS, Wells Fargo and Westpac.

[2] According to Euromoney league tables.

The FX market is the world's largest financial market, and effective and efficient exchange of currencies underpins the world's financial system. Sovereign entities, central banks and other government sponsored entities rely on the FX market being well-functioning and liquid, and corporations and investors regularly participate in the market for important operational needs: to reduce risk by hedging currency exposures; to convert their returns from international investments into domestic currencies; and to make cross-border investments and raise funding outside home markets.

Many of the current legislative and regulatory reforms have had, and will continue to have, a significant impact upon the operation of the global FX market, and the potential consequences of reforms should therefore be carefully evaluated before they are implemented.

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EXECUTIVE SUMMARY

Our comments are specifically focused on the portions of the DCO submissions related to clearing of FX non-deliverable forward ("NDF") transactions.

We acknowledge that the CFTC has indicated that, in posting the DCO submissions, it is not proposing additional swap clearing requirements, and that if the CFTC decides to propose a clearing requirement determination for any of the swaps covered by the DCO submissions, then, at that time, it will invite further public comment in response to a notice of proposed rulemaking. Nevertheless, we hope that the CFTC finds our comments helpful in considering if and when such a notice of proposed rulemaking might be suitable in respect of NDF products.

For the reasons set forth below, our view is that, while we fully support the CFTC taking initiatives to implement the G20 commitments to reform the OTC derivative markets, including proposing clearing mandates for derivatives where deemed appropriate, at this time we recommend allowing voluntary NDF clearing further time to develop organically, as margin for OTC uncleared derivatives and additional capital rules continue to be rolled out, and as certain other relevant rules are reviewed, related to SEF trading for example, before issuing a notice of proposed rulemaking and timeline for any clearing mandate for NDFs.

We recommend re-assessing whether an NDF clearing mandate might be appropriate, and what form such a mandate might take, after there has been further increasing NDF notional being voluntarily cleared, additional growth in the number of market participants voluntarily clearing NDF products, satisfaction as to a systemic risk justification, and sufficient deliberation around addressing outstanding technical issues and potential knock-on impacts of a CFTC NDF clearing mandate, for example in relation to prime brokered FX transactions, client clearing and mandatory trading obligations.

Importantly, because the FX market forms the basis of the global payments system, we also make the point that, in order for this market to continue to function effectively and in order to avoid unwanted fragmentation of what is an already highly automated, transparent and well-functioning market, substantive regulations, including any mandatory FX clearing obligations, should be harmonized to the greatest extent possible at the global level. To best achieve this, we believe the most appropriate time to re-assess whether an NDF clearing mandate might be suitable, and what such a proposal should require, is after MiFID II is applied in 2018.

We have reached these views as a result of taking into account the following considerations, discussed in more detail below:

1. Voluntary NDF clearing will still be developing, with the continued roll-out of uncleared margin and capital requirements, and has not yet achieved the same depth as IRS and CDS clearing had when clearing mandates were introduced for these products in the US and EU.

2. Key technical matters associated with NDF clearing remain unresolved.

3. It is critical to align the timing of any NDF clearing mandate in the US and EU. In this regard, the CFTC should in particular consider potential knock-on effects of a CFTC NDF clearing mandate.

4. The CFTC should consider whether the reduction of counterparty credit risk to be achieved from mandating participants to move bilateral NDF exposures to a centrally cleared environment would reduce systemic risk before proposing a clearing mandate.

We have also provided thoughts as to certain unique characteristics of the NDF market that we feel warrant special attention if and when the CFTC were to issue a notice of proposed rulemaking for mandated clearing of NDFs.

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BACKGROUND

Section 2(h)(2)(D)(ii) of the CEA provides that in reviewing a swap, group of swaps, or class of swaps for clearing requirements, the CFTC shall take into account five factors:

(I) The existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data.

(II) The availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded.

(III) The effect on the mitigation of systemic risk, taking into account the size of the market for such contract and the resources of the derivatives clearing organization available to clear the contract.

