By electronic mail: European Commission, DG MARKT, G-3
(MARKT-G3@ec.europa.eu)

9th May, 2014

Dear Sir/Madam,

RE: CONSULTATION ON FX AND FINANCIAL INSTRUMENTS

Please find attached the response of the UK's Investment Management Association (IMA[1]) to the above consultation. We are grateful for the opportunity to comment.

We set out in the response our credentials below buut would like to note here that the IMA's purpose is to ensure investment managers are in the best possible position to:

- Build people's resilience to financial adversity
- Help people achieve their financial aspirations
- Enable people to maintain a decent standard of living as they grow older
- Contribute to economic growth through the efficient allocation of capital

Our response to the questions raised in the public consultation is included as a follow-on to this cover letter. Please do not hesitate to contact me on +44 20 7831 0898 or at Richard.Metcalfe@investmentuk.org, should you wish to discuss any points in more detail.

Yours faithfully,

Richard Metcalfe,
Director, Regulatory Affairs (Institutional and Capital Markets)

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[1] The IMA represents the asset management industry from a UK perspective. Our members include independent fund managers, the investment arms of banks and life insurers, and the in-house managers of occupational pension schemes. They are responsible for the management of over £4.5 trillion of assets from the UK on behalf of domestic and overseas investors.

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RESPONSE OF THE INVESTMENT MANAGEMENT ASSOCIATION (IMA)

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

We believe a clarification is desirable, most immediately because of the practical consequences of the lack of consistency across Member States (MS) as to what is within the scope of EMIR. Under the single market, investment managers based in one jurisdiction serve asset owners in other MS as well as their own. But there are currently differences between MS as to which transactions to report into trade repositories, arising from the way the respective competent authorities interpret MiFID; and resulting in some cases of one side (party) having to report a given transaction as 'relevant' while another party, on the other side of the same transaction, does not have to.

We do, of course, note the extensive impact of any change to bring many more transactions into the scope of regulation, beginning with the 'switching-on' of MiFID conflict and conduct-of-business provisions plus the possible application of requirements to trade certain instruments on a venue or platform. Even within EMIR, of course, the requirements are not limited to reporting. There are also obligations to carry out certain 'risk-mitigation' tasks in relation to any instruments that are in scope, including portfolio reconciliation, where the portfolio size is sufficiently large.

(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?

From an investment management perspective, FX spot transactions – including those with deferred settlement – will typically be an adjunct to some other (financial) activity. Please note that this does not make such FX transactions 'optional' in any sense for an investment manager. A fund is likely to be formally constrained (notably by the terms of its mandate) as to the degree of currency risk it may take, however small the exposure may be in practice. Thus, a fund will typically have an incentive to close out what, for any other type of participant (and by extension for the system as a whole), would be a de minimis amount of risk.

Our view of spot FX is that, as an adjunct to other activities, it should not generally be viewed as a financial instrument in its own right.

(3) What settlement period should be used to delineate between spots 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?

Provided the number of days is not set too low, a single cut-off will work. We believe that, at least until one can better understand the likely impact of a radical change, this cut-off should be set high enough to accommodate common 'security-conversion' trades.

(By 'security-conversion' trades, we mean what would be normal spot foreign exchange transactions but for settlement being deferred by a small number of days, such that it coincides with settlement of transactions in or related to securities denominated in a foreign currency; for instance the sale of US dollar-denominated shares by a euro-denominated collective fund. The alternative, of course, is for the fund to face a mis-match in cash-flows, unnecessarily introducing FX-market risk into its performance. Please note that, even if that FX risk does not have a material impact on the performance, it violates the principle that a given fund is primarily targeting other exposures and will have been sold to investors on that basis.)

Setting the cut-off in a way that effectively recognises the phenomenon of security-conversion trades would conservatively imply a level of at least T+5 local business days, which would in practice take account of transactions in South African equities. The number could, of course, be subject to a review clause, such that any subsequent reduction – or even increase – that was justified could be enacted.

