October 2, 2020

Via Electronic Mail ([redacted])

Mr. Rick Sandilands
Senior Counsel, Europe
International Swaps and Derivatives Association
25 Copthall Avenue, 3rd Floor
London, EC2R 7BP
United Kingdom

Re: Request for Comments on Draft 2020 ISDA Interest Rate Derivatives Definitions (the "Definitions"): Provisions Relating to Deliverable Currency Disruption Events and Interest Rate Swaps Referencing Non-Deliverable Currencies

Dear Mr. Sandilands:

The private sector members of the Financial Markets Lawyers Group (the "***FMLG***")[1] respectfully submit this letter in response to a request for comments by the International Swaps and Derivatives Association ("***ISDA***") on provisions in its draft Definitions that relate to proposed deliverable currency disruption events and interest rate swaps referencing non-deliverable currencies (the "***Draft Provisions***").

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[1] The FMLG comprises lawyers who support foreign exchange and other financial markets trading in leading worldwide financial institutions. Currently, the private sector members of the FMLG include representatives from AllianceBernstein; Bank of America, N.A.; Barclays; BNP Paribas; Cboe Global Markets, Inc.; Citigroup Global Markets Inc.; CLS Bank International; Deutsche Bank; Goldman, Sachs & Co.; HSBC Securities (USA) Inc.; JPMorgan Chase & Co.; Millennium Management LLC; Morgan Stanley; State Street Bank and Trust Company; The Bank of New York Mellon; and Wells Fargo. A list of FMLG members from those firms is attached to this letter as Exhibit A.

The FMLG is sponsored by, but is not part of, the Federal Reserve Bank of New York. Any views expressed by the FMLG are the views of its private sector members, and do not necessarily represent the views of the Federal Reserve Bank of New York or the Federal Reserve System.

The FMLG expresses its appreciation for ISDA's outreach and the presentation made to the FMLG by ISDA representatives on July 9, 2020 regarding the Draft Provisions. The FMLG considers the issues underlying the Draft Provisions to be of importance.

After consideration of these issues, the FMLG is requesting ISDA to set the Draft Provisions aside from the Definitions and to defer these issues to be part of a review that includes sufficient analysis and input from participants in, and organizations that focus on, Foreign Exchange ("FX") markets. The FMLG suggests that ISDA accomplish this review as part of an overall review of defined terms and related master agreement provisions that govern FX transactions.

As explained further below, the FMLG makes this request for the following reasons:

- Basis risk is likely to arise between transactions covered by the Draft Provisions and other FX transactions that risk manage such transactions but are not covered by the Definitions.

- Further examination and discussion of the economic implications of the Draft Provisions is required in order to ensure that they reflect the pricing assumptions and ongoing risk management of parties to relevant transactions, along with the parties' intended economic purposes.

- Further legal review is required in order to ensure that the implementation of non-deliverable terms does not have the unintended consequence of recharacterization of transactions as "swaps".

- Further development is needed in order to put in place contemplated fallback rates, along with governance of fallback mechanics. Without a reliable fallback, disruption events may lead to calculation agent determinations, which (among other concerns) may create basis risk.

- Further analysis is needed to harmonize any disruption events and fallbacks with existing master agreement provisions that may apply to such events, and with likely causes of disruptions.

Basis Risk

The Draft Provisions will only apply to FX products covered (“***Covered Products***”) by the Definitions. Transactions in such Covered Products are commonly risk managed by FX transactions that are not covered by the Definitions. As a result, if a disruption event under the Draft Provisions were to be triggered, a party could find that there are different results for the set of FX transactions that were intended to be an integrated and risk managed portfolio. Parties presently do not expect such consequences, which would be adverse to FX markets and participants.

At a minimum, the 1998 FX Currency and Options Definitions would need to be aligned with the Draft Provisions in order to avoid basis risk. Requiring parties to use two separate definitional sources, however, can lead to operational risk if such definitional sources and any updates are not carefully monitored and harmonized.

To avoid basis risk and operational risks arising from multiplicity of governing definitions, the FMLG requests that a single source of definitional governance be developed. The FMLG requests that such single definitional source be harmonized with applicable master documentation provisions, as noted below.

