Memorandum

To	Global Markets Advisory Committee, CFTC
From	Foreign Exchange Markets Subcommittee
Date	December 5, 2014
Subject	**Response to request for recommendation on an FX NDF mandate**

The Foreign Exchange Markets Subcommittee (FEM) thanks the Global Markets Advisory Committee ("GMAC" or "Committee") for the opportunity to provide its views to the Committee on a prospective clearing mandate for foreign exchange ("FX") non-deliverable forwards ("NDFs").

<u>Executive Summary</u>

Should the Commodity Futures Trading Commission ("CFTC" or "Commission") decide to proceed with a clearing mandate for NDFs, such mandate should contain a clear timeline and method of implementation to ensure that market participants have appropriate opportunity to address the issues outlined in this paper.

Clarity on the timing of a clearing mandate will encourage all market participants to enable product standardization via the use of EMTA templates, and to accelerate preparation efforts including the completion of work already started to provide trade certainty and compliance with the CFTC's clearing FCM risk management requirements (Rule 1.73 compliance).

Harmonization among regulators of timelines, counterparty categories and currencies will limit any negative impact on global liquidity. In addition, the resolution of issues regarding the handling of package transactions, amending prime brokerage flows, and addressing outstanding no-action relief letters are all vital for a successful and stable implementation.

<u>Market Background</u>

Non-deliverable forwards are foreign exchange transactions that, unlike conventional FX trades, do not result in an exchange of principal. Instead the counterparts agree to settle based on the difference between the exchange rate at the time of the trade and the exchange rate at maturity. Using a pre-agreed reference rate, one counterparty makes a one-way payment to the other, usually in US dollars, representing the movement in the exchange rate.

NDFs are normally transacted outside the jurisdiction of the currency in question. Many countries restrict or prohibit onshore trading or delivery and this market structure respects those restrictions. If currency restrictions are eased, typically those NDF markets begin to shrink and theoretically should disappear. In reality, that process can be lengthy with deliverable and NDF markets trading side-by-side for years after lifting the controls that catalyzed the NDF market. For example:

The Ruble NDF market still accounts for two-thirds of total RUB forwards activity even though the currency became fully convertible in 2006.[1]

The Australian Dollar NDF market continued to function for another 3-4 years after restrictions on deliverability were lifted in 1983.

Chinese Renminbi NDFs, in contrast, have seen their volume growth ebb not because of convertibility but rather because an offshore deliverable – commonly called the CNH market – has developed to complement the NDF sector.

NDFs are used by a large number of market participants including: corporations hedging onshore investments or earnings; investors hedging or making directional investments; and dealers and others managing exposure between NDFs and onshore markets and providing market making services. Users often trade and hedge NDF exposures against other financial products, such as local fixed income markets; thus any change to NDF regulations should carefully consider their wider use.

Although popular, NDFs comprise a small portion of the overall foreign exchange market. According to the Bank for International Settlements triennial turnover survey, the market traded $127 billion per day in April 2013, roughly 20 percent of all forwards trading but only 2 percent of the $5.3 trillion that traded across all products.[2]

Six currencies account for two-thirds of the current volume: Brazilian Real, Chinese Renminbi, Indian Rupee, Korean Won, Russian Ruble, and Taiwan Dollar. The vast majority of trading in these currencies (and the market overall) occurs against the US dollar as the counter currency. The six currencies have activity concentrated in tenors of up to three months, although maturities can go out several years. As is the case with listed futures, market participants note that liquidity is lower as one goes further out the maturity spectrum. One-third of trading occurs in London with the major Asian centers also being active.

Current status of FX NDF clearing

The success of prime brokerage services ("PB") in the Foreign Exchange markets over the last fifteen years has in some ways prepared participants for the advent of clearing. Following the G-20 statement of September 2009, many CCPs started work to extend their members' existing PB infrastructure in the design of clearing services for foreign exchange.

The Singaporean exchange SGX was the first to launch an FX NDF clearing service in November 2011, closely followed by LCH.Clearnet Ltd and CME US in March and April of 2012 respectively.