(IV) The effect on competition, including appropriate fees and charges applied to clearing.

(V) The existence of reasonable legal certainty in the event of the insolvency of the relevant derivatives clearing organization or 1 or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds, and property.

We have referenced these factors, where applicable, in our comments.

SPECIFIC COMMENTS ON NDF CLEARING

1. Voluntary NDF clearing will still be developing, with the continued roll-out of uncleared margin and capital requirements, and has not yet achieved the same depth as IRS and CDS clearing had when clearing mandates were introduced for these products in the US and EU.

This point goes to Factor (I) of the CEA factors - the existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data.

We believe that the CFTC should take into account the development of pre-existing voluntary clearing in the NDF market, particularly in respect of client-clearing.

According to data from the most recent BIS Triennial Survey, trading in the FX markets averaged around $5.1 trillion per day in April 2016.[3] NDFs account for around 2.6% (or approximately $130 billion) of the total $5.1 trillion.[4] Estimates were made in 2014 that, depending on the currency pair, only between 0.4% - 3.6% of NDF daily turnover was being

[3] 2016 BIS Triennial Survey, at http://www.bis.org/publ/rpfx16fx.pdf ("2016 BIS FX Survey").

[4] 2016 BIS FX Survey.

voluntarily cleared.[5] We understand those numbers to be growing, but still smaller than those upon which the introduction of clearing mandates for IRS and CDS were predicated: approximately 60% of IRS contracts and 30% of CDS contracts were being voluntarily cleared when those mandates were introduced.[6] Furthermore, our understanding is that the number of market participants clearing NDF, while growing, is still somewhat limited, and that necessary capabilities for client clearing do not as yet exist.

We expect the volume of NDFs being voluntary cleared to grow over time, especially as additional relevant G20-related rules and regulations go-live. Accordingly, we believe that additional time should be allowed for voluntary NDF clearing to develop further, measured primarily by increasing notionals and number of market participants, before any clearing mandate is proposed, in particular as the FX market evolves and reshapes around margin rules for uncleared OTC derivatives and capital rules rolling out.

2. Key technical matters associated with NDF clearing remain unresolved.

This point goes to Factor (II) of the CEA factors - the availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded.

In our view, FX clearing services need further time to mature, for practices to be properly bedded down and tested and for fundamental unresolved issues to be properly addressed. The FX market already operates very efficiently, so we ask that the CFTC bear in mind technical readiness considerations before proposing any mandate for NDF clearing.

In relation to prime brokered FX transactions, there are outstanding issues in terms of capabilities for clearing the prime broker-executing dealer "street" leg of FX prime brokered transactions. For example, if a transaction between a prime broker and its client is early terminated, this leaves the prime broker with asymmetrical risk facing the executing dealer on the street leg of the prime brokered transaction. These and other issues require further thought and deliberation by those participating in this sector of the FX market, as they would be impacted by a clearing mandate.

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[5] In its 2014 consultation on clearing obligations, ESMA calculated that, depending on the currency, between 0.4%-3.6% was being cleared on LCH.Clearnet Ltd. See https://www.esma.europa.eu/sites/default/files/library/2015/11/esma-2014-1185.pdf.

[6] CFTC GMAC meeting, October 9, 2014 (presentation by Rodrigo Buenventura, ESMA).

Additionally, further development of capabilities for client clearing needs to occur. For an NDF clearing mandate to be workable, there must be a sufficient number of CCP clearing members providing FCM services for client clearing. Concentration risk in those entities that are able to be members of a clearinghouse also needs to be considered, since it's likely that clients (and some banks) will need to clear NDF through a clearing member.

Furthermore, we are concerned about the relative unfamiliarity of CCPs with managing disruption events and the valuation and settlement of FX contracts, in particular affecting currencies of EM jurisdictions. This point goes to Factor (V) of the CEA factors. The ability for market infrastructures to develop to support an NDF clearing mandate, and implement processes for managing events such as a counterparty default, has not been fully established or, more importantly, tested. Conversely, the introduction of clearing mandates for IRS and CDS was predicated on far more developed markets, with many start-up issues already addressed while clearing was still voluntary.