We note – from a straw poll of 23 of our members – that a significant minority of deliverable FX transactions (spot and forward) in any one month will consist of transactions with deferred or long-dated spot settlement. Thus, out of an aggregate total of just under £500 billion a month reported by the 23 firms, a third (32%) involves spot trades with settlement deferred beyond T+2. Around 15% of the monthly total (ie, just under half of those long-settlement trades; or some £70bn in absolute terms) settle at greater than T+5. It is worth adding that there is a slight trend towards more in the way of deferred settlement, the higher the amount of total deliverable FX that a firm sees. In other words among larger users of the FX markets, the desirability of accommodating long-dated settlement is larger – with over 40% of their transactions settling beyond T+2 and around half of those settling at greater than T+5.

(4) Do you agree that non-deliverable forwards be considered financial instruments regardless of their settlement period?

We agree that the starting point for analysing NDFs is that, as a form of cash-settled derivative, they can be considered financial instruments. For some currencies, however, NDFs remain the only way to close out the sort of mis-

match that is otherwise addressed by a 'security conversion trade'. The root cause of this is that there is no functioning market in physically settled forwards in these currencies[2]. In some cases, the absence of a market in physical forwards is because of local regulatory constraints. Whatever the reason for the constraint, though, long-dated spot transactions are not an alternative, because the same constraint would technically apply to them too.

As pointed out elsewhere in this response, the question of proportionality arises where short-dated transactions are concerned, because they pose reduced market risk and therefore correspondingly less counterparty-credit risk. There is, therefore, a clear argument that all FX transactions – including NDFs – for which settlement happens before a cut-off of, say T+5, should be treated as a spot transaction.

(5) What have been the main developments in the FX market since the implementation of MiFID?

We believe others are better placed to comment on this, though we would note that the increasing 'electronification' of the market means that a relatively high level of transparency exists in relation to it.

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

The risks associated with FX instruments are clearly: operational, market and (counterparty) credit risk. Operational risk is relatively low in FX, given the high level of automation in trade and post-trade processes. The degree of counterparty risk associated with deferred spot settlement should be the determining factor in setting the boundary between spot and forward. Market risk is embedded within any measure of counterparty credit risk (since the degree of market risk will drive the likely size of the counterparty-credit exposure). As noted below, it will be important to assess the materiality of this risk, particularly as compared with the risks arising in relation to the other instruments covered by EMIR, some of which have initial maturities that are measured in decades.

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

Yes, we believe that a transition period a) will be essential and b) should be not less than 6 months. The IT project planning and management process will require a clear 'specification' to be available, based on a stable legislative/regulatory position, in order for firms to even schedule such work (even if the changes are relatively simple in concept). In fact, we advocate a nine-month transition, given that EMIR very clearly sets out the underlying reasons for viewing much of FX risk as not being systemic, particularly in shorter-dated transactions. Any requirement to backload transactions should be subject

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[2] Eg, Brazil, Chile, India, Malaysia, Peru and Russia

to very careful consideration, given the complications noted recently by ESMA (viz, its May 8th 2014 letter to the European Commission on the subject of 'frontloading'). We would argue that a proportional approach would be to target only new transactions.

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

The US has adopted an approach, whereby long-dated settlement is permitted. Unfortunately, however, a party must go through a relatively cumbersome process to demonstrate this. The pragmatic approach would be to set the cut-off in such a way that long-dated settlement is possible, without having to take special steps to demonstrate trade by trade that this is the motivation. This simplifies the situation for supervisors as much as firms, while ensuring proportionality.

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

Strictly, there is a potential knock-on effect for UCITS, for whom any instruments that were newly designated 'forwards' would count towards the 'global exposure' taken on by the fund in question[3] and its counterparty-credit-risk exposures[4]. Clearly, to the extent that forwards entail material risk, then there is an argument that they should count towards such measures. Equally, where they do not, then the policy objective can be different, as can the treatment.

Otherwise, we are not aware of any implications additional to those mentioned in the consultation (*but please do note our comments, below, in response to question 10!*).

