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TO:

Central Bank of Russia
12 Neglinnaya Street
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Via email: svc_derivatives@cbr.ru

15 September 2016

Re: Consultation Paper - On Mandatory Clearing of Standardised OTC Derivatives

Dear Sir/Madam,

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 Paper on Mandatory Clearing of Standardised OTC Derivatives" issued by the Central Bank of Russia (CBR) on 1 July, 2016.

The GFXD was formed in co-operation 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 24 global foreign exchange (FX) market participants,[1] collectively representing around 85% of the FX inter-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, and effective and efficient exchange of currencies underpins the world's entire financial system. 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. The GFXD wishes to emphasize the desire of our members for globally coordinated regulation, which we believe will be of benefit to both regulators and market participants alike.

[1] Bank of America Merrill Lynch, Bank of New York Mellon, Bank of Tokyo Mitsubishi, Barclays Capital, BNP Paribas, Citi, Credit Agricole, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan, Lloyds, Mizuho, Morgan Stanley, Nomura, RBC, RBS, Société Générale, Standard Chartered Bank, State Street, UBS, Wells Fargo and Westpac.

[2] According to Euromoney league tables.

The FX market is also the basis of the global payments system. The volume of transactions is therefore very high and these transactions are often executed by market participants across geographical borders.[3] Achieving a globally harmonised approach to mandatory clearing for FX is therefore of utmost importance. If there are jurisdictional differences in clearing regimes, a party conducting a cross-border trade may be required to centrally clear that trade, when in their home jurisdiction they would not be mandated to do so. A lack of consistency will not only result in increased complexity of trade flows and execution decisions for market participants (with associated increased transaction costs) but also, as we discuss below, do nothing to mitigate settlement risk - the most significant risk involved in FX trading.

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EXECUTIVE SUMMARY

<u>**Mandatory Central Clearing**</u>

1. **International coordination in respect of clearing mandates is essential because the FX market is a central component of the global payment system. To best achieve a globally harmonized approach to mandatory clearing:**

   A. We recommend that the CBR exclude physically-settled FX swaps and forwards from any clearing mandate.

   - In the FX market, the majority of FX transactions are simple exchanges of currency, so the predominant risk with physically-settled (or, "deliverable") FX transactions is settlement risk, *i.e.* the risk that one party delivers its side of a currency exchange while the counterparty does not. Following extensive study of settlement risk by global central banks as a source of systemic risk for the FX market and therefore the global financial markets, the FX market went to considerable lengths to address settlement risk, ultimately leading to the creation of CLS Bank (CLS) in 2002. CLS's settlement system today eliminates virtually all settlement risk for its participants in the currencies CLS settles.

   - Physically-settled FX transactions are generally short-dated, meaning a significant reduction in counterparty credit risk as compared to other classes of derivatives with more long-dated tenors. The FX market is also liquid and transparent.

   - Central clearing counterparties (CCPs) are designed to mitigate credit, or "mark-to-market" risk, not necessarily settlement risk. In the FX markets, as mentioned, transactions are generally short-dated, and any residual mark-to market risk is mitigated through the use of credit support annexes (CSAs). Furthermore, significant issues with respect to CCPs ensuring the systemically sound clearing and settlement of physically-settled FX products, such as same-day liquidity challenges, still exist.

[3] As reported by the Bank of International Settlements in their 'Triennial Central Bank Survey: Foreign Exchange Turnover in April 2016' over 77% of FX activity was executed by market participants across five global jurisdictions. BIS 2016 Triennial Survey, available at http://www.bis.org/publ/rpfx16.htm, see pp. 8 and14.

- Mandatory clearing of FX products has not been implemented in either the US or Europe at this time. In the US, as discussed below, physically-settled FX swaps and forwards have been explicitly exempted from mandatory clearing regulations. In the EU, no clearing determination has been proposed for physically-settled FX swaps and forwards. There has been general global regulatory acknowledgment that there should be international convergence regarding any mandatory clearing determinations.

B. We recommend that the CBR delay establishing any clearing mandate for FX non-deliverable forwards (NDFs) pending such time as there is further clarity into whether, when, and how a clearing mandate for NDF transactions may be implemented by regulators in other jurisdictions, in particular the US and EU

- The majority of FX transactions are simple exchanges of currency, *i.e.*, trades settle via exchange of the full notional amount of the underlying currencies. NDF transactions comprise only a small fraction of the total FX market and are also generally short-dated.

- Although utilized, voluntary clearing of NDFs is still in its infancy at this time and, as such, certain processes, for example around client clearing models and default management, need further time to mature.

- Even if the CBR were to determine an NDF clearing mandate is appropriate at this time, a sufficiently tailored clearing obligation and suitable, globally coordinated, phase-in period for compliance and for substituted compliance/equivalency determinations needs to be ensured, to minimize the risk that the implementation of clearing obligations in Russia vs. elsewhere would not be detrimentally disruptive to the vital and well-functioning global currency market.

C. We recommend that the CBR delay establishing any clearing mandate for FX options pending such time as there is further clarity into whether, when and how a clearing mandate for FX options transactions may be implemented by regulators in other jurisdictions, in particular the US and EU.

- We repeat the points in respect of a clearing mandate for NDFs, and add that significant issues exist with respect to ensuring the systemically sound clearing and settlement of physically-settled FX options.