Since then EUREX, ICE and NASDAQ OMX have all publically stated their intent to offer cleared services for foreign exchange, but have yet to come to market.

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[1] See European Securities and Markets Authority, Consultation Paper, 1 October 2014, http://www.esma.europa.eu/system/files/esma-2014-1185.pdf.

[2] See Bank for International Settlements, "Triennial Central Bank Survey", September 2013, http://www.bis.org/publ/rpfx13fx.pdf; also, Bank for International Settlements, "Non-deliverable Forwards: 2103 and Beyond", March 2014, http://www.bis.org/publ/qtrpdf/r_qt1403h.htm.

Clearing of FX NDF contracts is thus relatively new and volumes of cleared NDFs are small. In the absence of a mandate, cleared NDFs are voluntary and account for roughly 4% of daily NDF turnover.

Today there are two CCPs authorized to clear FX NDF contracts in the US – CME US and SGX – and one authorized to clear FX NDFs in both the US and Europe, LCH.Clearnet Ltd. The European Securities Markets Authority ("ESMA") has said it expects CME Clearing Europe, ICE Clear Europe and NASDAQ OMX to offer clearing for FX NDFs, along with several third-country CCPs.

LCH.Clearnet Ltd has the majority of cleared volume, which is predominantly focused on interdealer business. Whilst LCH has four FCMs offering client clearing, with another eight making preparation, the actual amounts of client cleared transactions is *de minimis*.

Given that background providing context to the Subcommittee's analysis, we now address the three specific questions posed to the Subcommittee.

QUESTION 1: IS AN NDF CLEARING MANDATE APPROPRIATE?

The Subcommittee supports the G20 commitment that all standardized over-the-counter ("OTC") derivative contracts should be traded on exchanges or regulated trading platforms, where appropriate, and be cleared through central counterparties. In the United States the Treasury has exempted FX forwards and swaps from the mandatory clearing requirements of Dodd Frank, but not FX options or NDFs.

The Subcommittee debated intensely the question of whether a CFTC mandate for clearing of NDFs is appropriate and recommends that should the Commission decide to proceed with a clearing mandate for NDFs, such mandate should contain a clear timeline and method of implementation to ensure that market participants have appropriate opportunity to address the issues outlined in the rest of this paper.

All members of the Subcommittee agreed that the appropriateness of a clearing mandate is critically linked to the objective of mitigating systemic risk *(consistent with the goals of the G20).* In this regard, the group concluded that a CFTC clearing mandate for FX NDFs would result in a system-wide reduction of counterparty credit risk, but may not reduce systemic risk in the financial system given the small size *(about 2% of the overall FX market)* and short-dated tenor *(over 90% of volumes are transacted in tenors less than 3 months)* of the NDF market.

The Subcommittee also unanimously agreed that the question of whether or not NDF clearing is appropriate is also critically dependent upon the manner in which NDF clearing is implemented. Before addressing specific implementation issues in response to Question 2, we further highlight three broad and recurring issues emphasized throughout our discussions.

1. As noted earlier, NDFs are distinct from other FX products in that they do not have an exchange or delivery of principal and instead have cash settlement at maturity. NDFs are not subject to the liquidity and settlement risk issues associated with clearing deliverable products such as FX Options.

2. While small relative to the overall FX market, the NDF market is used by corporations, investors, banks, and others in all geographic regions. Failure to consider the impact of a clearing mandate on market access 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 that imply less competitive pricing.
3. While much has been done by infrastructure providers to support cleared NDFs, a number of critical issues remain outstanding and must be addressed by regulators or market participants, or both. The intended schedule for solving those issues is a critical input for CFTC adoption of the challenging but realistic timeline proposed in this paper, acknowledging the amount of work necessary to move this market to mandatory clearing in a non-disruptive manner.

QUESTION 2: WHAT IS THE BEST WAY FOR THE CFTC TO IMPLEMENT A CLEARING MANDATE?

