gfma afme/ asifma sifma

May 8, 2014

Via Electronic Mail: MARKT-G3@ec.europa.eu

European Commission
Internal Market and Services Directorate General
Financial Markets, Unit G3 – Securities Markets
Rue de Spa 2
Brussels 1000
Belgium

Re: Consultation Document on FX Financial Instruments (10 April 2014)

The Global Foreign Exchange Division ("GFXD") of the Global Financial Markets Association ("GFMA") welcomes the opportunity to comment on behalf of its members on the consultation document issued by the European Commission on FX financial instruments.

The GFXD was formed in cooperation 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 23 global FX market participants,[1] collectively representing more than 90% of the FX dealer market.[2] Both 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.

The FX market is the world's largest financial market. Effective and efficient exchange of currencies underpins the world's entire financial system. Sovereign entities, central banks and other governmental sponsored entities rely on this market being well-functioning and available at all times. Corporations and investors regularly participate in the market for 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 finance 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 we feel it is vital that the potential consequences are fully understood and that any new regulation improves efficiency and reduces risk in this market.

Foreign exchange is the world's largest financial market and a central component of the global payment system. The Bank for International Settlements ("BIS") estimates that average daily market turnover in FX increased to USD 5.3 trillion in April 2013, up from USD 4 trillion in April 2010 and USD 1.6 trillion in 1995.[3] Because transactions in FX spot, alongside FX swaps and FX forwards, are integral to the global payment system, international trade, cross-border activity and monetary policy, it is essential that the smooth functioning of the FX market not be disrupted. For these reasons, we wish to emphasize the importance in ensuring that the regulatory treatment of FX products within the European Union – and across multiple jurisdictions globally – is consistent.

[1] Bank of America Merrill Lynch, Bank of New York Mellon, Bank of Tokyo Mitsubishi UFJ, Barclays, BNP Paribas, Citigroup, Credit Agricole, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan, Lloyds, 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.
[3] BIS, Monetary and Economic Department, *Triennial Central Bank Survey – Foreign Exchange Turnover in April 2013: Preliminary Global Results* (Sept 2013) and *Global Foreign Exchange Market Turnover in 2013* ("BIS 2013 FX Survey").

EXECUTIVE SUMMARY

- **Clarification by the European Commission of the definition of an FX spot contract is necessary**
  - Spot contracts in FX are sufficiently distinguishable from other contracts in FX
  - There was no intention on the part of the European authorities to capture FX spot contracts as a MiFID financial instrument and therefore subject such contracts to MiFID regulation
  - Inconsistency exists among the European Union member states regarding the interpretation of FX spot contracts, but not whether such contracts are subject to MiFID regulation
  - FX spot contracts must be more clearly and objectively defined and implemented within Europe and globally given the importance of the MiFID financial instrument definition in current and future regulation and the role of FX in the global economy
- **Due to the unique characteristics of FX spot contracts and their role in the global FX market, FX spot contracts should not be considered a MiFID financial instrument**
  - FX spot contracts are cash products, physically settled through an exchange of two currencies for immediate delivery
  - FX spot contracts provide a critical source of liquidity and funding in the FX market as a global payment system, and underpin the global economy by facilitating and supporting international trade and cross-border activity
  - Underlying reasons for entering into an FX spot contract are presently not, should continue not to be, relevant to the classification of the contract as a MiFID financial instrument, except for FX securities conversions that have a longer duration settlement cycle
- **An FX spot contract is, and should be defined as, an agreement to exchange two currencies within the customary timeline of the relevant spot market, in general: (i) within two valid banking days for the currencies involved, and without regard to the underlying purpose for the contract or whether payment netting has been applied by the transacting parties as part of the settlement arrangements for such contracts; or (ii) beyond such two days if for the purpose of facilitating the purchase or sale of a security denominated in a foreign currency for settlement within the settlement cycle for the security; and such contract should not be considered a MiFID financial instrument**
- **The FX market in deliverable currencies is a deeply liquid and efficient market with high price transparency, with robust infrastructure advancements which have significantly strengthened the integrity of the marketplace from a systemic risk standpoint**
  - The source of systemic risk for this market – loss of principal – has been effectively mitigated via the use of CLS Bank International and its continued development of its services to more users, more currencies and more settlement sessions for deliverable FX contracts
  - Other risks for this market – replacement cost risk, liquidity risk and operational risk – are appropriately mitigated by a regime of encouraging prudent supervision, practice guidelines and capital implications
- **A transition period is necessary to implement any harmonization of standards if the European Commission determines that more FX contracts are to be defined as MiFID financial instruments than previously understood to be case in one/more European Union member states**
  - Due consideration would need to be given to the amount of time necessary to comply with each specific requirement under MiFID regulation and, *separately*, under EMIR regulation, and taking into account the number of contracts and participants or counterparties / counterparty relationships that such harmonization would affect
- **Defining FX spot contracts as recommended would be consistent with the approach taken by other jurisdictions globally and prudent to ensuring the FX market as a global payment system which underpins the global economy is not disrupted**

Question 1: Do you agree that a clarification of the definition of an FX spot contract is necessary?

Yes, a clarification of the definition of an FX spot contract is necessary to appropriately reflect the intention on the part of European authorities to exclude FX spot contracts from the MiFID definitions of financial instrument and therefore to exclude them from regulation under MiFID. In 2007, the European Commission expressly noted that while "[d]erivatives on currencies listed in Section C(4) of Annex I of MiFID are financial instruments . . . [s]pot market foreign exchange agreements are not considered to be financial instruments for the purposes of MiFID."[4] While we appreciate that MiFID Q&A 191 is non-binding on the European Union member states, this statement reflects a well-established understanding and position in Europe and globally that transactions in FX spot contracts are transactions in payments, specifically, transactions which contractually obligate the buyer and seller to exchange one currency for another currency for "immediate" delivery; and, as such, FX spot contracts have been considered outside the scope of regulation that applies to derivative and futures contracts (*i.e.*, contracts for "future" delivery).[5] As noted in our response to Question 8 below, this view has been shared by legislators and regulators globally, with the exception of jurisdictions where currency control restrictions are in place involving the local currency and/or local participants (*e.g.*, the South Korean won).

While we believe that the position taken in MiFID Q&A 191 is the correct one for the reasons described in our response to Question 2 below, neither MiFID, the MiFID Level 2 Regulation (Regulation (EC) No. 1287/2006) nor the MiFID Q&As define a "spot" market foreign agreement.[6] Although generally recognized as one of several products traded in the FX asset class (which additionally includes deliverable FX forward contracts, deliverable FX swap contracts, deliverable FX option contracts, non-deliverable FX option contracts ("NDOs") and non-deliverable FX forward contracts ("NDFs")), FX spot contracts are distinguishable from these other products on the basis of their short duration settlement cycle. The challenge is in establishing a common definition for FX spot contracts.

We agree with the statements made by the European Commission in this consultation that there is an inconsistency in how individual European Union member states have considered which FX products MiFID requires to be regulated. However, it is important to note there is no inconsistency among the member states regarding the exclusion of FX spot contracts from MiFID regulation. There is only an inconsistency with how individual member states may have defined or not defined an FX spot contract and therefore which types of contracts in FX are, or are not, MiFID financial instruments. Because MiFID is a directive, each member state has had to ensure that MiFID is properly enacted in its own national law, if necessary by introducing new national legislation. In doing so, each member state has had to assess (i) the scope of its existing regulation of FX products; (ii) the scope of the FX products required to be regulated by MiFID; and (iii) the extent to which its existing regulation would need to be extended, or amended, in order to ensure that the products required to be regulated by MiFID were captured. Because the boundary between spot and other contracts in foreign currency has not been defined under MiFID, the approach taken under national regulation has been inconsistent among European Union member states and, in some cases, very unclear.

Given the importance of the MiFID financial instrument definition, not only for MiFID regulation but for all other current and future regulation that utilizes this definition, it is extremely important for FX spot

[4] http://ec.europa.eu/yqol/index.cfm?fuseaction=question.show&questionId=191 ("MiFID Q&A ID 191")

[5] Please refer to our response under Question 3 below for a description of "immediate" vs. "future" delivery which should be considered when defining FX spot contracts.

[6] While there is no general definition of FX "spot" in MiFID, in the context of commodity and other contracts a spot transaction is a transaction under the terms of which delivery is scheduled for the later of (i) two trading days; and (ii) the period generally accepted in the market as the standard delivery period, unless parties understand otherwise. *See* Article 38(2) of the MiFID Level 2 Regulation.

contracts to be more clearly and objectively defined and for such definition to be consistently implemented within Europe. And, as further detailed in our response to Question 2 below, in the context of G-20 efforts surrounding OTC derivatives regulation, we urge the European Commission to proceed in a manner that is globally consistent given the role of the FX market, and especially FX spot contracts, as a global payment system which underpins the global economy.

Question 2: What are the main uses for and users of the FX spot market? How does use affect considerations of whether a contract should be considered a financial instrument?

Due to the unique characteristics of FX spot contracts and their role in the global FX market described below, FX spot contracts should **not** be considered a financial instrument under MiFID. This view is supported by the European Commission when it expressly noted in 2009 that "[s]pot foreign exchange transactions are not considered financial instruments under MiFID irrespective of the purpose of the operation, i.e. commercial or otherwise."[7]

The consequences of extending the MiFID financial instrument definition to include FX spot contracts will have material unintended consequences given the developing reliance of other regulation on the definition of a MiFID financial instrument. As regulation of the financial markets continues to develop and evolve – EMIR, MiFIR and CRD4 to name a few – it is imperative that legislators and regulators be specific regarding the objectives behind each regulation, define the products or activities that are subject to such regulation to achieve those objectives <u>and</u> that are **not** subject to such regulation to avoid unintended consequences such as undermining those objectives or disrupting a well-functioning market. As stated above, it is our view that it was not the intention of European authorities when MiFID was enacted for MiFID regulation to apply to the FX spot market and this is confirmed by the statements of the European Commission in MiFID Q&A ID 885. Further, the G-20 efforts surrounding OTC derivatives regulation were not intended to capture the FX spot market though left open discussion among the regulators and market participants surrounding how deliverable FX forwards and swaps should be treated under OTC derivatives regulation, namely in the context of mandatory clearing requirements.