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

EMIR was correct in identifying FX derivatives as requiring proportionality of regulatory treatment. (*Please see the Annex for the relevant wording from EMIR*.) We see no reason to diverge from this reasoned conclusion. One of the characteristics of the FX derivatives market in practice is the predominance of short-dated contracts, which by definition reduces the amount of time for systemically significant counterparty exposure to build up. In the current exercise of assessing the spot-forward boundary, a potential solution exists in the form of

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[3] UCITS Directive (2009/65/EC), Article 51.3 – *see Annex to this response for exact wording*

[4] Ibid, Article 52 (1) – *see Annex to this response for exact wording*

accepting as ‘spot’ anything with settlement up to at least T+5 (business days). Assuming that this solution is accepted, one would clearly be in the same ‘territory’, ie, short-dated risk. In other words, compared with the tenors of instruments such as interest rate swaps, which can run to decades, FX is clearly a different issue. We add that the Basel/CRD framework deliberately accommodates deferred settlement and that this provides a means of addressing such risk as might exist to the system from such transactions. (*See the CRR: R 575/2013, Article 272[2]*[5]!) A further consideration for the purposes of EMIR, of course, was and is the existence of the CLS mechanism for managing the dominant risk in physically settled transactions, ie, settlement risk. At the same time, there is no realistic prospect of clearing for physically settled FX, so no option to reduce risk in that way. The net result of this lack of ‘clearability’ is that ‘incidental’ users of physically settled FX transactions (who are not focusing on FX per se but using it as an adjunct to other investment activities) may have to post variation margin (on the non-cleared transactions) that can only be higher than it would in a multilaterally netted system, for a risk that EMIR in effect classifies as immaterial. This appears perverse, given the broad thrust of the rules on margin for non-cleared FX transactions, which demonstrably also view FX as a special case, deserving of proportionate treatment.

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[5] Article 272 (2) reads: “'long settlement transactions' means transactions where a counterparty undertakes to deliver a security, a commodity, or a foreign exchange amount against cash, other financial instruments, or commodities, or vice versa, at a settlement or delivery date specified by contract that is later than the market standard for this particular type of transaction or five business days after the date on which the institution enters into the transaction, whichever is earlier;”

Annex – extracts from EU legislation

1. **UCITS Directive 2009/65**

    a. Global exposure (*Article 51.3*)

"A UCITS shall ensure that its global exposure relating to derivative instruments does not exceed the total net value of its portfolio. The exposure is calculated taking into account the current value of the underlying assets, the counterparty risk, future market movements and the time available to liquidate the positions.... A UCITS may invest, as a part of its investment policy and within the limit laid down in Article 52(5), in financial derivative instruments provided that the exposure to the underlying assets does not exceed in aggregate the investment limits laid down in Article 52. Member States may provide that, when a UCITS invests in index-based financial derivative instruments, those investments are not required to be combined for the purposes of the limits laid down in Article 52."

NB: Box 2 of CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (CESR/10_788) requires the notional value of the current legs(s) of an FX forward to be included in the Global Exposure calculation for a UCITS using the Commitment Approach (http://www.esma.europa.eu/system/files/10_788.pdf)

    b. Counterparty exposure (*Article 52[1]*)

"The risk exposure to a counterparty of the UCITS in an OTC derivative transaction shall not exceed either:
(a) 10 % of its assets when the counterparty is a credit institution referred to in Article 50(1)(f); or
(b) 5 % of its assets, in other cases.

.....a UCITS shall not combine, where this would lead to investment of more than 20 % of its assets in a single body, any of the following:
(a) investments in transferable securities or money market instruments issued by that body;
(b) deposits made with that body; or
(c) exposures arising from OTC derivative transactions undertaken with that body."

2. **'EMIR' Regulation 648/2012**

The nature of FX transactions and the need to treat them differently (*Recital 19*)

“In determining which classes of OTC derivative contracts are to be subject to the clearing obligation, due account should be taken of the specific nature of the relevant classes of OTC derivative contracts. The predominant risk for transactions in some classes of OTC derivative contracts may relate to settlement risk, which is addressed through separate infrastructure arrangements, and may distinguish certain classes of OTC derivative contracts (such as foreign exchange) from other classes. CCP clearing specifically addresses counterparty credit risk, and may not be the optimal solution for dealing with settlement risk. The regime for such contracts should rely, in particular, on preliminary international convergence and mutual recognition of the relevant infrastructure.”