<u>**Exchange of Margin on Uncleared Transactions**</u>

2. We urge the CBR, in adopting any uncleared margin regulations in the future, to ensure that the regulations are harmonised and consistent with those in other jurisdictions, and comparable with the standards for margin requirements for non-centrally cleared derivatives established in the March 2015 "Margin requirements for non-centrally cleared derivatives" by the Basel Committee on Banking Supervision and International Organization of Securities Commissions (International Margin Framework).

Trade Reporting

3. **We support the CBR's proposal, however we would like clarity on whether counterparties are required to indicate that their original, bilateral trade was "intended for clearing," given that novation is likely to occur on a much shorter timeframe than trade reporting.**

We have focused our responses to the Consultation Paper on those topics we think potentially impact the FX market specifically, and therefore have not responded each and every question in the Consultation Paper. For some questions, we have indicated our support for comments made by ISDA in their comment letter to you dated September 15, 2016.

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1. Do you have any comments/suggestions regarding the abovementioned economic incentives for the submission of transactions for clearing to a CCP or the possibility of their implementation? If you do, please provide specific details.

We have no comments in response to this question.

2. Do you have any comments/suggestions as to existing or potential barriers that complicate the submission of OTC derivatives for central clearing and, if there are any, as to how they can be remedied? If you do, please provide specific details.

We have no comments in response to this question beyond our comments in response to Question 6 below.

3. Do you have any comments/suggestions as to the phasing in of the requirement for mandatory central clearing of standardised OTC derivatives? If you do, please provide specific details.

We would be supportive of the CBR taking a phased approach to the introduction of any clearing obligations in Russia. However, also see our response to Question 6 below.

4. Do you have any comments/suggestions as to the derivatives to which the requirement for mandatory central clearing should first be applied? If you do, please provide specific details.

We have no comments in response to this question beyond our comments in response to Question 6 below.

5. Do you have any comments/suggestions as to the choice of the list of currencies in which derivatives are denominated and as to the floating interest rates and terms set forth in Tables 2–4? If you do, please provide specific details.

We have no comments in response to this question.

6. Do you have any comments/suggestions as to the further expansion of the list of instruments subject to the requirement for mandatory central clearing to include certain FX derivatives (FX Forwards, FX Swaps)? If you do, please provide specific details.

As a general matter, we acknowledge the benefits that central counterparty clearing can bring to the OTC derivatives markets, for example in terms of operational efficiencies, transparency and counterparty credit risk reduction.

However, in considering the appropriateness of a clearing mandate for FX, regulators should bear in mind that the FX market is somewhat different from other markets in that it is a central component of the global payment system, and FX products are the critical medium of exchange used by cross-border payment systems globally. Furthermore, FX transactions are overwhelmingly short-dated in nature, meaning significantly reduced counterparty credit risk as compared to other classes of derivatives with more long-dated tenors.

Global co-ordination in respect of any FX clearing mandate is essential because the FX market is a central component of the global payment system

The FX markets are global and thus cross-border in nature. As reported by the BIS in its 2016 Triennial Survey, over 77% of FX activity was executed by counterparties across five global jurisdictions;[4] hence our continued view that regulations impacting the FX market should be harmonized at the global level. Cross-border markets cannot operate in conflicting regulatory landscapes and the natural outcome, should this be the case, is unwanted fragmentation of what is an already highly automated, transparent and well-functioning FX market.

For example, how would counterparties to a trade executed between Russia and the US or Europe manage their regulatory obligations, should only one party be required to clear? The outcome would likely take one of three paths:

- execution, and thus liquidity would become concentrated with counterparties that have a mandatory clearing obligation;
- the party that is not required to clear would be forced to clear, and incur extra costs (such as clearing and operational costs); or
- the trade is not executed, impacting the end-user's ability to hedge.

Clearly, in a global, cross-border market, any such increased bifurcation of liquidity is not desirable. For example, in the interest rate swaps market, indications have emerged that liquidity in cross-border pools fragmented along geographic lines coinciding with the introduction of the US swap execution facility (SEF) regime in October 2013.[5]

Furthermore, situations where there is a clearing requirement in one counterparty's jurisdiction but not the others could lead to conflicts of law, inconsistencies and legal uncertainty. All this could have negative impacts on competition as market participants select their counterparties for trading on the basis of regulatory rather than business factors.

[4] BIS 2016 Triennial Survey: http://www.bis.org/publ/rpfx16.htm, see pp.8 and 14.

[5] http://www2.isda.org/search?headerSearch=1&keyword=SEF. An April 2015 ISDA study showed that the October 2013 effective date for SEF compliance had an impact on trading relationships in the derivatives markets: liquidity in the interest rate swaps market fragmented following the start of the SEF regime, and split further since the first made-available-to-trade determinations came into force in February 2014, with trading between US persons and non-US having declined.