Economic Implications

Parties to deliverable FX transactions presently do not enter into such transactions with the expectation of any trigger arising from a disruption event, with an alternative basis for settlement that does not involve actual delivery of each of the currencies that are the subject of the relevant transaction. To date, other than for CNY and certain RUB transactions, market participants have refrained from separately addressing such events and have refrained from providing for nondeliverable fallbacks if such trigger events take place.

Further discussion is needed as to the potential pricing implications when parties enter into deliverable currency transactions, as well as risk management considerations during their lifecycle, if such transactions contain contractual disruption events triggers and nondeliverable fallbacks.

Further discussion also is needed in relation to the original purpose of a deliverable currency transaction and the implications of replacing delivery of each currency with a nondeliverable fallback. Parties may enter into deliverable currency transactions in order to balance sheet, payment or conversion needs that are premised upon receipt or delivery of the actual currency specified, and which may not be met by alternative payment of a net cash equivalent in an alternative base currency.

Based upon discussions to date with market participants, the FMLG observes the need for such supplemental discussion and study of the economic implications of the Draft Provisions, so that the fundamental purposes of the FX transactions governed by such provisions are not adversely impacted.

Recharacterization

Deliverable FX transactions presently are not treated as "swaps" for specified provisions of the Dodd-Frank Act and applicable regulations, including provisions relating to clearing and trade execution (SEFs), margin on uncleared swaps and real-time reporting of swaps. This regulatory treatment is based upon the definition of the term "swap" under the Dodd-Frank Act[2], taken in conjunction with the determination by the Department of the Treasury on November 16, 2012,[3] and consistent with the U.S. Commodity Futures Trading Commission's anti-evasion rule (the "***Anti-Evasion Rule***").[4]

The FMLG notes that the adopting release for the Anti-Evasion Rule includes language that raises questions as to the treatment of transactions containing contractual provisions that may result in a deliverable transaction being settled on a net cash basis.[5] While there are persuasive arguments that event-based triggers such as defaults and market disruptions are not the type of provisions that are intended to be covered by the Anti-Evasion Rule, the FMLG believes that this issue requires further analysis. Market participants should ensure that the Draft Provisions do not create legal uncertainty concerning existing product characterization for

2. 7 U.S.C. § 1a(47)(E).

3. Department of the Treasury, Final Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 77 Fed. Reg. 69694 (Nov. 16, 2012).

4. 17 C.F.R. § 1.6.

5. Commodity Futures Trading Commission & Securities and Exchange Commission, Further Definition of ''Swap,'' ''Security-Based Swap,'' and ''Security-Based Swap Agreement''; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48297 (Aug. 13, 2012).

regulatory purposes. Any recharacterization of deliverable FX products as "swaps" would result in substantial adverse financial and operational consequences for market participants.

Fallback Mechanics and Governance

Physical delivery of a currency entails the expectation by the parties to the transaction that each relevant central bank will make requisite amounts of the currency available in the jurisdiction where the currency is legal tender. If a central bank fails to make that currency available or otherwise is unable to perform its function in the delivery process (whether due to operational limitations, market or general commercial shutdown, or exchange controls) there may be no established or reliable process in place for assessing a "reference price" to determine the "value" of the currency.

In this context, unlike the marketplace for non-deliverable FX transactions, where reference rates have been established, the fallback reference rates for deliverable currencies do not yet exist. Based upon the experiences of market participants and an industry group in establishing reference rates for non-deliverable currencies, it is likely to take substantial time and resources to establish such rates. The establishment of reference rates for nondeliverable currencies has also required substantial time and resources to develop and implement the governance needed to support such rates, which can be of particular importance when a disruption occurs and any interpretive issue may present itself. [next paragraph deleted]

Adding a disruption event for a deliverable currency may lead to calculation agent determination, if there is no intervening fallback available. Given the potential lack of consistency among calculation agents, there may be differing results for different but related transactions (whether directly as a hedge or as part of an overall book of risk managed transactions), depending upon whether the calculation agent determination differs.

The potential for such divergent calculations for related transactions raises further concern as to the potential for basis risk. Consistent with the FMLG's concern noted above, parties presently do not expect such divergent consequences when entering into deliverable FX transactions, and such unanticipated basis risk would be adverse to FX markets and participants.