A. FX Spot Contracts are Cash Products, Physically Settled Through an Exchange of Two Currencies for Immediate Delivery

In contrast to OTC derivatives which are entered into as financially, cash-settled products, FX spot contracts are entered into on the basis of physical settlement, *i.e.*, the physical exchange of two currencies between transacting parties.[8] Additionally, these contracts are distinguishable from physically-settled FX forward contracts which have longer duration settlement cycles.

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[7] http://ec.europa.eu/yqol/index.cfm?fuseaction=question.show&questionId=885 ("<u>MiFID Q&A ID 885</u>")

[8] Among the FX products, the only characteristic that distinguishes an FX spot contract from an FX forward contract is a matter of duration. FX forwards provide delivery of desired currency to, and therefore currency risk mitigation for, corporations and investors beyond two business days (the customary settlement cycle for FX spot contracts). In contrast to an FX spot contract which involves a single exchange of the two currencies for immediate delivery, an FX swap contract embodies an exchange of currencies within a funding transaction, whereby one party borrows a currency from another party and simultaneously lends to that same party another currency with a redelivery of each such currency on the maturity (settlement) date. FX swaps are used primarily for hedging, represent perhaps the most efficient short-term funding vehicle worldwide and most actively traded FX instrument by far, and are widely used by institutions to raise liquidity across money markets for different currencies.

B. Deliverable FX Spot Contracts Provide a Critical Source of Liquidity and Funding in the FX Market as a Global Payment System, and Underpins the Global Economy by Facilitating and Supporting International Trade and Cross-Border Activity

As the critical medium of exchange, FX is at the heart of all international commerce. As the central component of the global payment system which underpins other financial markets and the global economy generally, FX is the world's largest financial market and represents the most global, standardized and liquid of all markets while maintaining a high level of price transparency. Activity in the FX market has become increasingly more global, with cross-border transactions representing 65% of trading activity in April 2010, while local transactions accounted for 35%.[9] The percentage of cross-border transactions fell to 58% in April 2013, its lowest level since the 2001 BIS triennial survey and a trend observed in the OTC markets generally. This decrease was not necessarily viewed to mean that trading activity had become less international, but rather potentially attributable to an increasing concentration of FX trading in large financial centres and thus a rising proportion of trading taking place between parties in these centres who might be headquartered elsewhere.[10] In 2013, FX activity became more concentrated in a handful of global financial centres, the vast majority of global FX trading occurring via the intermediation of dealers' sales desks in five jurisdictions (United Kingdom (41%), the United States (19%), Singapore (5.7%), Japan (5.6%) and Hong Kong SAR (4.1%)), and the role of the US dollar remaining the world's dominant vehicle currency (represented in one side of the transaction in 87% of all deals initiated in April 2013).[11]

Most international transactions require an exchange of currency, and most international economic activity, trade and investment, involves exposure to currency risk which needs to be managed. More specifically, corporations regularly participate in the FX market to:

- repatriate earnings from abroad;
- export goods abroad/import goods to the domestic market;
- make payments to nonlocal suppliers and service providers;
- invest in plant, equipment and businesses abroad;
- fund cross-currency balance-sheet needs;
- hedge net investment exposure or foreign balance-sheet/income statement positions;
- hedge net income, bid-to-award risk, and flows associated with royalties and dividends.[12]

Investors regularly participate in the FX market to:

- repatriate earnings from abroad;
- ensure adequate liquidity to meet obligations to pension owners, 401(k) owners, and other investors;
- settle the purchase or sale of foreign assets, for example, by allowing foreign investors to purchase U.S. assets;
- hedge the currency risk associated with holding foreign assets;
- offset sovereign risk;
- take currency views to manage portfolio risk and return.[13]

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[9] BIS, Monetary and Economic Department, *Triennial Central Bank Survey – Report on Global Foreign Exchange Market Activity in 2010* ("BIS 2010 FX Survey").
[10] BIS 2013 FX Survey.
[11] BIS 2013 FX Survey.
[12] Foreign Exchange Committee ("FXC"), *Overview of the OTC Foreign Exchange Market: 2009* (November 9, 2009) ("FXC Overview"). The FXC is an industry group that has been providing guidance and leadership to the global FX market since its founding in 1978. The FXC includes representatives of major financial institutions engaged in foreign currency trading in the United States and is sponsored by the Federal Reserve Bank of New York. Aware of the strong integration of the global FX market, the FXC is also an active partner to other FX committees and industry associations worldwide. http://www.newyorkfed.org/FXC/.
[13] FXC Overview.

The public sector also regularly participates in the FX market. How well the FX market, as a global payment system, functions has a direct effect on monetary policy implementation. Monetary policy implementation could be affected by the impact on the ability of the central bank to control the supply of and to forecast the demand for reserve balances, and by the impact on open market operations, central bank lending and other operating procedures. This might also affect interest rates and exchange rates.[14] To illustrate the relationship between FX and monetary policy: interest rate movements directly influence exchange rates, and the exchange rate affects demand for exports. The demand for exports in turn affects output for a country, the country's international competitiveness, and the composition of the country's gross domestic product. Similarly, exchange rates affect the currency's price of imports, which in turn affects inflation.

Regardless of the type of market participant – *i.e.*, dealers/banks reporting to the BIS triennial survey, non-financial customers and other financial institutions (*e.g.*, non-reporting dealers/banks, institutional investors, hedge funds, proprietary trading firms and the public sector) – each transacts its FX spot contracts in a **single** global, standardized and liquid FX market. The ability of all participants to manage their risks benefits from the significant price transparency that exists in this market in which prices are widely available 24 hours a day.[15] The deep liquidity of the market and the simple structure of its deliverable contracts also enable non-defaulting parties to get out of, and also back into, positions with extreme ease by executing FX spots, forwards, swaps or any combination thereof with other market participants during the course of any day and regardless of tenor.

C. Underlying Purpose for FX Spot Contract Should Not Be Relevant to Whether Such Contract is a MiFID Financial Instrument, Except for FX Securities Conversions With Longer Duration Settlement Cycles

The BIS central bank surveys conducted every three years document the types of counterparties transacting in the FX market and trends associated with their activities from 1989 to 2014. With limited exceptions, the FX market has experienced tremendous growth during this period of time in trading activity across all its products and with transactions in FX spot contracts comprising between 31% and 38% of the global FX market turnover. This has been steadily attributable over the years to growth in the following areas: (i) role of electronic platforms and electronic brokers, (ii) interest in FX as a asset class, (iii) active role of asset managers; (iv) importance of hedge funds; (v) consolidation in reporting dealers; and (vi) trading activity in emerging or restricted currency markets, including FX spot contracts.

We agree with the statement of the European Commission in MiFID Q&A ID 885 that "[s]pot foreign exchange transactions are **not** considered financial instruments under MiFID **irrespective of the purpose of the operation, i.e. commercial or otherwise**" (emphasis added), except in the context of FX security conversions with longer duration settlement cycles for the reasons set forth in our response to Question 3 below. As explained further below, there are serious policy repercussions which would need to be carefully considered by the European Commission – and in close consultation with central banks, banking supervisors and market participants in Europe and globally – if it were to consider any bifurcation of the current single, well-functioning, deliverable FX spot market (T+2) for purposes of regulation based on a transacting party's purpose or intention for entering into the deliverable FX spot contract. We also agree with the view of the European Commission in MiFID Q&A ID 885 that, in contrast to an FX spot

[14] BIS Committee on Payment and Settlement Systems ("CPSS"), *Settlement Risk in Foreign Exchange Transactions (*1996) ("Allsopp Report").
[15] London Foreign Exchange Joint Standing Committee ("FXJSC"), *FXJSC Paper on the Foreign Exchange Market* (September 2009) ("FXJSC Overview"). The FXJSC was established in 1973 under the auspices of the Bank of England, in the main part as a forum for banks and brokers to discuss broad market issues and the focus of the Committee's regular work remains issues of common concern to the different participants in the FX market. The Bank of England provides the Committee's Chairman and Secretary. http://www.bankofengland.co.uk/markets/Pages/forex/fxjsc/default.aspx.

contract, an FX contract for differences ("CFD")[16] is a MiFID financial instrument. The European Commission adopted a similar view when it further clarified in MiFID Q&A 982[17] that, "[a]s opposed to spot trading where there is immediate delivery, a rolling spot FX contract can be indefinitely renewed . . . [h]ence rolling spot foreign exchange contracts are a type of derivative contract (*i.e.* either a forward or a financial contract for difference) relating to currencies" and therefore a MiFID financial instrument.

To ensure the continued effectiveness and functioning of, and access to, the global payment system which underpins the international financial system, it is critical that the single deliverable FX market, especially FX spot contracts, which exists today remains whole, *i.e.*, is not bifurcated on the basis of the underlying purpose for the FX contract. Any such bifurcation of the current single, well-functioning, deliverable FX market would be unnecessarily disruptive. If the traditional FX spot market (which does not, as described above, include CFDs or rolling FX spot contracts) were to be split into two markets based on a transacting party's purpose or intention, this would result in decreased volume, decreased liquidity and increased prices. The potential ability of dealers to differentiate FX spot contracts, and management of two separate FX spot markets, on the basis of underlying purpose for such contracts is not known. Likewise, the potential impact on CLS Bank, the FX market's systemically important financial market infrastructure, is also not known. Further, such bifurcation may negatively impact common policy objectives of central banks. Central banks globally have had a historical interest in institutional FX market practices, with particular emphasis on risk management, and the impact of these practices for several reasons, including the efficiency of interbank settlements and markets; the stability and containment of systemic risk; and the effectiveness of policy instruments (*i.e.*, the ability to maintain effectiveness of policy instruments used to pursue ultimate objective of stability of central bank's currency; and to ensure continued ability to oversee developments in markets through which monetary and exchange rates policies are implemented).[18]

Multilateral and Bilateral Payment Netting. We also wish to note that any definition of an FX spot contract should clarify that each FX spot contract is not required to be settled independently. The failure to do so may undermine the well-established use of payment netting (also commonly referred to as settlement/obligation netting) as an effective risk mitigant for settling deliverable FX, including FX spot contracts, on a multilateral or bilateral basis – which in turn increases the risk of loss of principal ("Herstatt" or settlement risk) as a source of systemic risk to the financial system. In some instances, clients are requesting funding on a gross basis (no payment netting) to ensure its FX spot contracts are not at risk of being characterized as financially settled contracts under OTC derivatives regulation (in the case of Europe, by virtue of being classified as MiFID financial instrument). As described in our response to Question 6 below, payment netting has been, and continues to be, encouraged by prudential regulators in the FX market as a tool for reducing the size of principal risk exposures. Payment netting has been part of best practices for the market for well over a decade[19] and such practices, as applied traditional FX spot contracts, are distinguishable from CFDs and rolling spot contracts. Should the historical trend of payment netting be reversed, credit risk, settlement risk, liquidity risk and systemic risk in the financial system would increase. We believe that it for these reasons that the US Treasury expressly stated that a requirement for deliverable or physically-settled FX contracts to clarify that the use of payment netting by market participants during the settlement process does not undermine the characterization of FX contracts as deliverable / physically settled FX contracts:

> *The requirement to . . . "exchange" the two currencies should not be interpreted as requiring each foreign exchange swap or forward transaction to be settled independently. Rather, an entity, such as CLS or any other operator of a multilateral PVP [payment versus payment] settlement system, that settles a series of foreign exchange swap and forward transactions may use appropriate mechanisms to net transactions*

[16] A CFD is an agreement between two parties to replace a traditional FX contract with the obligation to make (or the right to receive) a single payment, in a predetermined currency, presenting the market gain or loss that would have resulted from the forgone FX contract. *See* BIS CPSS, *Reducing foreign exchange settlement risk* (1998).