As noted earlier the appropriateness of the mandates is linked to the manner of implementation and the Subcommittee identified the following issues that should be factored into the decision-making process and that the GMAC should consider recommending to the Commission. .

A. Harmonization across major geographies

Market participants have collectively called for harmonization between the US and European regulators with regard to the NDF clearing mandate to ensure users are able to access a robust liquidity pool. In light of the proposals recently published by ESMA we suggest that there are several aspects that can be synchronized:

- harmonization of products to be cleared (e.g. currency pairs and tenors)
- harmonization of counterparty categories; and
- harmonization of the timeline for mandatory clearing

Product harmonization. In comparing the ESMA proposal with the CFTC staff's presentation at the October 9, 2014 GMAC meeting, we note that the two proposals are already close in key details. While the CFTC staff have identified 12 currency pairs that could be subject to a clearing mandate compared to ESMA's proposal of 11 pairs, we note that the CCP on whose proposal ESMA based their consultation paper has since added the 12th currency and has notified ESMA of this. In short, this disparity is minor and appears on its way to being resolved. The addition or subtraction of currencies from the mandate could be handled over time through use of an agreed reference to the existing market documentation used to support the product, as defined by EMTA (the EMTA templates – see paragraph 2B).

Market participants are concerned that the CFTC set an appropriate tenor requirement for mandatory clearing of NDFs. The Subcommittee recommends that the GMAC advises the Commission that a tenor requirement that encompasses a substantial portion of the market liquidity to ensure that CCPs are only exposed to liquid NDFs. The ESMA consultation proposed including maturities up to two years for mandatory clearing. The Subcommittee also recommends that if the CFTC were to implement a clearing mandate for NDFs, such mandate should apply to outstanding maturities not greater than 12 months. The Subcommittee believes this would cover a substantial portion of the liquid market.

Counterparty category harmonization. In the US there is already certainty on the counterparties in each mandatory clearing category, and the ESMA consultation has provided some clarity on this point. Given the potential disparities between the CFTC and ESMA decisions, we suggest that a possible solution for the GMAC to consider recommending to the Commission would be for the CFTC and ESMA to strive to keep the implementation of the clearing mandate for Category 1 and Category 2 counterparties close together, as the sum of the two is broadly consistent across the jurisdictions.

Timing of phase-in for mandatory clearing. The Subcommittee recognises that both US and European regulators have already established for their markets the phase-in period among categories of counterparties for mandatory clearing of other asset classes *(rates and* credit). Respecting that both regulatory jurisdictions may wish to keep those same periods for the FX NDF mandate, we propose the following solution:

- ESMA's latest guidance on this point suggests that Category 1 participants will be subject to the clearing mandate in November 2015, with Category 2 participants to follow 180 days later.
- The CFTC would finalize a clearing determination for NDFs such that the clearing obligation for their Categories 1 and 2 is broadly aligned with the mandatory clearing dates for ESMA categories 1 and 2. For example, as shown on the diagram at the end of this paper, Category 1 clearing could begin on February 1, 2016 followed by a 90 day phase in for Category 2 of May 1, 2016.
- The slight divergence between the categories in each jurisdiction would present some operational challenges, but such a timeline would also reduce concerns around possible market fragmentation since voluntary clearing could be adopted by market users in one region to align with the other region.

As discussed at the October 9, 2014 GMAC meeting, market liquidity fragmentation is a concern and aligning the clearing mandates as closely as possible would significantly address that concern. Additionally, members of GMAC noted that there are a number of market participants who are not ready for centralized clearing. Market participants need the CFTC to provide some certainty about clearing timeframes so that they have adequate notice to prepare.

If there is flexibility from the CFTC with regard to the time between the phase-in of any mandate for the categories, we suggest that the GMAC recommend to the Commission to consider whether these milestones could be aligned to a greater extent with the commencement of mandatory clearing for the ESMA categories.