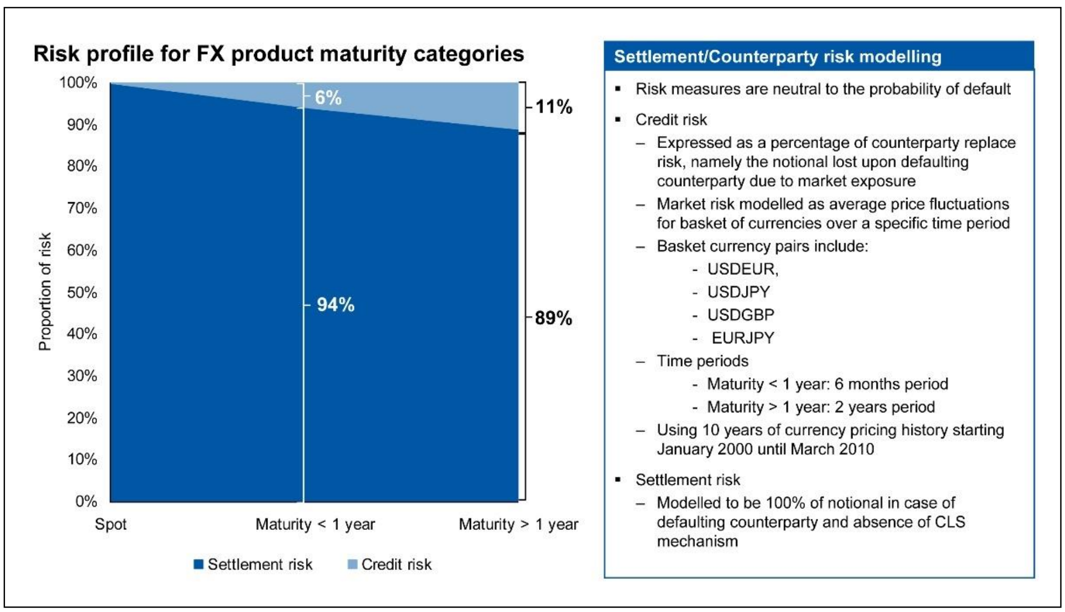
In light of this, and to best achieve a globally harmonized approach to mandatory clearing, we respectfully make the following comments to the CBR:

A. The CBR should exclude physically-settled FX swaps and forwards from a clearing mandate.

In the FX market, the majority of FX transactions are simple exchanges of currency, where the main counterparty risk is settlement risk, not counterparty credit risk.

The FX market has particularly large currency and capital needs because of its vast size and because FX trades are predominantly physically-settled via delivery of the full notional amount of each of the two underlying currencies being exchanged. Together, the FX swaps and forwards markets represent some 61% of the global FX market.[6]

Clearing deliverable FX forwards and swaps is not appropriate because while central clearing specifically addresses replacement cost risk, it is not the optimal solution for dealing with FX forwards and swaps, where the main risk is settlement risk. Settlement risk dwarfs credit risk in the FX market. The graph below, based on a 2010 GFXD/Oliver Wyman analysis, illustrates that settlement risk comprises 94% of the estimated maximum loss exposure in a transaction involving FX instruments with a maturity of 6 months and 89% for instruments with a maturity of 2 years.



Settlement risk in the FX market has been virtually eliminated, due to the creation of CLS in 2002, a systemically important financial market infrastructure which operates a payment-versus-payment settlement system and which is subject to a cooperative oversight arrangement among the central banks whose currencies CLS settles.

The efforts of central banks to raise awareness of settlement risk and to improve banks' self-monitoring of settlement risk have been remarkably successful. According to CPSS's calculations in the 2008 CPSS report

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[6] BIS 2016 Triennial Survey: http://www.bis.org/publ/rpfx16.htm, see p. 6.

on "Progress in reducing foreign exchange settlement risk,"[7] "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." CLS has had zero settlement failures since it was created, and now settles a large portion of foreign exchange transactions.

Physically-settled FX transactions are generally short-dated and the FX market is liquid and transparent.

Physically-settled FX transactions are generally short-dated, meaning a significant reduction in counterparty credit risk as compared to other classes of derivatives with more long-dated tenors. According to the BIS 2016 Triennial Survey, approximately 69% of the market for FX swaps and approximately 39% of the market for FX forwards matured in one week or less, and approximately 99% of the market for FX swaps and approximately 98% of the market for FX forwards matured in one year or less,[8] meaning a significant reduction in counterparty credit risk as compared to other classes of derivatives with more long-dated tenors.

Since most foreign exchange contracts have short maturities, the foreign exchange rate is unlikely to change significantly between the inception and maturity of most foreign exchange contracts. As a result, the in-the-money portion of the trade tends to be small relative to the principal value, which means the maximum possible loss for foreign exchange transactions consists overwhelmingly of settlement risk, which is largely eliminated through the settlement mechanics employed by CLS.

The foreign exchange market is also very liquid and transparent, leading other markets over the past decade in converting to electronic trading platforms, which has brought significant improvements in price transparency, liquidity and efficiency. Prices are widely available in the FX market, contributing to narrow spreads and deep liquidity. These robust infrastructure advancements have significantly strengthened the integrity of the FX marketplace from a systemic risk standpoint.

CCPs are designed to mitigate credit, or "mark-to-market risk," not settlement risk.

Because of their short duration and physical settlement, FX forwards and FX swaps stand in sharp contrast to most other swaps, for which counterparty risk is comprised almost exclusively of credit risk on the mark-to-market value of the swap. Credit risk is the risk that CCPs are primarily designed to address.

The physically-settled FX market thus presents different challenges from those seen with the more traditionally centrally-cleared products, such as interest rate derivatives. In particular, it is important to recognize the need to ensure the physical delivery of the full notional amount to settle a deliverable FX trade in the right currency and at the right time.

As mentioned, the predominant risk by far in the FX markets is settlement risk, with any credit, or "mark-to-market' risk managed in the FX markets through collateral support agreements (CSAs) between counterparties. Settlement risk in the FX market has been virtually eliminated, by CLS, and CSAs are used and relied on in the FX market and are a particularly effective risk mitigation tool. Mandatory clearing for FX forwards and swaps would therefore deliver almost no incremental risk mitigation.