[17] http://ec.europa.eu/yqol/index.cfm?fuseaction=question.show&questionId=982.

[18] *See* BIS 1990 Lamfalussy Report (available at http://www.bis.org/list/cpss/index.htm).

[19] *See Guidelines for Foreign Exchange Trading Activities* and *Management of Operational Risk in Foreign Exchange*, each revised in November 2010 by the FXC and published at http://www.ny.frb.org/fxc/about.html.

involving the ***same parties*** *and the* ***same currencies****, and deliver* ***each of the currencies*** *to the respective parties. Applying appropriate mechanisms during the settlement process to net qualifying foreign exchange swap and forward transactions conducted by a group of parties should satisfy the limitations under the CEA [Commodities Exchange Act] because the essential elements of each of those transactions – namely, an exchange of two different currencies at a predefined, fixed rate – are left intact*" (emphasis added).[20]

The above rationale applies equally to FX spot contracts.

Question 3: What settlement period should be used to delineate between spot contracts? Is it better to use one single cut-off period or apply different period for different currencies? If so, what should those settlement periods be and for which currencies?

A. FX Spot Contracts Are Agreements to Exchange Two Currencies Within Two Valid Banking Days

We recommend that the European Commission adopt one single cut-off period for purposes of delineating between FX spot contracts and other FX products, in particular FX forwards, for all currencies. The general market practice is for an FX spot transaction to settle within two valid *banking* days in the two currencies being exchanged in the transaction. We use the term *banking* days to ensure that the real-time gross settlement (RTGS) systems of the two central banks whose currencies are involved in the transaction are open in order to facilitate settlement. This naturally takes into consideration any scheduled banking holidays at the time of trade execution, and would take into consideration any unscheduled bank holiday after trade execution due to unanticipated disruptions to one of the relevant RTGS systems that could result in delayed settlement; in either of these cases and for these reasons, the FX spot contract would appear in a firm's operational systems as greater than T+2 *calendar* days. We note that there are no spot market conventions that are greater than two valid banking days for each of the two currencies in the pair of currencies traded, other than FX spot contracts executed to facilitate the settlement of securities (described below) which should be regarded as FX spot transactions as well.

As the European Commission points out in the consultation, while this spot market convention of T+2 is not necessarily "immediate", the convention was originally borne out of necessity – the need to negotiate, execute, confirm, and operationally process and settle the transactions in a cross-border context and across multiple time zones. Limited exception to the T+2 valid banking day spot market convention include, *e.g.*, USD/CAD, where the above-named issues were not all present. Another example involves, *e.g.*, the USD and an Asia Pacific currency depending on the exact *local* time of settlement, such as a USD/JPY FX spot contract executed on a Monday where the JPY leg is settled on T+2 Wednesday (16:00 Tokyo, 09:00 CET, 03:00 EST) but the USD leg is settled late in the US time zone on that day (T+2 Wednesday 20:00 EST / T+3 Thursday 02:00 CET / T+3 Thursday 09:00 Tokyo). In all cases, the spot market for each currency pair is widely recognized as the deepest and most active and liquid for the currency pair. For this reason, while parties can execute contracts for the exchange of two currencies for settlement in less than two valid banking days, *e.g.*, next day T+1 or same day T+0, the available liquidity for that transaction will be much less – and therefore cost more – than an FX spot contract in that currency pair.[21]

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[20] *See* final determination issued by the US Treasury in November 2012 to exempt FX swaps and forwards from most requirements of the Dodd-Frank Act, available at http://www.gpo.gov/fdsys/pkg/FR-2012-11-20/pdf/2012-28319.pdf ("US Treasury FX Determination"), page 69704.

[21] We also wish to note that the critical settlement infrastructure for the institutional FX market, CLS Bank International, can process payments relating to FX contracts for settlement on a future date, *i.e.*, T+1 or greater; and, albeit to a much lesser extent due to operational reasons attributable to its design and the need for overlapping RTGS hours, on a same-day T+0 basis. The

Most European Union member states have determined a delineation for FX spot contracts using the T+2 convention. This is consistent with the approach taken in the final regulations of the United States for the purpose of excluding such contracts as instruments subject to OTC derivatives regulation, but also even in Canada whose currency has a USD/CAD T+1 spot market convention.[22] For these reasons, and given the very limited exception of FX spot contracts for currency pairs of less then T+2, we strongly urge the European Commission to define an FX spot contact as an agreement between two parties to exchange one currency for another currency within the customary timeline of the relevant spot market, in general (in circumstances other than related to FX security conversions discussed immediately below) *within two valid banking days* for the two currencies, and without regard to (i) a transacting party's purpose or intention for entering into the deliverable FX contracts and/or (ii) whether payment netting has been applied by the transacting parties as part of the settlement arrangements for such contracts. This will ensure ease of implementation and ensure a greater degree of harmonization globally.

B. FX Security Conversions are FX Spot Contracts Which Settle Beyond T+2 But Within the Settlement Cycle for the Relevant Securities and Therefore Should Not be Treated as a MiFID Financial Instrument

As indicated in our recent submission to the European Commission on ESMA on March 25th,[23] we have requested that the European Commission consider an FX transaction that is entered into solely to effect the purchase or sale of a foreign security – commonly referred to as an "FX Security Conversion" – to be a *bona fide* FX spot contract in situations where the settlement period is greater than T+2 banking days and clarify that any such contract is not a MiFID financial instrument. For these purposes, we suggest that an FX Security Conversion Transaction be defined as the purchase, sale or exchange of a foreign currency for the sole purpose of effecting a purchase or sale of a security denominated in a foreign currency when the settlement period for such FX transaction is within the settlement cycle for such security.

Many of our members act as custodian for the securities of, in the case of broker-dealers, their customers and, in the case of banks, for their customers and those of their affiliated broker-dealers. Due to the increased access and investor interest in foreign markets, growing numbers of these customers are invested in foreign securities. To facilitate the purchase or sale of these foreign securities, bank custodians and broker-dealers, as part of their duties, often enter into a FX transaction that is incidental to and for the sole purpose of effecting the foreign securities transaction. For example, when a non-US customer wishes to purchase a US dollar-denominated security, its broker-dealer or bank custodian will enter into a corresponding FX transaction to have US dollars on hand to meet the cash currency requirements necessary for the customer to complete its purchase of the securities. These FX transactions are an integral part of the settlement process. Typically, the settlement cycle for most non-EUR denominated securities is trade date plus three days ("T+3").[24] Accordingly, the bank custodian or broker-dealer would enter into a FX transaction on a T+3 basis as well. In some securities markets, for example in South Africa, the settlement cycle can take up to seven days (T+7).

To date, regulatory authorities in each of the United States and Canada have defined transactions used solely to fund the purchase or sale of a foreign security where the settlement period is greater than T+2 days as an FX spot contract and are thus outside the scope of OTC derivatives regulation within those jurisdictions. We urge the European Commission to apply the same treatment to these transactions by not treating them as a MiFID financial instrument.

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ability of market participants to reduce the risk of loss or principal associated with settlement of deliverable FX contracts, including FX spot, via a system like CLS Bank does not affect what constitutes and FX spot market for two currencies and therefore is not relevant to how FX spot contracts should be defined or how the FX spot market convention might evolve over time.

[22] Please refer to our response to Question 8 below.

[23] *See* http://www.gfma.org/Initiatives/Foreign-Exchange-(FX)/GFMA-Submits-Comments-to-the-EC-and-the-ESMA-on-Consistent-Regulatory-Treatment-for-Incidental-Foreign-Exchange-Transactions/.

[24] *See* www.sec.gov/investor/pubs/tplus3.htm.

i. Implications of Not Treating FX Security Conversions as FX "Spot" Contracts

As mentioned above, we consider that global regulatory efforts post-financial crisis – and therefore domestic derivatives legislation – cannot have been intended to cover spot market transactions in currencies effected in connection with securities transactions that might not, because of the settlement cycle of the relevant securities, result in an exchange of currencies within two days. Such transactions result in an exchange of currencies to be used to settle the relevant securities transactions denominated in a foreign currency. Subjecting these transactions that are incidental to related securities transactions to OTC derivatives regulation would expose bank custodians, broker-dealers and their customers to needless operational, price, credit and other risks. As a result, participants may restrict FX Security Conversions to T+2 FX spot contracts, even when the securities settlement takes longer, thereby exposing the customer to FX risk while exposing the bank to certain operational risks and changing – and disrupting – the long-standing and well-functioning settlement processing for the systemically relevant securities markets that exists today.[25]

OTC derivatives regulation simply should not be applied to the types of incidental transactions at issue here and will not provide any meaningful protection to participants (in the form of disclosures) or meaningful information to the regulatory authorities (in the form of regulatory reporting). Inconsistent treatment of these transactions globally should be avoided to ensure that the lack of an exclusion for FX Security Conversions from OTC derivatives regulation in some jurisdictions (*e.g.*, Europe) doesn't create unnecessary disincentives from transacting in securities in those jurisdictions by raising their transactional costs relative to other jurisdictions which have excluded them (*e.g.*, in the United States and Canada).

ii. Developments Surrounding Security Settlement Cycles

It is also important to note that efforts are underway in a number of major jurisdictions to shorten the securities settlement cycle from T+3 to T+2 (and even eventually to T+1) with the aim of reducing risk. European Union countries will move to a T+2 securities settlement cycle by the start of 2015 and the United Kingdom in October 2014. Similar efforts are observed in the US, Australia, etc. As the securities settlement cycle in any given jurisdiction continues to shorten to T+2 (or T+1) and thus align itself to the FX spot market convention which exists outside of the securities settlement context, the need for to recognize longer-dated FX Security Conversions as FX "spot" contracts will naturally fall away over time – but only as and when such a standard has been adopted by the most, if not all, the key jurisdictions globally, hence the need to clarify this ruling on FX Security Conversions.