3. It is critical to align the timing of any NDF clearing mandate in the US and EU. In this regard, the CFTC should in particular consider potential knock-on effects of a CFTC NDF clearing mandate.

We believe that the most appropriate time to re-assess whether an NDF clearing mandate might be suitable, and the scope and specifics of any such mandate, is after MiFID II becomes live in 2018.

Although clearing mandates in the EU are decided via EMIR, waiting for finalization and implementation of the MiFID II rules will, we believe, enable better coordination to be achieved in consultations regarding NDF clearing mandates across the US and EU. For our FX members, given the global nature of the FX market and extent of trading conducted across borders,[7] harmonization between the rules in these two key FX hubs is vital, and we feel it is especially important for timeframes for any clearing mandates to coincide in the US and EU. In its February 2015 "Feedback Statement on Consultation on the Clearing Obligation for Non-Deliverable Forwards," ESMA recognized and highlighted the importance of international consistency in the implementation schedule of a clearing obligation for NDFs.[8]

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[7] As reported in the 2016 BIS FX Survey, over 77% of FX activity was executed by counterparties across five global jurisdictions, see BIS 2016 FX Survey, p.8.

[8] In February 2015, ESMA said it would not yet propose a clearing obligation for NDF classes, to enable more time to address concerns raised, in particular related to the timing for a potential obligation and the experience of counterparties with NDF clearing, see

More specifically, we ask that the CFTC bear in mind the knock-on implications of a clearing mandate on mandatory trading in the US, vs. the process in the EU. Clearing mandates in the EU are determined via EMIR, with trading mandates separate and to follow under MiFIR.[9] We don't expect any EU trading mandate for FX until questions around liquidity are addressed, likely to be post MiFID II go-live in 2018, to allow for the collection and collation of necessary data. This differs to the approach under the current rules in the US, where clearing and trading mandates are connected and can essentially occur at the same time. We are concerned that cross-border markets cannot operate in conflicting regulatory landscapes and the natural outcome, should this be the case, is unwanted fragmentation and potential bifurcation of liquidity.[10]

We recommend that the CFTC also consider that there are outstanding areas of focus that exist with the current US SEF/Trading framework, such as: review of the "Made Available to Trade" ("MAT") process; codification of certain existing no-action relief related to block transactions, SEF documentation, error correction policies and package transactions; and the status of SEF/MTF recognition following MiFID II Technical Standards.

We understand the CFTC intends to issue a rulemaking to address some of these areas, and to make further efforts to harmonize the CFTC's rules in this regard with those coming on-line globally. We also understand that the CFTC may be considering changes to the SEF rules and MAT process in the US. We would hope to see the clearing/MAT link eliminated, but in any event it would make sense, we believe, to address issues regarding the SEF/Trading framework and MAT process before initiating a proposed clearing mandate for NDFs.

4. **The CFTC should consider whether the reduction of counterparty credit risk to be achieved from mandating participants to move bilateral NDF exposures**

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https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-esma-234_-_feedback_statement_on_the_clearing_obligation_of_non_deliverable_forward.pdf.

[9] On September 20, 2016, ESMA published a discussion paper on the trading obligation for derivatives under MiFIR. The discussion paper seeks views on ESMA's first proposals of how to implement the trading obligation for derivatives and on ESMA's preliminary analysis of some classes of derivatives that could become subject to the trading obligation. A further consultation paper on this topic is envisaged in the first quarter of 2017 and a draft technical standard, if deemed appropriate, is expected to be submitted to the European Commission in the summer of 2017.

[10] For example, see http://www2.isda.org/search?headerSearch=1&keyword=SEF. An April 2015 ISDA study showed that the October 2013 effective date for SEF compliance had an impact on trading relationships in the derivatives markets: liquidity in the interest rate swaps market fragmented following the start of the SEF regime, and split further since the first made-available-to-trade determinations came into force in February 2014, with trading between US persons and non-US having declined.

to a centrally cleared environment would reduce systemic risk before proposing a clearing mandate.