If we overlay the CFTC clearing implementation process on the expected ESMA timeline, and give the market sufficient time to prepare for any mandate, this would result in the **CFTC clearing determinations being proposed no later than August 1, 2015**. Subsequently:

- the CFTC mandate would be finalized on November 1, 2015
- Category 1 participants would be subject to the clearing mandate on February 1, 2016

- Category 2 participants would be subject on May 1, 2016; and
- Category 3 participants would be subject on August 1, 2016.

We believe this would give market participants sufficient time to prepare for centralized clearing. As noted previously the diagram at the end of this paper illustrates this recommendation.

B. Standardization via use of EMTA currency templates.

The Emerging Markets Trade Association (EMTA) has done much to reduce risk by standardizing the terms under which many NDFs are traded. Working with market participants the EMTA templates provide:

- The settlement currency
- The settlement date
- The primary fixing source to be used for valuing the contract for settlement
- The secondary fixing source to be used in disruption events; and
- Fallback conventions that address the risk of potential market/sovereign events disrupting the value or settlement of the emerging market currencies underlying these contracts (e.g. suspension of trading, sovereign default, an unexpected bank holiday or other significant disruption to valuation, payment or settlement processes).

Each term is a key feature of the FX NDF contract and material to each party's ability to manage the totality of a contract's risks, from trade execution through to actual settlement.

These contractual specifications are an essential feature for NDF market participants, who price transactions based upon the existence of a known, transparent and pre-agreed set of template provisions to handle unpredictable events. Without these predictable and consistent contractual pathways, it is likely that market participants will be materially impaired as to their ability to manage the NDF contract's risks end-to-end, i.e., from trade execution through to actual settlement. Such differences in risk characteristics may result in treating the NDF for a Non-Deliverable Currency cleared by one CCP to be a different product – with different pricing, different risk management and different methods to deal with disruption events – than the NDF for the same Non-Deliverable Currency traded on a CCP with alternative contractual specifications.

Presently, there is lack of uniform adoption of these templates resulting in differing contract terms being cleared by several CCPs. The Subcommittee's view is 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.

C. Market Readiness for Client Clearing

Not all clients and FCMs are operationally ready for NDF clearing in the United States. We believe this may be because of the lack of clarity on the timing of the clearing mandate. While the FX industry has broadly adopted pre-trade credit checks, a clearing mandate would establish a timeline for incorporating the robust controls of execution venues into the CCP's processes for accepting trades for clearing. The execution venues have long offered pre-trade credit checks and several post-trade technology providers offer client clearing affirmation/matching, post-trade allocation and

CCP trade registration workflows for market participants. Such third-party products have been used for voluntary FX NDF clearing by a limited number of FX market participants and FCMs at the two CCPs that offer NDFs for clearing.

However, given the highly decentralized market infrastructure which supports the OTC FX market, there are still many bilateral operational processes that need to be enhanced and standardized for a cleared environment, developed by clearing firms and implemented by their clients to support any clearing mandate for FX NDFs. Examples of these include:

- Clearing and allocation of voice trades
- Pre-allocated and bunched order trades on Swap Execution Facilities ("SEFs")
- Voice block trade, package trades and others

The Subcommittee notes such efforts will require resourcing by many market participants. We believe our recommended timeline for a clearing mandate provides adequate time for such resourcing and preparation.

D. Preparation to support trade certainty and CFTC Rule 1.73 compliance

Certainty of clearing is necessary at the time of trade execution to ensure counterparties have confidence their transactions will clear. In addition, under current rules, NDF products that are mandated to clear and are traded on SEFs, whether subject to an execution mandate or not, would be required to comply with CFTC Rule 1.73 for pre-trade risk checking and certainty of clearing.[3]

In the rates and credit markets, there were disruptions to the pre-existing SEF trading volumes beginning in October 2013 as pre-trade checks were unexpectedly required on SEF trades. Consequently, the readiness of SEFs and their participants for 1.73 compliant pre- and post-trade processes for NDF trading, including support for FCM credit checks, pre-allocated trades and post-clearing allocations ("Bunched Orders") should be considered when implementing the Subcommittee's recommended timeline.

QUESTION 3: ARE THERE LIKELY TO BE ANY EXECUTION ISSUES IN LIGHT OF THE MADE AVAILABLE TO TRADE ("MAT") DETERMINATION FILINGS?