Relevant Risk Issues and Harmonization with Existing Master Agreement Provisions

Any contractual remedies in relation to deliverable currency disruption events must be aligned with the risks that the parties to the contract may face. The key risk issues that the FMLG notes are:

- Inability to transfer the currency outside of the jurisdiction where it serves as legal tender;
- Exchange controls that limit and/or prohibit exchange of a currency for one or more other currencies;
- Central bank failure to perform its function, or inability to do so, in relation to making a currency available for delivery;
- Inability of a nostro bank to enable the delivery process to be accomplished; and
- Market conditions that impair liquidity such that parties may not be able to accomplish their delivery obligations.

Existing master agreement documentation may contain provisions that may apply to these issues. In particular, the FMLG notes that the 1992 and 2002 ISDA master agreement, as well as FX-specific master agreements such as IFXCO, FEOMA, IFEMA and ICOM, contain illegality provisions that may apply to issues that arise as a result of legal/regulatory restrictions such as exchange controls, and that the force majeure provisions of the 2002 ISDA master agreement and impossibility provisions included in the guide to the 1992 ISDA master agreement and in the forms of FX-specific master agreements, may apply to issues that arise due to practical restrictions on performance. The impact of these master agreement provisions in relation to the Draft Provisions requires further review and analysis. Any additional contractual provisions, such as disruption events and fallback rates, need to be harmonized with these master agreement provisions, with a goal of consistent outcomes that supports legal certainty, reflects the economic expectations of the parties when they enter into transactions and that avoid basis risk and other unexpected results when a disruption may occur. The FMLG supports working towards improved harmonization, while noting that further work needs to be done to accomplish this goal.

In doing so, the FMLG also noted that any new proposed contractual provisions, such as disruption events and fallback rates, need to reflect market and risk management expectations. It is not yet evident whether market participants would trade or value contracts differently if disruption events and fallbacks would apply to a given deliverable currency contract. It also is not yet evident whether risk management units of market participants would manage risks differently based upon the inclusion of such contractual provisions. At this juncture, based upon discussions to date, it is the FMLG's understanding that market participants presently rely upon existing contractual provisions in master agreements and are not yet prepared to implement the methodologies (risk management and otherwise) needed to support the informed decision making needed for any contractual changes in relation to these issues. As such, further work needs to be done to prepare the marketplace as a whole for contractual changes.

Conclusion

The FMLG recognizes the importance of the issues identified in the Draft Provisions, and supports further work involving the FX industry to find improved contractual formation and remedies in relation to these issues.

We would be happy to discuss any questions that ISDA may have with respect to this request. Please don't hesitate to contact the FMLG's representative member, Maria Douvas of Morgan Stanley, at [redacted] or at [redacted].

The FMLG thanks ISDA for the opportunity to submit these comments.

Very truly yours,

The Financial Markets Lawyers Group

By: /s/Maria Douvas
Maria Douvas

<u>EXHIBIT A</u>

Private Sector Members of the FMLG

Syed Riaz Ali
Managing Director and
Associate General Counsel
JPMorgan Chase & Co.

Sarah Ashkenazi
Director and Assistant General Counsel
Bank of America

James Brown
Director
Barclays

Maria Douvas-Orme
Managing Director
Morgan Stanley

Chinedu Ezetah
Director & Associate General Counsel
Citigroup Global Markets, Inc.

Terence Filewych
Senior Counsel
Wells Fargo

Jill Hurwitz
Director and Senior Counsel
Deutsche Bank

Glade A. Jacobsen
Managing Director and
Associate General Counsel
Goldman, Sachs & Co.

Robert F. Klein
Managing Director and Counsel
Citigroup Global Markets Inc.

Matthew Lillvis
Deputy General Counsel
Millennium Management LLC

Nancy Rigby
Vice President and
Assistant General Counsel
U.S. Bank

Jeffrey Saxon
Managing Director
BNP Paribas

Lisa A. Shemie
Associate General Counsel and
Chief Legal Officer, Cboe FX & Cboe SEF
Cboe Global Markets

David A. Trapani
Head of U.S. Legal
CLS Bank International

James Wallin
Senior Vice President
AllianceBernstein

Frank Weigand
General Counsel
HSBC Securities (USA), Inc.

R. Bryan Woodard
Executive Vice President and
Global Managing Counsel
State Street Bank and Trust Company