This point goes to Factor (III) of the CEA factors - the effect on the mitigation of systemic risk, taking into account the size of the market for such contract and the resources of the derivatives clearing organization available to clear the contract.

CCPs are designed to mitigate credit risk. Before proposing a mandate for NDF clearing, the CFTC should also consider whether the reduction of counterparty credit risk to be achieved from mandating participants to move their bilateral exposures to a centrally cleared environment for NDF contracts would reduce risk in the aggregate and, most importantly, also reduce systemic risk. "Systemic risk" can be broadly characterised as the risk that financial instability becomes so widespread that it impairs the functioning of a financial system to the point where economic growth and welfare suffer materially."[11, 12]

In this regard, the CFTC should take into account the relatively small size of the NDF market (as compared to other classes of derivatives that are cleared) and the concentration of trading NDF in short-dated tenors. According to the 2016 BIS Triennial Survey, around 97.5% of the market for FX forwards (which includes NDF) matured in one year or less: 58.9% of outright forwards initiated in April 2016 had a contractual maturity of between seven days and one year, 38.6% a tenor of 7 days or less and only 2.5% of outright forwards had a tenor of over 1 year.[13]

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[11] European Central Bank, The concept of systemic risk", Financial Stability Review (December 2009). http://www.ecb.europa.eu/pub/fsr/shared/pdf/ivbfinancialstabilityreview200912en.pdf?a3fef6891f874a3bd40cd00aef38c64f. Also referenced in U.S. Department of the Treasury, Office of Financial Research, Working Paper #0001, A Survey of Systemic Risk Analytics (January 5, 2012).

[12] See Group of Ten, *Report on Consolidation in the Financial Sector*, 2001 (IMF working definition of systemic risk); available at http://www.bis.org/publ/gten05.pdf. See also Gerlach, Stefan of the European Parliament's Policy Department: Economic and Scientific Policies, *Defining and Measuring Systemic Risk* (2009) (report produced at the request of the European Parliament's Committee on Economic and Monetary Affairs, which highlights three important characteristics of the IMF's working definition: First, it must impact on a "substantial portion" of the financial system. Thus, it is risk to the financial system as a whole. Second, systemic risk involves spillovers of risk from one institution to many others. In turn, this implies that in measuring it, attention should presumably be focused on the ways in which adverse shocks affecting one or a few institutions can be transmitted to the financial system at large, that is, on the interlinkages between institutions. Third, episodes in which systemic risk materialized would typically be associated with highly adverse macro economy efforts in the absence of rapid and strong policy responses. By this standard, it is clear that the current episode of financial instability [2008-2009], reflects a systemic crisis.); available at http://www.europarl.europa.eu/document/activities/cont/200911/20091124ATT65154/20091124ATT65154EN.pdf.

[13] 2016 BIS FX Survey, p.12.

Bearing in mind that NDFs represent only around 2.6% of the total \$5.1 trillion (*i.e.*, notional of approximately \$130 billion of the total \$5.1 trillion), that credit support agreements are used and relied on in the FX market as required under the uncleared OTC margin rules and as a risk mitigation tool, and that a growing portion of NDF activity is already voluntarily cleared, we see relatively limited incremental credit risk reduction to be achieved by mandating NDF clearing as gross credit exposures between dealers, after taking into account legally enforceable netting and collateral agreements would be a fraction of the \$130 billion.

Whilst mandating NDF clearing would transfer a certain amount of bilateral exposure which exists between market participants to CCPs, the size of and amount of risk in the NDF market is orders of magnitude less than in rates and credit, and thus the level of risk reduction that a clearing mandate for NDFs would bring in comparison to rates and credit would be similarly less.

5. Certain unique characteristics of the NDF market warrant special attention if and when the CFTC were to issue a notice of proposed rulemaking for mandated clearing of NDFs.