Question 4: Do you agree that non-deliverable forwards should be considered financial instruments regardless of their settlement period?

We appreciate the classification of an FX NDF as an instrument that is subject to OTC derivatives regulation globally. This product involves settlement based on valuation, *i.e.*, by reference to something else, in this case a reference currency. However, we wish to draw the attention of the European

[25] For an indication of the size of the securities market in Europe please see https://www.ecb.europa.eu/press/pdf/sis/md1402.pdf (new issuance of quoted shares by euro area residents totaled EUR 8.7 billion in February 2014, redemptions came to EUR 2.3 billion net issues amounted to EUR 6.4 billion; and market value of the outstanding amount of quoted shares issued by euro area residents totalled EUR 5,758 billion at the end of February 2014) and http://fese.eu/en/?inc=art&id=51b (European equity market trading statistics); and in the US please see http://www.dtcc.com/en/asset-services.aspx (Depository Trust Company ("DTC"), a central securities depository, provides settlement services for virtually all equity, corporate and municipal debt trades and money market instruments in the US, with approximately 1.4 million settlement-related transactions per day, with a value of approximately $600 billion, and custody and asset servicing (including underwriting, corporate actions processing, securities processing, and issuer services) from 131 countries and territories valued at US$37.2 trillion).

Commission to a joint petition filed last year with the CFTC from the Investment Company Institute, ICI Global, the American Bankers Association and the ABA Securities Association requesting exemptive relief for FX NDFs from certain aspects of OTC derivatives regulation in the United States.[26] The petition highlights the economic and policy rationale supporting the view of their members that FX NDFs in restricted currency markets should receive the same regulatory treatment as FX forwards in the United States and therefore not be subject to the full scope of regulatory requirements – *e.g.*, mandatory clearing, SEF trade execution or initial margin if uncleared [27] – that would otherwise apply to FX NDFs as a derivatives ("swap") in the United States.

Question 5: What have been the main developments in the FX market since the implementation of MiFID?

The FX market in deliverable currencies is a deeply liquid and efficient market with high price transparency. Its ability to withstanding widespread market disruptions, including the crises of the 1990s, the bursting of the tech-stock bubble in 2000-2001 and various large bankruptcies in recent years is evidence of the market's liquid, transparent nature, strong operational infrastructure and simplicity of its products in deliverable currencies. The most recent financial crisis in 2008-2009 provided a significant test of the FX market's ability to withstand major disruptions and continue operating in a safe and sound manner.

As mentioned above, FX market has, with limited exception, experienced tremendous growth over the past two decades in trading activity across all its products and in the types of participants transacting in FX contracts and the available venues and currencies. Specifically, the growth is attributable to growth in the (i) role of electronic platforms and electronic brokers, (ii) interest in FX as a asset class, (iii) active role of asset managers; (iv) importance of hedge funds; (v) consolidation in reporting dealers; and (vi) trading activity in emerging or restricted currency markets, including FX spot contracts.

The source of systemic risk for this market with an average global daily turnover of USD 5.3 trillion has been effectively mitigated by the continued development of the services provided by the CLS Bank International, a user-owned systemically relevant financial market infrastructure that protects against the lost of principal associated with the settlement of deliverable FX contracts: more users, more currencies and more sessions have led to the settlement of FX contracts settling in a much more prudent manner for market participants and the financial system as a whole. This has all taken place in the context of the risks associated with the most actively traded FX contracts – deliverable FX spot, forwards and swaps – mitigated by a regime of encouraging prudent supervision, practice guidelines and capital implications. In addition to settlement risk reduction efforts, replacement cost (or market) risk reduction has been achieved through appropriate usage of collateral arrangements (for contracts other than FX spot), and strengthened supervisory guidance focused on ensuring that sufficient capital is held against potential exposures to all FX settlement-related risks, including liquidity risk and operational risk, arising from transactions in all FX contracts (including FX spot contracts).

[26] *See* https://www.aba.com/Advocacy/LetterstoCongress/Documents/2-26-13PetitionforExemptiveRelief.pdf.

[27] The US Commodities Exchange Act, as amended by Dodd-Frank, provides that "foreign exchange swaps" and "foreign exchange forwards" will be considered "swaps" subject to comprehensive regulation unless the Secretary of the Treasury determines that they should not be regulated as swaps and are not structured to evade Dodd-Frank. *See* Section 1a(47)(E) of the CEA (7 U.S.C. § 1a(47)(E)). Consistent with this provision, on November 16, 2012, the Secretary of the Treasury issued a determination that exempts FX swaps and FX forwards from the definition of swap under the CEA. *See* US Treasury FX Determination. As so exempted, FX swaps and FX forwards remain subject to business conduct, regulatory reporting, anti-fraud and anti-manipulation provisions of the CEA relating to swaps, as well as to the CFTC's existing jurisdiction over retail transactions under Section 2(c)(2) of the CEA.

And, as detailed in our response to Question 6 below, operational risk is has been increasingly mitigated through the market's strong operational infrastructure. This market led other markets over the past decade in converting to electronic trading platforms, which brought significant improvements in price transparency, liquidity and efficiency for FX products of all tenors. Prices are widely available in the FX market 24 hours a day, contributing to its narrow spreads and deep liquidity. Nearly all FX transactions between dealers are processed via straight-through processing, meaning they are processed electronically without any human input, and thus trades are promptly confirmed. The proliferation of multi-dealer and single-dealer electronic communications networks in this market over the years has also led to a high degree of systemic redundancy and resiliency. In the event that one trading system fails, market participants can easily route their trades to another electronic platform. These robust infrastructure advancements have significantly strengthened the integrity of the marketplace from a systemic risk standpoint.

We wish to note that while the main developments in the FX market summarized above have taken place over the last decade since the implementation of MiFID, we do not believe that they are in response to, or a result, of MiFID regulation.

Question 6: What other risks do FX instruments pose and how should this help determine the boundary of a spot contract?

The risks associated with the most actively traded FX contracts – deliverable FX spot, forwards and swaps – are presently mitigated by the current regime of encouraging prudent supervision, practice guidelines and capital implications. This includes **principal (or "Herstatt" or settlement) risk** reduction through use of CLS, **replacement cost (or market) risk** reduction through appropriate usage of collateral arrangements (often referred to as a credit support annex ("CSA") to an ISDA master agreement) for transactions other than FX spot, and strengthened supervisory guidance focused on ensuring that sufficient capital is held against potential exposures to all FX settlement-related risks, including **liquidity risk** and **operational risk**, arising from transactions in all FX contracts, including FX spot. Further, this regime is continuously reviewed and monitored not only by banking supervisors but by central banks who have a keen interest in the FX market, specifically its impact on payments in their respective home currencies from a broad policy perspective and because of its criticality to a central bank's ability to carry out monetary policy. In particular, the BCBS FX Supervisory Guidance published in 2013 provides updated guidance to supervisors and the banks they supervise on approaches to managing the risks associated with the settlement of FX transactions by providing a comprehensive and detailed view of the key risks that arise from an FX trade during the period between trade execution and final settlement (*i.e.*, during the pre-settlement and settlement periods).[28] The BCBS and CPSS intend to monitor banks' and supervisors' progress in implementing this guidance and commence a review of that progress in 2015.[29]

A. Settlement Risk Has Been Dramatically Reduced by Establishment and Use of CLS, With Trend of Further Settlement Risk Reduction by FX Dealers and CLS

The predominant risk associated with a counterparty default on uncleared deliverable FX swaps and forwards is principal risk, also commonly referred to as "settlement risk" or "Herstatt risk." Settlement risk in the context of the FX market is the risk of loss of principal, *i.e.*, of paying out sold currency without receiving the purchased currency in return. Settlement risk is the predominant bilateral counterparty credit risk presented by FX swaps and forwards and is the source of systemic risk for this market. This risk has been dramatically reduced by the development and use of CLS, a private-sector initiative that settles

[28] *See* BCBS FX Supervisory Guidance.
[29] *See* BCBS FX Supervisory Guidance.

payments for deliverable foreign spot, forward and swap transactions.[30]

i. Following Decades of Extensive Study, Central Banks Conclude Settlement Risk is the Source of Systemic Risk for the FX Market

In 1996, the governors of the G10 central banks endorsed a comprehensive strategy under which the private and public sectors can together seek to contain systemic risk inherent in the FX market.[31] Following the infamous 1974 failure of Bankhaus Herstatt, central banks and supervisors took a number of steps to increase their coordination and conduct a number of extensive studies spanning several decades, with a view towards ensuring that the structures and designs of systems supporting domestic and cross-border systems did not create unacceptable interbank credit exposures and did not generate liquidity risks for the financial markets or for the national or international banking systems.