[7] http://www.bis.org/cpmi/publ/d83.htm

[8] BIS 2016 Triennial Survey: http://www.bis.org/publ/rpfx16.htm

We believe that the significant operational risk and costs to the global payment system of implementing mandatory clearing for deliverable FX far exceed the benefits of mitigation for any small residual unsecured credit risk of FX swaps and forwards. Central clearing of physically-settled FX products has the real potential of increasing, rather than decreasing, systemic risk, especially in times of crisis, thereby significantly outweighing the marginal benefits that central clearing would provide.

As noted in the US Treasury's November 2012 Fact Sheet discussing its exemption of FX swaps and forwards from mandatory clearing in the US (discussed in more detail below): "settlement of the full principal amounts of the contracts would require substantial capital backing in a very large number of currencies, representing a much greater commitment for a potential clearinghouse in the FX swaps and forwards market than for any other type of derivatives market."[9]

Notwithstanding numerous efforts to do so, no CCP has demonstrated an ability to implement safe and sound measures that ensure the deliverable FX market, with the CCPs, can appropriately manage the liquidity and credit risks associated with clearing deliverable FX forwards and swaps. Indeed, in recent years, central banks have expressed their need, from a broad policy perspective, to receive more information about the FX-related clearing proposals of each individual CCP to understand and review the potential implications of each proposal for their currencies and for the FX market.

When approached by CCPs seeking to clear FX transactions, central banks whose currencies settle in CLS raised a number of issues and made requests for further information and analyses regarding the concept of clearing FX contracts. These issues include the potential effects of mandatory clearing on the central banks' home currencies and on the safety and soundness of the deliverable FX market generally, including on CLS.[10]

The central banks' concerns stem from their need to understand and evaluate the impact of a CCP's activities on the FX market and on payments in their home currencies from a broad policy perspective. There is also an important policy interest in not seeing settlement risk reintroduced to the financial system. Since settlement risk comprises an overwhelming portion of the counterparty default risk for FX contracts, the failure of an CCP to guarantee FX settlement would largely defeat the purpose of clearing through the CCP, particularly for a market that is essentially a payment system. If a CCP that guaranteed settlement did not use CLS (and in this regard, we are aware that the RUB is not a currency settled by CLS), the CCP would need to settle through a private bank, in which case any default by the private bank would pose serious liquidity and other risks to the clearing house and thus to all its participants. If a CCP did not guarantee settlement and did not use CLS, its clearing participants would be subject to settlement risk, which would be substituting settlement risk – by far the larger risk in an FX transaction – for replacement cost risk. In addition to their respective needs to determine the safety and soundness of any CCP's proposal to clear deliverable OTC FX products, central banks have also separately expressed a need to determine the safety and soundness of CLS's acceptance of such cleared transactions for settlement processing.

The FX industry has continued to work with regulators and CCPs with respect to the clearing of deliverable FX products and is acutely aware that to meet these requirements for the mainstream FX market a CCP

[9] US Treasury Press Release 'Fact Sheet: Final Determination on Foreign Exchange Swaps and Forwards', available at http://www.treasury.gov/press-center/press-releases/Pages/tg1773.aspx

[10] See CLS letter to the US Department of the Treasury (November 23, 1010) in response to request for comment on determination of foreign exchange swaps and forwards.

would face significant challenges. This is especially true in light of the need for immediate access to sufficient liquidity in all currencies to be able to meet in full the settlement obligations of a defaulting member, and in a manner that does not put the CCP itself at significant risk during stressed market conditions. CCPs would require immediate access to sufficient liquidity in all currencies to be able to meet in full the settlement obligations of a defaulting member, and in a manner that does not put the CCP itself and its members at significant risk during stressed market conditions. As noted above, the specific settlement characteristics of the FX market make this issue significantly more acute than in other asset classes. As a result, this is a formidable challenge for which, to date, no satisfactory solution has been found. The complexities around introducing CCP clearing into the FX market are significant – such as the large currency and capital needs that would arise if CCPs were also responsible for guaranteeing settlement given the sheer size and volume of trades in the deliverable FX forwards and swaps market; and the operational challenges and potentially disruptive effects that arise from introducing a layer of clearing between trade execution and settlement. These would significantly outweigh the marginal benefits from a mandatory clearing obligation.

CPSS and IOSCO jointly issued in 2012 final "Principles for Financial Market Infrastructures" (PFMI).[11] Included in the PFMI are a number of key principles to be considered when seeking to apply clearing to the FX market, notably: Principle VII on liquidity risk; Principle VIII on settlement finality; and Principle XII on exchange-of-value settlement systems. As confirmed in a number of discussions with regulatory authorities and market participants, when applied to deliverable FX forwards, swaps and options, these principles would require physically-settled FX products to be cleared only by CCPs that can provide a "guaranteed, on-time clearing and settlement model." The large currency and capital needs required by the FX market to physically settle FX products would have to be met by CCPs if such products were to be made subject to mandatory clearing. Specifically, an FX CCP must, for a physically-settled market:

- guarantee the full and timely settlement of the currencies the subject of the trade; and
- ensure the guarantee is credible and addresses extreme but plausible market conditions as identified by rigorous stress testing, including default scenarios.