We are encouraged by the CFTC's willingness to pro-actively address any specific issues that might arise as a result of the trading mandate.

At the meeting on October 9, 2014, several GMAC members expressed concern over the potential systemic risk impact of market participants not having adequate time to prepare for mandatory trading. Such risk would occur if a Made Available to Trade (MAT) determination followed too closely after a mandatory clearing determination. We agree that such systemic risk impact should be considered, and that market participants should be given adequate time to prepare for MAT of NDFs. We recommend careful review of this matter and that any definition of "adequate time" for market participants be balanced against the needs of the SEFs, many of which were created in

[3] The Commodity Futures Trading Commission sets risk management requirements for FCMs in Rule 1.73 of its rules for clearing members.

October 2013 in order to facilitate the eventual MAT environment, to have clarity on when the MAT determinations will be available.

We recognize that the Commission has the benefit of learning from the experiences in the Rates and Credit markets, which have already undergone this transition. Three main issues arose after MAT filings were approved in those markets:

The handling of package transactions. It was not clear whether these multi-leg transactions, which include at least one leg that is subject to MAT determinations and at least one leg that is not, should be executed exclusively on swaps executions facilities ("SEFs") or not.

In the NDF market, package transactions take the form of NDF swaps and strips-of-forwards. For example, an NDF swap may consist of a 6-month non-deliverable forward leg (which could be subject to a MAT determination) and a 2-year non-deliverable forward leg (which, while clearable, may not be subject to an MAT determination), or could also consist of an NDF swap (which could be subject to a MAT determination) traded with an emerging market bond which is not subject to CFTC jurisdiction or cleared. We therefore recommend that the GMAC advise the CFTC to pro-actively address package transactions in their determinations, and recommend consistent treatment of an Interest Rate Swap or Credit Derivative package transaction and a Foreign Exchange package transaction.

Prime Brokerage. Market participants are also waiting for guidance from the CFTC regarding prime-brokered transactions executed on SEFs. The CFTC has received feedback from the SEF, swap dealer, and prime broker communities about the inconsistencies between SEF practices and the role that prime brokers have long played in the FX market. This issue will be somewhat mitigated by the clearing determination, as centrally-cleared trades need not involve a prime broker. However, the issue remains even after a clearing determination, and is exacerbated by a MAT determination. Currently many clients who use prime brokers to provide credit intermediation are unable to trade on SEFs, either because their prime broker is unable to reconcile its tri-party agreements with SEF rules, or because liquidity providers are unable to execute with these clients due to uncertainty about the prime broker's standing *vis-à-vis* the SEF. Yet those prime-brokered clients will need to execute certain transactions on SEFs following the clearing determination, but will be unable to execute the prime-brokered transactions on SEFs as well. This will create an unnecessary dual-business practice for those clients. We urge the GMAC to advise the Commission to consider the feedback already provided by the industry, and provide guidance regarding its stance on prime-brokered SEF trades.

Outstanding areas under no-action relief. In addition, there are several outstanding issues that are currently benefitting from no-action relief or have not yet been addressed by the CFTC. MAT determinations would exacerbate the fact that these issues remain unaddressed. One such example is as follows:

> *The issue of SEF confirmations, and particularly 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 counterparty to a non-cleared trade executed on a SEF. The CFTC is aware from conversations with SEFs and various industry groups that this is not achievable without great expense and effort. While this issue will be somewhat mitigated when the majority of SEF executions are centrally cleared, it remains a concern for those SEF executions which are not centrally cleared, including SEF executions with*

counterparties who rely upon the end user exemption. In fact, the issue becomes more extreme because the effort and expense to comply with Footnote 195 consistent with CFTC staff views, relative to the number of non-cleared transactions executed on SEFs, makes the cost-benefit analysis of Footnote 195 even harder to justify.

We strongly recommend that the GMAC advise the CFTC to resolve these issues prior to, or along with the MAT determinations.

US and European Clearing Timelines