The G10 central banks identified settlement risk as **the** source of systemic risk associated with FX spot, swap and forward transactions, expressing their conclusions that (emphasis added):

> *To be sure, FX trading poses many other forms of risk, including market risk (the risk of loss from an unfavourable exchange rate movement), replacement risk (the risk of having to replace, at current exchange rates, an unsettled yet profitable FX transaction with a failed counterparty) and operational risk (the risk of incurring interest charges or other penalties for misdirecting or otherwise failing to make FX settlement payments on time owing to an error or technical failure). FX market participants must recognise and manage appropriately each of these risks. [footnote: For instance, the Basle Capital Accord currently covers replacement risk. In January 1996 the Accord was amended by the Basle Committee on Banking Supervision to explicitly cover market risk…]* ***Nevertheless, since the associated amounts at risk represent only a fraction of the underlying value of each transaction, they are dwarfed by the size of foreign exchange settlement exposures.***
>
> *[A] bank's maximum FX settlement exposure could equal, or even surpass, the amount receivable for three days' worth of trades, so that at any point in time - including weekends and public holidays - the amount at risk to even a single counterparty could exceed a bank's capital….*
>
> *Secure and well-functioning payments systems are necessary for the attainment of central banks' monetary, macroprudential, supervisory and other policy objectives. They are also essential mechanisms in the management by individual commercial banks of their assets and liabilities, and in the settlement of their own transactions as well as those of their customers. It is therefore appropriate that central banks should be concerned that the settlement arrangements in the foreign exchange markets should be structured so as to minimise systemic risk (the risk that the failure of one market participant to meet its required FX settlement or other obligations when due may*

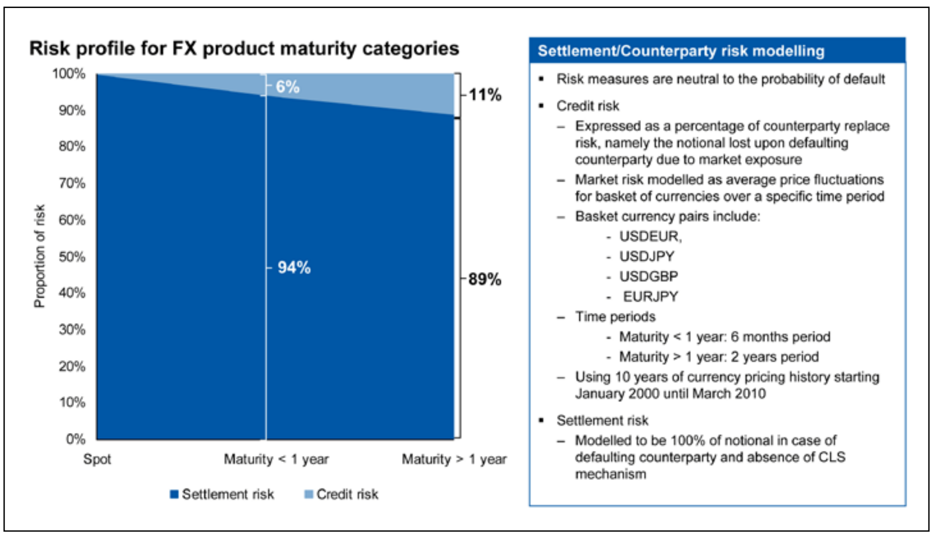
[30] CLS processes for settlement a pair of payment instructions relating to an underlying single deliverable FX transaction, meaning a single FX spot transaction, a single FX forward transaction, a single leg of a FX swap transaction (*i.e.*, CLS processes each leg, near and far, separately in its system), as well as the deliverable FX spot or forward transaction resulting from an exercised FX option transaction.

[31] Allsopp Report. As explained in this report, the work of the G10 central banks on international payment arrangements produced several studies, including the February 1989 *Report on Netting Schemes* (the "Angell Report"), the November 1990 *Report of the Committee on Interbank Netting Schemes* (the "Lamfalussy Report") and the September 1993 report on *Central Bank Payment and Settlement Services with respect to Cross-Border and Multi-Currency Transactions* (the "Noël Report"). The report further explains that through these studies, central banks identified issues that may be raised by cross-border and multi-currency netting arrangements, recommended minimum standards and an oversight regime for cross-border netting schemes, and examined possible central bank service options that might decrease risk in the settlement of FX trades; and in June 1994 the CPSS formed the Steering Group on Settlement Risk in Foreign Exchange Transactions to build upon this past work and to develop a strategy for reducing FX settlement risk.

cause significant liquidity or credit problems for other participants, and so may threaten the stability of the financial markets)….

The vast size of daily foreign exchange (FX) trading, combined with the global interdependencies of FX market and payments system participants, raises significant concerns regarding the risk stemming from the current arrangements for settling FX trades. These concerns include the effects on the safety and soundness of banks, the adequacy of market liquidity, market efficiency and overall financial stability.[32]

These conclusions were reached by the G10 central banks at a time when turnover in the FX market was estimated by the BIS to be USD 1.2 trillion, a fraction of the USD 5.3 trillion estimated in 2013. According to the result of a recent study, settlement risk comprises 94% of the maximum loss exposure in a trade for FX instruments with maturity of less than one year, and 89% for instruments with maturity of greater than a year.[33] The chart below illustrates the break-down of the maximum risk of loss between settlement risk and the remaining risk, namely replacement cost risk, for FX contracts of different maturities. Only 6% of the maximum risk of loss associated with a counterparty default for these products is replacement cost risk which is dwarfed by the 94% which represents settlement risk.[34] This stands in sharp contrast to most OTC derivatives for which counterparty credit risk is comprised almost exclusively of replacement cost risk. For FX spot contracts, all or nearly all the risk is considered to be settlement risk relative to replacement cost risk for the FX market.



The efforts of banking supervisors and central banks to raise awareness of settlement risk and to improve banks' self-monitoring of settlement risk have been remarkably successful. CLS has extended its settlement risk reduction services for global FX activity from 7 currencies for 39 members in 2002 to 17 currencies and 63 members and their 7,000 third parties in 2011.[35] While the head or home offices of CLS' members are located in 23 jurisdictions, the FX activity of the members and their customers are transacted, confirmed and processed world-wide. CLS has had zero settlement failures since it was created. It now

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32 Allsopp Report. *See also* Noël Report ("the loss of principal in settling … a foreign exchange trade would dwarf any gain or loss that might have accrued to the counterparties to the original transaction.").

33 Oliver Wyman analysis.

34 Oliver Wyman analysis. All else being equal, the amount of replacement cost risk is higher for longer maturities because there is more time for the exchange rate to move.

35 http://www.cls-group.com/About/Documents/CLS%20Bank%20-%20Core%20Principles%20Assessment.pdf. Approximately 7,000 third parties participated indirectly in CLS during the first three quarters of 2011. While over 90% of such third parties are funds, this group also includes banks, as well as corporations and other non-financial institutions.

settles a large portion of FX transactions, including 87.7% of inter-bank FX trades,[36] the transactions most relevant to systemic risk.

According to the calculations of the CPSS in a 2008 progress report, "if the obligations settled by CLS had instead been settled via other available methods, settlement exposures would have been on average almost two to three times higher than reported."[37] The report also found that 92% of institutions surveyed subject FX settlement exposures to credit management controls (*e.g.*, credit limits) equivalent to the controls they apply to other similar exposures, and 80% apply the same weight to FX settlement exposures as to other similar exposures.

ii. Continued Use of Payment Netting As an Effective Risk Mitigant to Further Reduce Settlement Risk Associated with Physically-Settled FX Products

There is a well-established and long-standing practice in the institutional FX market of netting (commonly referred to as settlement/obligation/payment netting) applied to the settlement of deliverable FX contracts, *i.e.*, FX spot as well as FX forwards and FX swaps. According to the Basel Committee on Banking Supervision ("BCBS"), bilateral payment netting is "[a] form of netting where two counterparties agree (via a legally-enforceable netting agreement) to settle transactions by making or receiving a **single** payment in **each** of the currencies (*i.e.* each counterparty has an obligation to pay a single amount in those currencies in which it is a bilateral net seller).[38] This reduces the value at risk by replacing multiple gross obligations (that would, otherwise, be settled on a trade-by-trade basis) with one netted obligation [in each currency]" (emphasis added).[39]

For well over a decade, payment netting has been, and continues to be, encouraged by prudential regulators in the FX market as a tool for reducing the size of principal risk exposures, and is part of best practices for the market.[40] These arrangements are distinguishable from an agreement between two counterparties (i) to net cash settle in a single currency, *i.e.*, to settle one or more FX trades by netting all obligations in/across multiple currencies to a single or reference currency; (ii) to net offsetting obligations and cancel and replace the original contracts which created such obligations with a new contract (commonly referred to as legal novation netting or compression); (iii) to replace an FX contract with the obligation to make (or the right to receive) a single payment, in a predetermined currency, presenting the market gain or loss that would have resulted from the forgone FX contract (commonly referred to as a financial contract for difference or "CFD"); or (iv) to continuously or automatically "roll forward" the settlement date of each contract by amending its settlement date to a later date (commonly referred to as a "rolling FX spot contract" which is, by its terms, automatically renewed, with an indefinite duration, at its historical price).

iii. Replacement Cost Risk is Appropriately Mitigated Through Collateral Exchanged Under CSAs, and With Enhanced Supervisory Requirements Coming Into Effect

Following settlement risk, the remaining bilateral counterparty credit risk associated with the FX market is "replacement cost risk", where the failure of one's counterparty may leave the non-failing party with an unhedged or open market position or deny it unrealized gains on the position. This resulting exposure is the cost of replacing, at current market prices, the original transaction. As noted above, for FX spot contracts, all or nearly all the risk is considered to be settlement risk relative to replacement cost risk.

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[36] *Compare* CLS Bank, *CLS Statistics on Foreign Exchange Activity* (2010) ("CLS Statistics") *with* BIS 2010 Survey.

[37] BIS CPSS, *Progress in reducing foreign exchange settlement risk* (2008). ("CPSS 2008 Progress Report").

[38] *See* BCBS "Supervisory Guidance for managing risks associated with the settlement of foreign exchange transactions" (February 2013) ("BCBS FX Supervisory Guidance") available at http://www.bis.org/publ/bcbs241.pdf.

[39] As noted in our response to Question 2 above, this can also be achieved by a group of counterparties in a multilateral setting, as recognized in the US Treasury FX Determination.

[40] *See Guidelines for Foreign Exchange Trading Activities* and *Management of Operational Risk in Foreign Exchange*, each revised in November 2010 by the FXC and published at http://www.ny.frb.org/fxc/about.html.

In addition to the achievements surrounding settlement risk reduction and despite the significant difference in maturity profiles between, on the one hand, FX swaps and forwards and, on the other hand, OTC derivatives generally (*e.g.* interest rate swaps and credit default swaps whose terms to maturity generally concentrate between two to thirty years and five to ten years, respectively), the FX market has increasingly adopted use of master netting agreements and CSAs to further manage counterparty credit risk.[41] According to a recent study conducted by the FXC, the number of CSAs grew by 51% between 2007 and 2010; and as of September 2008, 88% of the total mark-to-market exposures of those reporting firms was covered under CSAs.[42] GFXD also performed an indicative analysis of dealers which indicated 85% or more of mark-to-market exposure in 2010 related to counterparties (excluding corporates) for which CSAs were in place.[43]

Further, the BCBS FX Supervisory Guidance issued in February 2013 includes a requirement for banks to:

- use legally enforceable collateral arrangements and have an explicit policy on margin, eligible collateral and haircuts to reduce replacement cost risk; and
- exchange (ie both receive and deliver) the full amount of variation margin necessary to fully collateralise the mark-to-market exposure on physically settled FX swaps and forwards with counterparties that are financial institutions and systemically important non-financial entities; and
- to exchange variation margin with sufficient frequency (eg daily) with a low minimum transfer amount.