To date, even for the deliverable FX options market (discussed further below), which is substantially smaller than the deliverable FX forwards and swaps market, no model put forward by a CCP and/or market participant has demonstrated an ability to implement safe and sound measures that address the above requirements and ensure the market, working with the CCPs, can appropriately manage the liquidity and credit risks associated with clearing these products.

It is reasonable to assume that central banks will be unlikely to embrace mandatory clearing requirements for the deliverable FX market in the absence of evidence that it can be implemented without causing more harm than good to sovereign currencies and existing settlement processes.

[11] http://www.bis.org/cpmi/publ/d101a.pdf

Mandatory clearing of FX products has not been implemented in either the US or Europe at this time

In the United States, the Department of Treasury (DoT) has evaluated the appropriateness of mandating clearing of deliverable FX forwards and swaps and, following extensive study and consultation, determined not to apply such a requirement to such products.[12]

In doing so, the DoT considered several factors to assess whether the required clearing of these products would create systemic risk, lower transparency, or threaten the financial stability of the US. In its determination, the DoT concluded that, given the reduced counterparty credit risk profile of this market, the challenges of implementing central clearing within this market significantly outweighed the marginal benefits that central clearing and exchange trading would provide. Clearing deliverable FX forwards and swaps would require insertion of a central counterparty into an already well-functioning and highly interconnected settlement process, which could result in unnecessary operational and settlement challenges.

Three main reasons were outlined by the DoT for exempting physically-settled FX swaps and forwards from a clearing requirement:

- FX swaps and forwards involve fixed terms and the physical exchange of currencies. Market participants therefore know the full extent of their own payment obligations to the other party to a trade throughout the life of the contract.

- The FX market already has a well-functioning settlement process. This is crucial, given that as mentioned earlier the predominant risk in FX is settlement risk.

- FX swaps and forwards are predominantly short-term transactions.

The DoT also noted:

- The complexities around introducing CCP clearing into the FX market, specifically the large currency and capital needs that would arise if CCPs were responsible for guaranteeing settlement, given the sheer size and volume of trades in the FX swaps and forwards market.

- The operational challenges and potentially disruptive effects that arise from introducing a layer of clearing between trade execution and settlement.

In Europe, no clearing determination has been proposed for physically-settled FX swaps and forwards, and there has been general global regulatory acknowledgment that there should be international convergence regarding any mandatory clearing determinations.

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 which exists today remains whole, *i.e.*, is not bifurcated into a mandatorily cleared v. un-cleared market for these key products which have a primary purpose of facilitating payments. Any such bifurcation would negatively

[12] See 77 Fed. Reg. 69694 (November 20, 2012), available at: http://www.gpo.gov/fdsys/pkg/FR-2012-11-20/pdf/2012-28319.pdf and http://www.treasury.gov/press-center/press-releases/Pages/tg1773.aspx

impact liquidity and increase funding costs for end users. Most importantly, as detailed in our comments above, introducing mandatory clearing into the deliverable FX market without ensuring that CCPs only bear risks that they can properly manage would increase, rather than decrease potential systemic risk, especially in times of crisis.

FX Securities Conversion Transactions

On a related note, we also urge the CBR to confirm that FX Security Conversion Transactions (as defined below) are deemed spot transactions and therefore not included within the scope of derivatives regulation in Russia even if they are settled on a longer than T+2 basis.

Because this approach has been adopted by the CFTC in the final product definitions issued pursuant to the US Dodd-Frank Act,[13] by the Canadian regulatory authorities in proposed updated model rules and guidance issued this year on OTC derivatives regulation,[14] and European Securities and Markets Authority (ESMA) in the MiFID II draft Delegated Act,[15] we encourage the CBR to adopt the same approach.

FX Security Conversion Transactions as 'spot' transactions

Many of our members act as custodian for their customers who are asset managers. Due to increased access to and investor interest in foreign financial markets, growing numbers of these customers are invested in foreign securities. To facilitate the purchase or sale of these foreign securities, these custodians, as part of their service offering, often enter into an FX transaction that is incidental to and for the purpose of effecting their customer's foreign security transaction (FX Security Conversion Transaction).

For example, when a non-Russian customer wishes to purchase a RUB-denominated security, its broker-dealer or bank custodian will enter into a corresponding FX transaction so that the customer has RUB available to meet the cash currency requirements necessary to complete the purchase or sale of the security. These FX transactions are, therefore, integral to the settlement of the security. Typically, the settlement cycle for most non-RUB denominated securities is trade date plus three days (T+3). Accordingly, the bank custodian or broker-dealer would enter into a FX transaction with its customer on a T+3 basis as well. We note that in South Africa, for example, the securities settlement cycle can take up to seven days (T+7).

In the European Commission's Delegated Act published on 25th April, 2016,[16] an FX spot contract includes "a contract for the exchange of one currency against another currency….where the contract for the exchange of those currencies is used for the main purpose of the sale or purchase of a transferable security or a unit in a collective investment undertaking, [and delivery is scheduled to be made within] the period generally accepted in the market for the settlement of that transferable security or a unit in a collective investment undertaking is the standard delivery period or 5 trading days, whichever is shorter." By being classified as a spot transaction, these FX Security Conversion Transactions are not a "financial instrument" for the purposes of, and therefore are outside the scope of, EU derivatives regulation.

