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

Mr. Jonathan Faull
Director General
Internal Market and Services Directorate General (DG MARKT)
European Commission
Rue de Spa 2
1000 Brussels
Belgium

Re: *Consultation Document: FX Financial Instruments*

Dear Mr. Faull:

ICI Global[1] appreciates the opportunity to provide comments on the consultation paper issued by the European Commission on foreign exchange ("FX") financial instruments under the Markets in Financial Instruments Directive ("MiFID").[2] Specifically, the Commission requests views on the boundary between an FX spot and an FX forward. A spot FX instrument would not be subject to MiFID or to the European Market Infrastructure Regulation ("EMIR")[3] while an FX

[1] ICI Global, an affiliate of the Investment Company Institute, is a global fund trade organization based in London; members include regulated U.S. and non-U.S. based funds publicly offered to investors in jurisdictions worldwide. ICI Global seeks to advance the common interests and to promote public understanding of global investment funds, their managers, and investors. Members of ICI Global manage total assets of $1.4 trillion in non-U.S. funds. The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds ("ETFs"), and unit investment trusts ("UITs"). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $16.8 trillion and serve over 90 million shareholders.

[2] Consultation Document, FX Financial Instruments, European Commission, April 10, 2014, *available at* http://ec.europa.eu/internal_market/consultations/2014/foreign-exchange/docs/consultation-document_en.pdf ("Consultation Paper"). *See* Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC.

[3] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.

financial instrument (*i.e.,* an FX derivative that falls outside the category of spot FX instrument) would be subject to MiFID and EMIR. We believe international coordination among regulators in implementation of derivatives reform is critical to the derivatives market by helping to alleviate duplicative and potentially conflicting regulation of transactions that are conducted on a cross-border basis (which are the majority of derivatives transactions). Therefore, we encourage the Commission to adopt a definition of an FX spot transaction that is substantively similar to the definition adopted by the Commodity Futures Trading Commission ("CFTC"). We provide below answers to certain of the questions posed by the Commission in the Consultation Paper, which are of particular interest to our members.

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

We agree that the Commission should clarify the definition of a spot FX contract to ensure a uniform implementation of EU legislation, including EMIR, across the EU Member States. As the Commission notes in the Consultation Paper, the definition of financial instruments in Article 4 and Annex I Section C of MiFID is cross-referenced in several other significant pieces of EU legislation, including EMIR. The majority of EU Member States, however, do not have a definition of a forward or delineate a boundary for FX spots (which fall outside the MiFID definition of a "financial instrument") in their national laws. We believe market participants and national regulators must have certainty regarding which FX instruments would be considered "financial instruments" and subject to the provisions of EMIR.

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?

U.S. funds that are regulated under the Investment Company Act of 1940 ("ICA") and non-U.S. regulated funds publicly offered to investors (collectively, "Regulated Funds") use FX spot transactions for a variety of reasons. Spot FX transactions are typically entered into for the settlement of foreign (*i.e.,* non-domestic currency-denominated) security[4] purchases and sales, dividend payments, and other similar transactions. These FX transactions are inextricably linked to investments in foreign securities and are used to facilitate the payments associated with investments in foreign securities.

FX transactions that are conducted in connection with foreign investments have relatively short settlement cycles, which present significantly fewer risks to the counterparties and to the financial markets than derivatives transactions, and therefore do not need the protections intended for the derivatives markets. FX transactions also facilitate investment by non-EU investors in European

[4] For purposes of this discussion, a foreign security means a security denominated in a currency other than the currency in which the fund shares are denominated.

securities. European issuers (including sovereign issuers) would benefit if the ability for market participants to access spot FX markets in connection with these transactions was maintained and such transactions were regulated as spot transactions.