The above mandatory variation margin requirements for uncleared deliverable FX forwards and swaps were included as part of the global efforts surrounding OTC derivatives regulation, including the joint efforts of the BCBS and IOSCO to establish a framework for margin requirements for non-centrally cleared derivatives.[44] In addition, the BCBS-IOSCO Margin Requirements apply both mandatory variation margin *and* initial margin requirements to uncleared FX options and NDFs. While FX spot contracts are associated with no, or incredibly low, replacement cost risk, we view the absence of any discussion relating to margin requirements for FX spot contracts as recognition by the global regulatory community that such contracts were never intended to be within the scope of OTC derivatives regulation.

iv. Risk of Liquidity Shortfalls is a Key Risk Associated with Deliverable FX Contracts

In the context of a deliverable FX spot, forward or swap contract, a party to the contract may face a significant liquidity shortfall if the counterparty to the contract fails to deliver one leg of the FX contract (the purchased currency) *on time*.[45] The FX market is fundamentally about liquidity, *i.e.*, addressing the need to receive payments on time to support the global payment system which underpins the global economy. During and after the recent financial crisis, there has been heightened awareness and sensitivity of intraday liquidity flows, especially during times of market stress[46] and in light of increasingly greater interconnectedness of payment and settlement systems, including multiple roles held by their participants, which creates tighter interdependencies and thus increases the potential for disruptions to spread quickly

[41] FXC Overview.
[42] *See* FXC letter to U.S. Department of Treasury (November 29, 2010) in response to request for comment on determination of FX swaps and forwards.
[43] These dealers accounted for approximately 66% of the dealer market according to Euromoney league tables.
[44] BCBS and Board of the International Organization of Securities Commissions ("IOSCO"), *Margin requirements for non-centrally cleared derivatives* (September 2013) ("BCBS-IOSCO Margin Requirements") available at http://www.bis.org/publ/bcbs261.pdf. This final framework was developed in consultation with the CPSS and the Committee on the Global Financial System ("CGFS").
[45] *See* BCBS FX Supervisory Guidance.
[46] Payments Risk Committee ("PRC"), *Intraday Liquidity Flows* (March 30, 2012) available at http://www.newyorkfed.org/prc/files/prc_120329.pdf. The PRC is a private sector group of senior managers from U.S. banks that is sponsored by the Federal Reserve Bank of New York. The primary goal of the PRC is to foster enhancements to the safety and resiliency of financial market infrastructure, including steps to strengthen the clearing and settlement of financial transactions, and to inform the Federal Reserve Bank of New York about developments, conditions, and practices in payments, clearing, and settlement systems.

and widely across multiple systems.[47] For these reasons, the management of liquidity shortfalls is a continuing key area of focus for banks with their supervisors under the BCBS FX Supervisory Guidance with respect to all FX activity. Please refer to Appendix A to this letter for information on recent industry efforts focused on same-day liquidity risk management.

v. Operational Risk in the FX Market is Mitigated Through its Strong Operational Infrastructure

The FX market in deliverable currencies is a deeply liquid and efficient market with high price transparency. As mentioned above, in the past decade, this market led other markets in converting to electronic trading platforms, which brought significant improvements in price transparency, liquidity and efficiency for FX products of all tenors. Prices are widely available in the FX market 24 hours a day with a high degree of automated transaction processing and more than 95% of FX transactions between dealers are processed via straight-through processing. Further, the proliferation of multi-dealer and single-dealer electronic communications networks in this market over the years has also led to a high degree of systemic redundancy and resiliency.

Notwithstanding the foregoing, FX market participants have also committed to further strengthening the FX market's operational infrastructure, with broad support from FX dealers and central banks. Beginning in October 2008, the Foreign Exchange and Currency Derivatives Major Dealers[48] have made a series of commitments to a group of global supervisors[49] to improve the operational infrastructure of this market.[50] The FX industry has been working to meet specific targets related to the increased automation of transaction processing and committed to providing transparency in the form of metrics around OTC FX contract execution, demonstrating even further electronification of those contracts. Because having robust and well-understood legal documentation is central to reducing risk, opportunities to enhance and standardize trade documentation that would also help facilitate increased automation of the confirmation process are continually sought, with a number of successes achieved with the legal documentation underpinning FX transactions .[51]

vi. Even With a Proven Track Record of Withstanding Widespread Market Disruption Under the Current Regime, Trend in the FX Market of Further Mitigation of Credit (Settlement and Replacement Cost) Risk, Liquidity Risk and Operational Risk

The FX market's liquid, transparent nature, strong operational infrastructure and the simplicity of its products in deliverable currencies is evidenced by its proven track record of withstanding widespread market disruptions, including the crises of the 1990s, the bursting of the tech-stock bubble in 2000-2001 and various large bankruptcies. The most recent financial crisis in 2008-2009 provided a significant test of the FX market's ability to withstand major disruptions and continue operating in a safe and sound manner.

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[47] CPSS, *The interdependencies of payment and settlement systems* (June 2008) available at http://www.bis.org/publ/cpss84.pdf.

[48] These dealers include Bank of America Merrill Lynch, Barclays Capital, BNP Paribas, Citigroup, Credit Suisse AG, Deutsche Bank AG, Goldman, Sachs & Co., HSBC Group, JP Morgan Chase, Morgan Stanley, The Royal Bank of Scotland plc, Société Générale, UBS AG and Wells Fargo Bank, N.A. Participants in the process also include State Street Global Markets and Bank of New York Mellon.

[49] The Supervisors include the Board of Governors of the Federal Reserve System, Commodity Futures Trading Commission, Connecticut State Banking Department, Federal Deposit Insurance Corporation, Federal Reserve Bank of New York, Federal Reserve Bank of Richmond, French Prudential Supervisory Authority (*Autorité de Contrôle Prudentiel* - ACP), German Federal Financial Supervisory Authority, Japan Financial Services Agency, New York State Banking Department, Office of the Comptroller of the Currency, Securities and Exchange Commission, Swiss Financial Market Supervisory Authority, and United Kingdom Financial Services Authority.

[50] *See* Letters from the Foreign Exchange and Currency Derivatives Major Dealers to the OTC Derivatives Supervisors Group, dated October 31, 2008, June 2, 2009, March 10, 2010, September 27, 2010 and March 31, 2011.

[51] FXC Overview. *E.g.*, standardizing NDF and NDO confirmations in selected emerging market jurisdictions, creation of common forms of give-up agreements and compensation agreements for use in OTC FX prime brokerage arrangements, development of master confirmation agreements, as well sponsorship by CLS' of protocols through which market participants have agreed to best practices for deliverable FX and NDF transactions regarding legally binding confirmations and standard terms for trades processed in its settlement system.

The FXC found in November 2009 that:

> *The market functioned well [during the financial crisis], despite strains seen in international funding and credit markets, and enabled participants to measure and mitigate risk dynamically in a global marketplace. During this time, transaction costs were elevated, owing to the volatility and spillover from U.S. dollar funding challenges. However, systemic risk mitigants built into the OTC foreign exchange market structure over the years proved successful in providing a liquid and continuous market despite the volatility, defaults, and disruptions of [2008 and 2009].*[52]

Similarly, the FXJSC found that the FX market's sophisticated settlement system, together with its well-established code of best practices and high degree of transparency and liquidity, allowed this market to function well throughout the 2008 financial crisis.[53] Close-out netting was particularly effective because the simple structure of FX transactions and the deep liquidity of the FX spot market made FX instruments easy to value and thus to net against one another. Market participants were "able to execute trades and manage their currency exposure on an uninterrupted, twenty-four hour basis in a relatively liquid market" and had enough confidence in the payment system to continue executing FX transactions.[54]

The success of the central bank and supervisory strategy for addressing risks in the FX market – which called on private and public sector actions and close collaboration – cannot be understated. In the absence of this strategy and its implementation, the most recent financial crisis would have been much worse. Particularly noteworthy are remarks of the Chairman of the Board of Governors of the Federal Reserve, Ben Bernanke, that "[i]n the global foreign exchange market, CLS Bank International, a system that began operating in 2002 with the purpose of addressing settlement risk, is widely credited with maintaining confidence for continued interbank trading and settlement of foreign exchange."[55]

With respect to further settlement risk reduction, banks on the FXC and the FXJSC have publicly expressed support for efforts to add more currencies, settlement sessions and participants to CLS. CLS has also added a number of new settlement members since the financial crisis that began in 2008 and, as part of its strategic planning, is continuing its efforts to expand the products that CLS can settle, namely same-day FX transactions and additional currencies. Efforts to further reduce replacement cost risk through increased use of CSAs will be greatly enhanced by the margin requirements established by the BCBS and IOSCO for uncleared FX contracts (excluding FX spot) expected to come into effect in 2015. As described earlier, efforts to improve management of liquidity risk and, in particular, liquidity shortfalls and the operational efficiency of the OTC FX market are ongoing.

Question 7: Do you think a transition period is necessary for the implementation of harmonised standards?

To the extent that the MiFID financial instrument definition is harmonised in a manner that results in more FX contracts being included in this definition than was previously understood to be case in one or more European Union member states, a transition period is necessary to implement such harmonised

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52 FXC Overview.

53 London Foreign Exchange Joint Standing Committee ("FXJSC"), *FXJSC Paper on the Foreign Exchange Market* (September 2009). The FX JSC was established in 1973 under the auspices of the Bank of England, in the main part as a forum for banks and brokers to discuss broad market issues and the focus of the Committee's regular work remains issues of common concern to the different participants in the FX market. The Bank of England provides the Committee's Chairman and Secretary. http://www.bankofengland.co.uk/markets/Pages/forex/fxjsc/default.aspx.

54 FXC Overview.

55 Chairman Ben Bernanke, speech on *Clearinghouses, Financial Stability, and Financial Reform* (April 4, 2011): http://www.federalreserve.gov/newsevents/speech/bernanke20110404a.htm.

standards. Due consideration would need to be given to the amount of time that would be necessary to comply with each specific requirement under MiFID regulation and, *separately*, under EMIR regulation, and taking into account the number of contracts and participants or counterparties / counterparty relationships that such harmonisation would affect. For example, if more FX contracts are considered MiFID financial instruments, there may be market participants who become subject to registration requirements under MiFID and/or EMIR regulation who previously were not. Regardless of whether previously registered, each firm would then need to analyze how much effort would need to be undertaken to bring the firm into compliance, which will depend on the number of counterparty relationships which are brought into scope and number of contracts, the resources available to the firm (existing or future) ranging from business, operational, IT and/or legal and the nature of each requirement under MiFID and/or EMIR regulation. Such an assessment would also need to be conducted by service providers and infrastructures (*e.g.*, a trade repository may need to assess its capability and readiness to receive information from new firms and/or for FX contracts not previously considered MiFID financial instruments in one or more jurisdictions for EMIR dual-reporting purposes).