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[13] http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2012-18003a.pdf

[14] http://www.osc.gov.on.ca/documents/en/Securities-Category9/rule_20150727_91-506_unofficial-consolidation-derivatives.pdf

[15] http://ec.europa.eu/finance/securities/docs/isd/mifid/160425-delegated-regulation_en.pdf

[16] http://ec.europa.eu/transparency/regdoc/rep/3/2016/EN/3-2016-2398-EN-F1-1.PDF

Similarly, in the US, the Commodity Futures Trading Commission (CFTC) considers transactions for the sale or purchase of an amount of foreign currency to effect the actual delivery of a security by the relevant securities deadline to be a bona fide spot FX transaction, and therefore outside of the definition of a "swap."[17]

The GFXD has historically supported the above position with regulatory authorities in other global jurisdictions. We note that regulatory authorities in Canada have included FX Security Conversion Transactions as FX spot and thus outside the scope of Canadian derivatives regulation. Regulatory authorities in Hong Kong, Singapore and Australia have also excluded FX Security Conversion Transactions from trade reporting obligations. We are currently in discussions with regulatory authorities in Australia[18] and Hong Kong[19] on the application of variation margin to FX Security Conversion transactions.

<u>Implications of not treating FX Security Conversion Transactions as 'spot' transactions</u>

We consider that global regulatory efforts - and therefore domestic derivatives legislation - cannot have been intended to cover spot transactions in actual currencies affected 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 (T+2). Such transactions are entered into for the purpose of, and result in an exchange of currencies to be used to settle the related securities transactions denominated in a foreign currency. Subjecting these spot transactions that are incidental to related securities transactions to 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 Conversion Transactions to T+2 FX spot transactions, 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 securities settlement processing that exists today.

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), meaningful information to the regulatory authorities (in the form of regulatory reporting), or meaningful risk mitigation (in the form of daily variation margin). Furthermore, inconsistent treatment of these transactions globally should be avoided to ensure that the lack of an exclusion for FX Security Conversion Transactions from derivatives regulation in some jurisdictions (*e.g.*, Russia) 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 from derivatives regulations (*e.g.*, in the US and EU).

B. The CBR should delay any clearing mandate for FX non-deliverable forwards (NDFs) pending such time as there is further clarity into whether, when, and how a clearing mandate for NDF transactions may be implemented by regulators in other jurisdictions, in particular the US and EU.

Certain unique characteristics of the NDF market warrant special attention when considering a clearing mandate. These characteristics distinguish NDFs from the markets for interest rate and credit derivatives

[17] https://www.gpo.gov/fdsys/pkg/FR-2012-08-13/pdf/2012-18003.pdf

[18] http://gfma.org/correspondence/item.aspx?id=823

[19] http://gfma.org/correspondence/item.aspx?id=816

products, which mean NDFs are less suited to a clearing mandate at this time than interest rate and credit derivatives.

Furthermore, as mentioned in the Executive Summary, central clearing of NDFs is still in its infancy. The number of CCPs offering NDF clearing is somewhat limited and the number of firms offering client clearing services for NDFs is still small. As such, the ability for market infrastructures to develop to support an NDF clearing mandate, and implement processes for managing events such as a counterparty default, has not been established or, more importantly, tested. Premature introduction of mandatory clearing may unnecessarily introduce additional risk to the market and, as a result, undermine the benefits of central clearing.

Furthermore, NDF clearing has not achieved the same depth as IRS and CDS clearing had when the clearing mandate was first introduced for those asset classes in the US and in Europe. Whilst we understand that single digit percentages of NDF contracts are currently being voluntarily cleared, the introduction of the clearing mandate for the IRS and CDS was predicated on far more developed markets with many start-up issues already addressed while clearing was still voluntary (*i.e.*, approximately 60% of IRS contracts and 30% of CDS contracts were being voluntarily cleared since 1999 and 2009, respectively, when such mandates were or are being introduced). Further, key technical matters associated with NDF clearing remain unresolved. Because FX clearing services need time to mature, for their practices to be properly bedded down and "battle-tested" and for fundamental unresolved issues to be properly addressed, we are concerned that a mandate might unnecessarily introduce additional risk to the global currency market and, as a result, undermine the benefits of central clearing.

Such considerations were relevant in ESMA's 2015 response to its NDF clearing consultation in Europe: ESMA determined that the European NDF market was not yet ready to support a mandatory clearing obligation at that time.[20] Furthermore, as ESMA noted in its determination on NDF mandatory clearing, in cross-border markets participants are concerned that the application into force of clearing mandates should be globally synchronised to the greatest extent possible.

We therefore recommend the CBR delay any clearing mandate for NDFs (even if the actual commencement of the mandate would not to begin to take effect until at least 2018) pending such time as there is further clarity into whether, when, and how a clearing mandate for NDF transactions may be implemented by regulators in other jurisdictions, in particular the US and EU.

Given that NDF transactions comprise only a very small fraction of the total FX market[21] and are overwhelmingly short-dated in nature,[22] we also recommend that the CBR considers whether the reduction of counterparty credit risk to be achieved from mandating participants to move their bilateral exposures to a centrally cleared environment for NDF contracts at this time would in fact reduce risk in the aggregate and, most importantly, also reduce systemic risk.