This point also relates to Factor (II) of the CEA factors - the availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded.

If and when the CFTC were to propose an NDF clearing mandate, a sufficiently tailored clearing obligation and lengthy phase-in for compliance should be provided for, and global coordination should be prioritized, to minimize the risk that the implementation of required clearing obligations (and any subsequent trading obligations) in the US vs. elsewhere would be unnecessarily disruptive to the vital and well-functioning global currency markets.

Specifically, in this regard:

- <u>Any recommendation for an NDF clearing mandate should not apply to contracts that have not adopted the relevant currency template in the form published by EMTA</u>.

  As part of their commitment to derivatives reform, the G20 Leaders agreed in 2009 that all standardized OTC derivatives contracts would be cleared through CCPs. To ensure the level of standardization achieved to date in the NDF market is preserved, any clearing mandate for NDF contracts should be sufficiently clear that it only applies to standardized contracts which incorporate industry standardized currency templates in the form published by the Trade Association for the Emerging Markets (EMTA) without modification. Any proposal for a clearing mandate should not apply to contracts that have not adopted the relevant currency template in the form published by EMTA as those contracts would have different economic terms. This would ensure the clearing mandate does not encompass instruments with non-standard terms.[14] Faced with limited liquidity, CCPs would find it difficult to manage the default of a clearing member responsible for transactions in varying currencies and maturities.

- Global agreement and harmonization. It is important for regulatory authorities in EU, US and the Asia Pacific region to coordinate to ensure that there is sufficient agreement concerning NDF contract specifications, including the adoption of EMTA templates, before any clearing determinations are introduced in their respective jurisdictions.

- Tenor of one year or less. Any clearing obligation for NDFs should be limited to contracts with a tenor of one year or less. Open interest in NDF contracts is concentrated in shorter-dated tenors, there is insufficient liquidity in these contracts beyond one year to support clearing and, given the limited liquidity, CCPs would find it difficult to manage the default of a clearing member responsible for transactions with maturities greater than one year.

- Extended Phase-In Period. Any determination to introduce a clearing mandate for NDFs requires a sufficiently extended phase-in period, both in terms of timing and of the participants required to clear, to allow market participants to address issues arising from the fact that NDF clearing is continuing to develop. We recommend that the phase-in period allow for any NDF clearing mandate account for development of a mature client clearing offering, and allow for a sensible substituted compliance/equivalent regime to be implemented where NDFs are traded cross-border.

CONCLUSION

Whilst we appreciate that if the CFTC decides to propose a clearing requirement for NDFs, then, at that time, the CFTC will invite further public comment in response to a notice of proposed rulemaking, we hope that the CFTC finds our comments helpful.

[14] We believe that voluntary clearing, over time, may lead to even greater standardisation of contract terms. Certain products will attract more liquidity than others and network effects should result in market participants migrating to those products. Further, as the new Basel III capital requirements come into effect, market participants will have an incentive to embrace a particular standard and margin on uncleared OTC trades will likely mirror those standardised terms because of the portfolio benefits.

We expect the volume of NDFs being voluntary cleared to continue to grow over time, especially as other relevant rules and regulations take effect, such as those concerning capital requirements and the exchange of margin on uncleared OTC derivatives contracts. For the reasons we've explained above, our view is that at this time we recommend the CFTC allow voluntary NDF clearing further time to develop organically, as these rules continue to be rolled out and as other relevant derivatives focus areas are reviewed, before issuing a notice of proposed rulemaking and timeline for any clearing mandate for NDFs.

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We are very grateful for the CFTC's willingness to hear from and engage with the FX industry on questions around FX clearing mandates, and appreciate the opportunity to share our views on the considerations we have raised in this letter. Please do not hesitate to contact Victoria Cumings on 212-313-1141, email vcumings@gfma.org should you wish to discuss any of the above.

Yours sincerely,

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Cc: Sarah Josephson, Deputy Director, Product Review, and Melissa D'Arcy, Special Counsel - Division of Clearing and Risk, CFTC