In light of the foregoing, we also assume that any such harmonised standards will only apply prospectively to contracts entered into <u>after</u> the end of the necessary transition period and strongly urge the European Commission to state this clearly. Such clarification would remove the risk of a perception that the outcome of this consultation is one which clarifies the existing scope and standards in MiFID (as opposed to imposing a new legal or regulatory requirement in certain jurisdictions). Any such perception raises the possibility of retrospective effect upon the historical activities of a wide range of FX market participants, including those which have transacted solely in FX forwards for commercial purposes (presently not a MiFID financial instrument in the UK). Any retrospective effect of harmonised standards on historical activity could create significant unintended consequences, particularly with respect to MiFID licensing requirements for market participants exclusively conducting commercial FX forwards to date permissibly without such licensing or, if so licensed based on other business conducted, the application of MiFID requirements to commercial FX forwards. For example, historical contracts could become subject to legal challenge in those European Union member states where proper authorisation is a condition of contract enforceability under national law. Even where there is an expectation that courts would ultimately reach a reasonable conclusion, there is a danger that a counterparty to such contracts would exploit opportunities to bring litigation, however spurious, to invalidate one or more contracts which turned out to be unfavorable to the counterparty.

Question 8: What is the approach to this issue in other jurisdictions outside the EU? Where there are divergent approaches, what problems do these create?

A. Ensuring That FX Spot Contracts Which Settle Within Two Days Are <u>Not</u> Classified as a MiFID Financial Instrument Definition Would be Consistent with the Approach Taken in Other Jurisdictions Outside the European Union

As mentioned above, the G-20 efforts surrounding OTC derivatives regulation were not intended to capture the FX spot market though left open discussion among the regulators and market participants surrounding how longer dated FX contracts, such as deliverable FX forwards and swaps, should be treated under OTC derivatives regulation, namely in the context of mandatory clearing requirements. This view is supported by the implementation of OTC derivatives regulation post-financial crisis, *e.g.* in the following jurisdictions with final product definitions relevant to such regulation:

- United States (joint CFTC and SEC final product rules for "swaps"):[56] *The CEA generally does not confer regulatory jurisdiction on the CFTC with respect to spot transactions. In the context of foreign currency, spot transactions typically settle within two business days after the trade date ("T+2"). The accepted market practice of a two-day settlement for spot foreign currency transactions has been recognized by the CFTC and the courts. . . . The Commissions do not believe that Congress intended, solely with respect to foreign exchange transactions, to extend the reach of the CEA to transactions that historically have been considered spot transactions. . . .*

  Accordingly, the Commissions are providing an interpretation that a bona fide foreign exchange spot transaction, i.e., a foreign exchange transaction that is settled on the customary timeline of the relevant spot market, is not within the definition of the term "swap." In general, a foreign exchange transaction will be considered a bona fide spot transaction if it settles via an actual delivery of the relevant currencies within two business days. In certain circumstances, however, a foreign exchange transaction with a longer settlement period concluding with the actual delivery of the relevant currencies may be considered a bona fide spot transaction depending on the customary timeline of the relevant market.[fn 566]

  fn 566: *In this regard, while the Commissions will look at the relevant facts and circumstances, they will not expect that an unintentional settlement failure or delay for operational reasons or due to a market disruption will undermine the character of a bona fide spot foreign exchange transaction as such.*

- Canada (model provincial rules of the Canadian Securities Administrators, as implemented by provinces such as Ontario):[57] *A contract or instrument is prescribed not to be a derivative if it is a contract or instrument for the purchase and sale of currency that, (i) except where all or part of the delivery of the currency referenced in the contract or instrument is rendered impossible or commercially unreasonable by an intervening event or occurrence not reasonably within the control of the parties, their affiliates or their agents, requires settlement by the delivery of the currency referenced in the contract or instrument . . . within two business days . . . , (ii) is intended by the counterparties, at the time of the execution of the transaction, to be settled by the delivery of the currency referenced in the contract within the time periods set out in subparagraph (i), and (iii) does not allow for the contract or instrument to be rolled over . . . .*

Further, in our analysis of global efforts to implement OTC derivatives regulation regarding the applicability of such regulation to the FX market and, specifically which products, to date, we have not come across any jurisdictions (*e.g.*, Australia, Hong Kong, Japan, Singapore and Malaysia) which has extended such efforts to FX spot contracts. The only exception to this, however, is in jurisdictions where currency control restrictions are in place involving the local currency and/or local participants (*e.g.*, the South Korean won).

B. Ensuring That FX Security Conversion are FX Spot Contracts Which Settle Beyond Two Days But Within the Settlement Cycle for the Relevant Securities Are Not Classified as a MiFID Financial Instrument Would be Consistent with the Approach Taken in Other Jurisdictions Outside the European Union

Our view that FX Security Conversions should be treated as FX spot contracts and which are excluded from the MiFID financial instrument definition is supported by the implementation of OTC derivatives regulation post-financial crisis, *e.g.* in the following jurisdictions with final product definitions relevant to such regulation:

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[56] Commodity Futures Trading Commission ("CFTC") and Securities Exchange Commission ("SEC"), *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping* (August 13, 2012) ("CFTC-SEC Final Product Definitions") available at http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-18003a.pdf.

[57] Ontario Securities Commission ("OSC"), OSC Rule 91-506 Derivatives: Product Determination (November 14, 2013) ("OSC TR Product Definitions") available at http://www.osc.gov.on.ca/documents/en/Securities-Category9/rule_20131114_91-506_91-507_derivatives.pdf.

- United States:[58] *In certain circumstances, . . . a foreign exchange transaction with a longer settlement period concluding with the actual delivery of the relevant currencies may be considered a bona fide spot transaction depending on the customary timeline of the relevant market. In particular, . . . the Commissions will consider a foreign exchange transaction that is entered into solely to effect the purchase or sale of a foreign security to be a bona fide spot transaction where certain conditions are met. The CFTC will consider the following to be a bona fide spot foreign exchange transaction: An agreement, contract or transaction for the purchase or sale of an amount of foreign currency equal to the price of a foreign security with respect to which (i) the security and related foreign currency transactions are executed contemporaneously in order to effect delivery by the relevant securities settlement deadline and (ii) actual delivery of the foreign security and foreign currency occurs by such deadline (such transaction, a "Securities Conversion Transaction"). For Securities Conversion Transactions, the CFTC will consider the relevant foreign exchange spot market settlement deadline to be the same as the securities settlement deadline. As noted above, while the CFTC will look at the relevant facts and circumstances, it does not expect that an unintentional settlement failure or delay for operational reasons or due to a market disruption will undermine the character of a bona fide spot foreign exchange transaction as such.*

- Canada:[59] *A contract or instrument is prescribed not to be a derivative if it is a contract or instrument for the purchase and sale of currency that, (i) except where all or part of the delivery of the currency referenced in the contract or instrument is rendered impossible or commercially unreasonable by an intervening event or occurrence not reasonably within the control of the parties, their affiliates or their agents, requires settlement by the delivery of the currency referenced in the contract or instrument . . . after two business days provided that the contract or instrument was entered into contemporaneously with a related security trade and the contract or instrument requires settlement on or before the relevant security trade settlement deadline, (ii) is intended by the counterparties, at the time of the execution of the transaction, to be settled by the delivery of the currency referenced in the contract within the time periods set out in subparagraph (i), and (iii) does not allow for the contract or instrument to be rolled over . . . .* (emphasis added)

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 we feel it is vital that the potential consequences are fully understood and that new regulation improves efficiency and reduces risk in for this market.

C. Consistency in the Treatment of the FX Spot Contracts Among Key Jurisdictions Is Prudent to Ensure the FX Market as a Global Payment System Which Underpins the Global Economy is Not Disrupted

In the context of legislative and regulatory efforts to enhance the financial markets, regulators have an obligation to not cause harm to the well-functioning market structure of FX, given its criticality as a global payment system which underpin the global economy. As previously mentioned, as the critical medium of exchange, FX is at the heart of all international commerce and intrinsically cross-border in terms in terms of participants and currency. As the central component of the global payment system which underpins other financial markets and the global economy generally, FX is the world's largest financial market and represents the most global, standardized and liquid of all markets while maintaining a high level of price transparency. Furthermore, FX is essential not only to the private sector but also to the public sector which regularly participates in the FX market – how well the FX market functions has a direct effect on monetary policy implementation.

With this in mind, we wish to draw attention to the US Treasury Secretary's statement made before the Senate Committee on Agriculture, Nutrition and Forestry in December of 2009:

> *The FX markets are different. They are not really derivative in a sense and they don't present the same sort of risk and there is an elaborate framework in place already to limit settlement risk. These markets actually work quite well. We have a basic obligation to do no harm, to make*

[58] CFTC-SEC Final Product Definitions.
[59] OSC TR Final Product Definitions.

sure that as we reform we don't make things worse and our judgment is because of the protection that already exists in these foreign exchange markets and because they are different from derivatives, have different risks and require different solutions, they require a different approach.[60]

For these reasons, we urge the European Commission to exercise extreme caution to ensure any regulatory measures are carefully tailored to take into consideration the role and function of the FX market and, in particular, FX spot contracts. Globally, legislative and regulatory authorities must proceed prudently when approaching and addressing risks through regulation of this market given its systemic relevance. In the case of Europe, the consequences of extending the MiFID financial instrument definition to include FX spot contracts will have material unintended consequences given the developing reliance of other regulation on the definition of a MiFID financial instrument. It is imperative that authorities are specific regarding the objectives behind each regulation, to define the products or activities that are subject to such regulation to achieve those objectives <u>and</u> that are **not** subject to such regulation to avoid unintended consequences such as undermining those objectives or disrupting a well-functioning market.

Question 9: Are there additional implications to those set out above of the delineation of a spot FX contract for these and other applicable legislation?

No additional comments beyond those provided above.

Question 10: Are there any additional issues in relation to the definition of FX as financial instruments that should be considered?