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[20] https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-esma-234_-_feedback_statement_on_the_clearing_obligation_of_non_deliverable_forward.pdf

[21] Approximately 2.6% of the total FX market. BIS 2016 Triennial Survey: http://www.bis.org/publ/rpfxf16fxt.pdf

[22] According to the BIS 2016 Triennial Survey, approximately 39% of the market for FX forwards matured in one week or less, and approximately 98% of the market for FX forwards matured in one year or less. BIS 2016 Triennial Survey: http://www.bis.org/publ/rpfx16.htm

If, however, the CBR were to consider a clearing mandate for NDFs at some point, we also want to highlight several specific factors that we believe should be considered in determining the scope of any NDF clearing mandate:

- **Application of EMTA published currency templates without modification**. As part of their commitment to derivatives reform, the G20 Leaders agreed in 2009 that all standardised OTC derivatives contracts would be cleared through CCPs. To ensure the level of standardisation achieved to date in the NDF market is preserved, any clearing mandate for NDF contracts should be sufficiently clear that it only applies to standardised contracts which incorporate industry standardised currency templates in the form published by the Trade Association for the Emerging Markets (EMTA) (*i.e.*, without modification). This would ensure the clearing mandate does not encompass instruments with non-standard terms. Faced with limited liquidity, CCPs would find it difficult to manage the default of a clearing member responsible for transactions in varying currencies and maturities. For NDFs, any recommendation of a clearing mandate should not apply to contracts that have not adopted the relevant currency template in the form published by EMTA as those contracts would have different economic terms. It is important for regulatory authorities in Europe, US and the Asia Pacific region to coordinate to ensure that there is sufficient agreement concerning NDF contract specifications, including the adoption of these templates, before any clearing mandates are introduced in their respective jurisdictions.

- **Tenor of One-Year.** Any clearing mandate for NDFs should be limited to contracts with a tenor of one year or less. Open interest in these contracts is concentrated in shorter-dated tenors, there is insufficient liquidity in these contracts beyond one year to support clearing and, given the limited liquidity, CCPs would find it difficult to manage the default of a clearing member responsible for transactions with maturities greater than one year.

- **Extended Phase-In Period.** Any determination to introduce a clearing mandate for NDFs requires a sufficiently extended phase-in period, both in terms of timing and of the participants required to clear, to allow market participants to address issues arising from the fact that NDF clearing is in its infancy. Furthermore, we recommend that the phase-in period allow for any NDF clearing mandate development of a mature client clearing offering, and allow for a sensible substituted compliance/equivalent regime to be implemented where NDFs are traded cross-border.

We expect the volume of NDFs being voluntary cleared to grow over time, especially as other rules and regulations become live, such as those concerning capital requirements and the exchange of margin on uncleared OTC derivatives contracts. We therefore recommend that the CBR watch to see how voluntary NDF clearing evolves globally and as related rules and regulations come into play around the world before implementing any clearing mandate for NDF transactions in Russia.

C. The CBR should delay any clearing mandate for FX options pending such time as there is further clarity into whether, when and how a clearing mandate for FX options transactions may be implemented by regulators in other jurisdictions, in particular the US and EU.

Physically-settled FX options are "derivatives" but, once exercised, become a physically-settled FX transaction. Although FX options represent a very small portion of the FX market (approximately 5%),[23] physically-settled FX options face the same challenges regarding clearing as physically-settled FX forwards and swaps, as described previously in this letter.

In this regard, we wish to draw attention to a quantitative study we commenced in 2013 to understand the scale of transactions in the physically-settled OTC FX options market in order to size the same day liquidity challenge for clearing this market. Quantifying the size of this problem informs CCPs interested in extending their services to FX options products of the same day liquidity risk that they must be capable of managing in order to: (i) guarantee full and timely settlement of the currencies traded for this product; and (ii) ensure the guarantee is credible.

In contrast to other markets, 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.

In order to try and size the currency requirements facing a CCP when clearing physically-settled FX option trades, we produced the results of research[24] into the size of the physically-settled OTC FX options market, to establish the scale of the liquidity challenge of clearing physically-settled FX options. The study, which covered over 90% of OTC physically-settled FX option dealer flow over a number of years, estimated the size of the same-day liquidity risk from a failure of two clearing firms[25] to be the equivalent of $161 billion for each day, across 17 currencies.[26]

Furthermore, the same-day liquidity risk for physically-settled OTC FX options is in addition to the replacement cost risk and market risk which a CCP must manage with respect to its clearing service, and which must also be understood and analysed in relation to those (and other) risks. While the industry is collectively working together to find a solution for FX options clearing and settlement, given the size of the same-day liquidity challenge identified, whether and when a credible, robust and safe solution for clearing physically-settled FX options will in fact be implemented remains uncertain.

We expect the volume of FX options being voluntary cleared may grow, once a robust mechanism for settlement has been established, and as other rules and regulations become live, such as those concerning capital requirements and the exchange of margin on uncleared OTC derivatives contracts. We therefore recommend that the CBR wait to see how voluntary FX options clearing evolves globally before implementing any clearing mandate for such transactions in Russia.[27]

7. Do you think it is appropriate to apply the requirement for mandatory central clearing to other derivatives not indicated in this Section of the consultation paper, for example, to cross-currency interest rate swaps or options?

We have no comments in response to this question beyond our comments in response to Question 6 above.

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[23] BIS 2016 Triennial Survey http://www.bis.org/publ/rpfx16.htm

[24] http://gfma.org/Initiatives/Foreign-Exchange-%28FX%29/FX-Options-Clearing/

[25] The two firms chosen represented the largest, combined settlement obligation in each currency on any given settlement date.

[26] http://gfma.org/Initiatives/Foreign-Exchange-%28FX%29/FX-Options-Clearing/

[27] Even if the actual commencement of a mandate would not to begin to take effect until at least 2018.