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

We generally believe FX transactions with a short settlement period (*e.g.,* T+6 business days or fewer) should be considered spot contracts. For international consistency, however, we urge the Commission to adopt an interpretation of spot contracts as: (1) FX transactions that generally have two business days delivery; (2) FX transactions with a longer settlement period concluding with the actual delivery of the relevant currencies that settle according to the customary timeline of the relevant market;[5] and (3) FX transactions that are entered into in connection with investment in a foreign security ("Securities Conversion Transaction"). The CFTC has adopted similar interpretations for certain FX transactions.[6]

The ability to engage in Securities Conversion Transactions is critical to the management of Regulated Funds that invest in foreign securities. A Regulated Fund investing in a foreign security may need to sell or purchase the foreign currency in which the security is denominated to settle the security purchase or repatriate the funds arising from the security sale as well as to manage the cash flows that may arise from such investment, such as transaction fees, taxes, dividends, coupon payments, and other distributions with respect to securities and capital calls. The customary settlement cycle for purchases of foreign securities may be longer than two business days.[7]

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[5] As noted by the Commission, settlement is frequently conducted cross border and different bank or official holidays may extend settlement periods.

[6] The Commission notes that two business days delivery appears to be the most widely used delineation for a spot contract. The CFTC also takes the view that "[i]n 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." *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping,* 77 FR 48208 at 48257, *available at* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-18003a.pdf ("CFTC Release Adopting Definition of Swap"). The CFTC also provided interpretive relief that an FX transaction that is settled on the customary timeline of the relevant spot market is not within the definition of the term "swap." The CFTC also will consider an FX 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. *Id.* We understand that there are a number of complex interpretive questions/issues that arise from the conditions imposed by the CFTC, and we urge the Commission not to incorporate these conditions into its standards.

[7] Under current market arrangements, settlement of securities globally occurs anywhere from one to five days after trade execution.

For example, a UCITS fund may invest in a U.S. equity security, which settles on a T+3 basis.[8] To reduce exposure to currency risk on the securities transaction between trade date and settlement date, the UCITS fund would want to have the FX transaction settle at the same time as the securities transaction, which would be longer than two business days after the trade date. In addition, in certain jurisdictions, the settlement cycle for securities may be even longer, for instance up to seven business days in South Africa. These FX transactions allow Regulated Funds to effect payment for financial market activity in the local currency. Similarly, purchases and sales (*i.e.,* subscriptions and redemptions) of shares of Regulated Funds may occur in a currency other than the one in which the funds invest.[9] If the customary settlement cycle for a Regulated Fund is longer than two business days, the Regulated Fund would need to engage in an FX transaction that matches the settlement period of the Regulated Fund to convert the currency in which investors purchase or sell fund shares into or from the investment currency. These transactions also should be considered Securities Conversion Transactions. We understand that, if Securities Conversion Transactions are considered financial instruments and subject to EMIR, dealers may restrict FX transactions to T+2 FX spot transactions regardless of when the securities actually settle, exposing Regulated Funds to unnecessary FX risk.[10]

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

In the Consultation Paper, the Commission notes that spot and FX derivatives transactions are subject to three main risks – counterparty credit risk, market risk, and settlement risk. We believe that the short settlement cycle associated with these contracts minimizes the counterparty credit and market risks. Moreover, we believe that settlement risk is virtually eliminated when an FX transaction is settled using a "payment-versus-payment" ("PVP") settlement system, of which CLS Bank International

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[8] In the United States, equity trades clearing through The Depository Trust & Clearing Corporation ("DTCC") generally settle three days after the trade (T+3). *See also* http://www.sec.gov/investor/pubs/tplus3.htm.

[9] For example, a UCITS fund that invests in U.S. dollar denominated securities may be valued in dollars but, for convenience, permit EU investors to purchase and sell (*i.e.,* subscribe for and redeem) shares in Euros. If an investor purchases €100 of fund shares, which settles in T+3, the UCITS fund would engage in an FX transaction that also settles in T+3 to match the settlement of the fund shares. This transaction allows the UCITS fund to convert the currency in which the investor purchased shares (Euros) into the currency in which the UCITS fund invests (U.S. dollars).

[10] ICI has endorsed an industry initiative led by DTCC to shorten settlement cycles for a range of securities to trade date plus two days (T+2). We understand that the European Union countries will move to a T+2 securities settlement cycle by beginning of 2015. We believe if the exception is drafted to follow the securities settlement cycle of the foreign security for which the Securities Conversion Transaction is conducted, the exception will adjust automatically to match the shortened settlement cycle.