We would like to reinforce the importance of a more clearly and objectively defined definition of an FX spot contract which is excluded from the definition of MiFID financial instrument. The MiFID definitions are critical not only for current regulation but also future legislation that may utilize them. As regulation of the financial markets continues to develop and evolve, it is imperative that legislators and regulators be specific regarding the objectives behind each regulation, define the products or activities that are subject to such regulation to achieve those objectives <u>and</u> that are **not** subject to such regulation to avoid unintended consequences such as undermining those objectives or disrupting a well-functioning market. Importantly, this also applies to *deliverable FX forward contracts and deliverable FX swap contracts* included as MiFID financial instruments. To the extent that future legislation utilizes the MiFID financial instrument definition and therefore would automatically apply, by definition, new rules to FX forwards and FX swaps, legislators and regulators must remain vigilant and assess, up front and on a case-by-case basis, whether it would be appropriate to apply those new rules to these contracts.[61] As a critical source of liquidity and funding, FX

[60] Testimony of Timothy Geithner, Secretary of the Treasury, Before the United States Senate Committee on Agriculture, Nutrition & Forestry Hearing on December 2, 2009 on Over-the-Counter Derivatives Reform (as reported in Reuters. "Highlights: Geithner's testimony on derivatives and risk." December 2, 2009. http://uk.reuters.com/article/idUKTRE5B13JW20091202).

[61] This is in contrast to the approach taken in other jurisdictions. For example, deliverable FX forwards and swaps are not defined as "swaps" (*i.e.*, a derivative) in the United States under the Commodities Exchange Act ("<u>CEA</u>"), as amended by the Dodd-Frank Act, due to the US Treasury FX Determination. As a result, these contracts are not subject to derivatives regulation in the United States except for limited purposes (*e.g.*, trade repository reporting, certain business conduct rules and anti-fraud provisions) and therefore any future regulation which may utilize the CEA "swap" definition would not automatically apply to them. Instead, authorities in the United States would need to expressly list FX forward or FX swap contracts as subject to the new regulation, typically in the text of the new regulation, *after* affirmatively reaching a determination, on a case-by-case basis, that it would be appropriate to apply the regulation to these contracts. The approach is similar in Canada where each set of derivatives

forwards and swaps are an essential part of the FX market.[62] If a conclusion were reached that it would not be appropriate to apply a specific new piece of legislation, in whole or in part, to these contracts, authorities must ensure the new rules, in whole or in part, do not apply to such contracts, notwithstanding their classification as MiFID financial instruments, by expressly stating so in the legislative text.

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We appreciate the opportunity to share our views on this consultation paper issued by the European Commission. Please do not hesitate to contact me at +44 (0) 207 743 9319 / jkemp@gfma.org, Andy Harvey at +44 (0) 207 743 9312 / aharvey@gfma.org or Mandy Lam at +1 (212) 313 1229 / mlam@gfma.org should you wish to discuss any of the above.

Yours sincerely,

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requirements (*e.g.*, trade repository reporting) defines the products which are specifically in scope for that particular set of requirements.

[62] In contrast to OTC derivatives which are entered into as financially, cash-settled products, FX forwards and swaps are entered into on the basis of physical settlement, *i.e.*, the physical exchange of two currencies between transacting parties. Their only "derivative" characteristic that distinguishes them from deliverable FX spot contracts is a matter of duration, i.e., actual delivery takes place at a point in time longer than two days. Except for the fact that an FX forward contract is a longer dated instrument than an FX spot contract, it is largely the same instrument. Likewise, an FX swap contract is not a "derivative" in the traditional sense – it embodies an exchange of currencies within a funding transaction, whereby one party borrows a currency from another party and simultaneously lends to that same party another currency with a redelivery of each such currency on the maturity (settlement) date. Given the similarities between an FX swap and a traditional banking activity like lending and deposit-taking, the BIS has characterized FX swaps as "effectively collateralized transactions." (*See* BIS, *From Turmoil to Crisis: Dislocations in the FX Swap Market Before and After the Failure of Lehman Brothers* (2009).) As a practical matter, the fact that FX swaps are funding vehicles and FX forwards are payment vehicles is also a distinction without a difference.

[63] The Global Finanical Markets Association (GFMA) brings together three of the world's leading financial trade associations to address the increasingly important global regulatory agenda and to promote coordinated advocacy efforts. The Association for Financial Markets in Europe (AFME) in London and Brussels, the Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington are, respectively, the European, Asian and North American members of GFMA.

Appendix A

The management of liquidity shortfalls is prominently featured in the efforts of the global regulators with respect their oversight over payment, clearing and settlement systems. Examples include the joint publication by the CPSS and IOSCO of *Principles for Financial Market Infrastructures* in April 2012 ("BCBS-IOSCO PFMIs")[64] and their collective efforts to monitor implementation of the PFMIs globally.[65] In the context of efforts to reduce replacement cost risk associated with OTC derivatives in a centrally cleared environment, central banks have expressed a need to understand and evaluate the impact of clearing by central counterparties ("CCPs"), individually and collectively, on the deliverable OTC FX market – *i.e.*, FX forwards, swaps and/or options – from a broad policy perspective.

OTC FX Options Quantitative Study. We would like to raise the attention of the European Commission to a quantitative study completed in 2013 by the GFMA Global FX Division ("GFXD") to understand the scale of transactions in the physically-settled OTC FX options market in order to size the risk of same day liquidity shortfalls associated with clearing this deliverable market which represents approximately 6 percent of global FX market turnover.[66] Consistent with the G-20 commitments, each G-20 member continues to assess which products will be subject to a "mandatory" clearing requirement in its jurisdiction. With this in mind, and consistent with the global regulatory expectations established in the PFMIs, it is important to ensure that all participants accurately identify, understand and manage their credit and liquidity risks individually and to a CCP; and that the CCP can also identify, understand and manage its credit and liquidity risks. For physically-settled FX, the PFMIs are widely understood to require a "guaranteed, on-time clearing and settlement model" – which includes satisfying the cover 2 liquidity requirement.

Because the FX market – as a global payments system – is fundamentally about liquidity, *i.e.*, ensuring funds in the correct (needed) currency are received when they are expected to be received by transacting parties, CCPs must understand the size and nature of the same day liquidity risk in order to guarantee full and timely settlement of currencies traded for this product, and ensure this guarantee is credible. And, as noted above, central banks' have expressed a need, from a broad policy perspective, to receive more information about FX-related clearing proposals of each individual CCP to understand and review potential implications for their currencies and for the FX market.

GFXD collected and analyzed transactional level data for OTC FX options traded globally (both interdealer and client activity) from January 2007 through December 2011 from 22 of its members who represent over 90% of OTC FX dealer flow.[67] Results from the GFXD analysis indicate that if these physically-settled FX options had been cleared, CCPs would have needed to demonstrate an ability to maintain *minimum* capabilities of converting funds, same day, into currencies non-failing clearing firms were

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[64] http://www.bis.org/publ/cpss101a.pdf.

[65] *See* BCBS and IOSCO, Implementation of monitoring of PFMIs – Level 1 assessment report (August 2013) available at http://www.bis.org/publ/cpss111.pdf.

[66] *See* BIS *Triennial Central Bank Survey: Global foreign exchange market turnover in 2013* (February 2014) available at http://www.bis.org/publ/rpfxf13fxt.pdf.

[67] *See* http://www.gfma.org/initiatives/foreign-exchange-(fx)/fx-options-clearing/. The question asked and answered by this study: "What is the **size of the same day liquidity shortfall** which could have resulted from the failure of two clearing firms representing the largest combined settlement obligation in each currency on any given settlement date with respect to executed OTC FX options that were exercised and due for settlement on such date"? The answer to this question represents minimum, baseline capabilities CCPs must demonstrate for converting funds, same day, into the currencies which its other (non-failing) clearing firms were expecting to receive on that date in satisfaction of the PFMI "cover 2" liquidity requirement.
Deliverable OTC FX is traded and settled on the basis of physical settlement, i.e., the exchange of principal in two currencies on the settlement date; the expectation is for CCPs to ensure transacting parties are made "whole" by guaranteeing they will receive what they were expecting to receive on settlement date, i.e., the currencies they purchased (in exchange for currencies they sold). In contrast, most OTC derivatives are traded and settled on basis of net cash settlement in a single currency that reflects the mark-to-market value of the trade; CCPs for these products ensure transacting parties are made "whole" by guaranteeing they will receive what they were expecting to receive during the life of the instrument and on settlement date, i.e., the mark-to-market each day, including on the settlement date.

expecting to receive – in an amount equal to 161 billion (in USD equivalent) and in no fewer than 17 currencies.[68] This liquidity risk shortfall is *in addition to* the replacement cost risk and market risk which a CCP manages but which must be understood, analyzed and managed in relation to those (and other) risks. Because the size of the settlement obligation is a function of the settlement mechanism used, how the settlement mechanism is structured and designed can affect and, in some cases, limit the size of the liquidity risk shortfall which is presented to, and must be must be managed by, a CCP. This 161 billion liquidity risk shortfall, which is based on CCPs using a gross settlement mechanism, is potentially reduced by nearly 75 percent, to 44 billion, if a net settlement mechanism were used instead.

The results of this analysis represent a significant step forward in responding to regulatory expectations. Due to insufficient understanding in the industry of the size and nature of risks for which a solution has previously being sought, no OTC FX options clearing model put forward by CCPs and considered by industry has demonstrated an ability to implement safe and sound measures that (i) address the OTC FX options clearing challenge; and (ii) ensure the market can appropriately manage its liquidity and credit risks. While the results of this analysis do not provide a solution, it sheds light on the size and nature of the same-day liquidity risk shortfall for this market. In doing so, market participants and interested stakeholders are now informed of the same day liquidity risk that CCPs must be capable of managing in order to guarantee full and timely settlement of the currencies traded for this product and to ensure the guarantee is credible. As a result, the results should inform and shape ***how*** CCPs, with industry, develop clearing models for physically-settled OTC FX options and the manner in which regulatory authorities might assess the robustness and resiliency of these solutions against the PFMIs.

[68] It is important to note these are minimum, baseline figures, i.e., the calculations are based on the failure of the two clearing firms with the largest daily funding obligations with respect to historical FX options that *were* exercised, under the cover 2 liquidity requirement of the FMI Principles. It does not reflect stress testing, such as FX rate movements that could have resulted in more FX options being exercised, growth in the FX options market, etc.