("CLS") is the most widely used.[11] One of the key risk mitigants utilized by a PVP settlement system is a simultaneous PVP settlement of matched payment instructions. The combination of simultaneous exchange of settlement payments and other risk management processes typically used by PVP settlement systems represents strong protection for FX transactions.

Do you think a transition period is necessary for the implementation of harmonized standards?

We believe an adequate transition period is necessary for the smooth implementation of the harmonized standards. Market participants will have to adopt policies and procedures to distinguish between spot and forward FX transactions for compliance with the new harmonized standards. We request a minimum transition period of at least one year from the date that the Commission's implementing measures enter into force.

Moreover, the harmonized standards should only apply to transactions entered into following the expiry of the transition period and not to transactions entered into prior to, but still outstanding at, the end of the transition period. Therefore, EMIR should only apply to transactions entered into after the expiry of the transition period to the extent that such transactions were not previously subject to EMIR because of national regulatory regimes. Otherwise, compliance would be significantly more onerous by forcing market participants to comply retroactively with the new standards, for example back-reporting.

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

As mentioned above, the CFTC has adopted an interpretation of spot FX transactions,[12] and we urge the Commission to adopt a definition that is similar in substance. FX transactions are by their nature global, and it is imperative that regulators coordinate their rules particularly in this area. The definition of what constitutes spot and forward FX transactions is a key factor in ensuring consistent regulation of the derivatives markets around the world. If the definition of an FX spot were

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[11] The role of PVP settlement systems in eliminating settlement risk has been recognized and acknowledged by the Basel Committee on Banking Supervision ("BCBS"). *See, e.g., Supervisory Guidance for Managing Risks Associated with the Settlement of Foreign Exchange Transactions,* Basel Committee on Banking Supervision, Section 2.11, February 2013, *available at* http://www.bis.org/publ/bcbs241.pdf ("BCBS Supervisory Guidance") ("In addition, investment in infrastructures that facilitate PVP settlement across many participants, currencies and products can play a significant role in the elimination of principal risk and other FX settlement-related risks"). *See also, Progress in Reducing Foreign Exchange Settlement Risk*, Bank for International Settlements, Committee on Payment and Settlement Systems, p. 10, May 2008, *available at* http://www.bis.org/publ/cpss83.pdf ("CLS provides a payment-versus-payment (PVP) service that virtually eliminates the principal risk associated with settling FX trades").

[12] *See* CFTC Release Adopting Definition of Swap, *supra* note 6.

significantly different in the United States and the European Union, market participants (and regulators) would have to ascertain whether a particular cross-border FX transaction is a spot or a forward under the laws of each jurisdiction and then potentially attempt to comply with conflicting rules if they were classified differently in each jurisdiction. Moreover, adopting vastly differing interpretations of which FX transactions would be subject to derivatives regulations would add yet another level of complexity to an already difficult issue of how cross-border transactions should be regulated. We urge the Commission to avoid this harmful outcome and harmonize substantively its interpretation with those of the CFTC to the extent possible. A harmonized interpretation also will further the ability of the Commission and the CFTC to make equivalence/substituted compliance determinations with respect to each other's laws regulating derivatives. Finally, adopting a common definition of an FX spot transaction will discourage regulatory arbitrage.

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In sum, we respectfully request that the Commission adopt a definition of FX spot as recommended above and deem Securities Conversion Transactions to be FX spot transactions. As discussed above, these transactions typically have very short settlement cycles, which present lower risks to the counterparties and to the financial markets more generally. Requiring these transactions to comply with the requirements under EMIR and with other regulations would add operational complexity and unnecessary cost without providing any significant protection to market participants. In addition, inconsistent treatment of Securities Conversion Transactions by global regulators may cause dealers to limit Securities Conversion Transactions to T+2 spot transactions, reducing the ability of Regulated Funds to make foreign investments efficiently.

We appreciate the opportunity to respond to the Consultation Paper. If you have any questions on our comment letter, please feel free to contact the undersigned, Sarah Bessin at +1-202-326-5835, Jennifer Choi at +1-202-326-5876, or Giles Swan at +44-203-009-3103.

Sincerely,

/s/ Dan Waters

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