8. Do you have any comments/suggestions regarding the classification of participants of the OTC derivative market for phasing in the requirement of mandatory central clearing of standardised OTC derivatives? If you do, please provide specific de-tails.

We support the points made by ISDA in its comment letter regarding the question of whether the obligations would apply to foreign entities. In our view, they should not, and the CBR should clarify this. We also refer however to our responses to Questions 11 and 12 below in respect of recognition of foreign CCPs.

9. Do you have any comments/suggestions regarding the Threshold Value for the purposes of implementing the requirement for mandatory central clearing of standardised OTC derivatives? If you do, please provide specific details.

We agree with the concept of a de minimis threshold and agree with the comments made by ISDA in its comment letter.

10. Do you have any comments/suggestions regarding the terms for phasing in the requirement for mandatory central clearing of standardised OTC derivatives depending on participant and derivatives category? If you do, please provide specific details.

Please see our response to Question 6 above, where we propose that if the CBR were to establish a clearing mandate for NDF transactions at this time, that the CBR consider whether the reduction of counterparty credit risk to be achieved from mandating participants to move their bilateral exposures to a centrally cleared environment for NDF contracts at this time would in fact reduce risk in the aggregate and, most importantly, also reduce systemic risk.

If so, a sufficiently tailored clearing obligation and suitable length for a phase-in period for compliance, to allow for and ensure global coordination, would be necessary to minimise the risk that the implementation of clearing obligations in Russia vs. elsewhere would not be unnecessarily disruptive to the global currency market.

11. Do you have any suggestions on applying the requirement for mandatory central clearing to standardised OTC derivatives entered into by an entity, which is a foreign resident?

We support the points made by ISDA in its comment letter. We too recommend that trades between a Russian entity and a foreign entity should not be captured by mandatory clearing obligations, but in the event that the CBR elects to subject foreign entities to the obligation, we recommend this should only be the case if the CBR establishes a framework for recognition of foreign CCPs and permits the obligation to be discharged by clearing at those CCPs instead.

12. Do you consider it reasonable to secure the recognition of a Russian CCP by a foreign state as a condition for mandatory central clearing of derivatives, where one party is an entity which is a resident of the foreign state in question? Do you think the condition should be expanded to include the requirement of simultaneous recognition of a CCP of the foreign state in question by the Russian Federation?

We recommend that an effective substituted compliance/equivalence process be established between CCPs/jurisdictions to support cross border activity. The imposition of any FX clearing mandate should be predicated on the basis that entities subject to Russian obligations are able to satisfy the obligations by clearing the relevant products through "recognized" third-country CCPs. If for example NDFs which involve a Russian party and a counterparty that is a foreign entity are deemed subject to a mandatory clearing obligation, we believe that such counterparties should be able to satisfy the Russian obligation to clear by clearing instead thorough a recognized third country CCP. As such, we believe that the CBR should have a process whereby it can recognize third-country CCPs.

Given a significant proportion of the trading activity in the FX market involves foreign institutions, restricting the ability of market participants to satisfy a clearing mandate solely via a local Russian CCP has the potential to fragment liquidity. In this respect, we agree with ISDA and encourage the CBR have continued regulatory dialogue with foreign regulators on achieving cross-border recognition of third country CCP regimes.

We would encourage the CBR, in establishing a timeline for the introduction of any mandate for NDF trades between Russian and foreign entities, to explicitly take account of the necessary lead time required to negotiate the cross-border recognition of CCPs, at least with major jurisdictions, and to ensure there is flexibility built into the Russian rules to allow for the suspension or deferral of the deadline should recognition not be achieved by proposed implementation dates.

13. Do you have any comments/suggestions regarding the exception from the general requirement of mandatory central clearing of Intra-Group Derivatives? If you do, please provide specific details.

We support the exemption of intragroup trades from any clearing mandate.

14. Do you have any comments/suggestions regarding the proposed conditions for classification of a derivative as an Intra-Group Derivative? In particular, are the requirements for a common (centralised) risk management system aligned with the existing business models?

We have no comments in response to this question.

15. Do you have any proposals regarding extension of the list of exemptions from the requirement for mandatory central clearing? In particular, is it necessary to exclude the derivatives made for the purpose of hedging from the requirement for mandatory central clearing? If you do, please provide specific details.

As discussed in our response to Question 6 above, we recommend that the CBR exempt physically-settled FX swaps and forwards from any clearing mandate. This does not mean that such transactions could not be voluntarily cleared, where this is desired and possible, but would best achieve a globally harmonized regulatory approach to <u>mandatory</u> clearing.

We also support the comments made by ISDA in this regard in their comment letter.

16. Do you have any comments/suggestions regarding the abovementioned legal devices for submitting a transaction for central clearing, and any suggestions on their improvement? If you do, please provide specific details.

We have no comments in response to this question.

17. Do you have any comments/suggestions regarding the proposed term (T0) to transfer a transaction to central clearing when the system relying on the execution of the initial transaction between the parties is applied? If you do, please provide specific details

We have no comments in response to this question.

18. Do you have any comments/suggestions regarding the principal-to-principal transaction model in terms of submitting a client's transaction for central clearing? If you do, please provide specific de-tails.

We have no comments in response to this question.

19. Do you have any comments/suggestions regarding the need of any improvements to the provisions of Clause 12, Article 4 of the Law on Clearing in terms of their applicability to the submission of a client's transaction for central clearing? If you do, please provide specific details.

We have no comments in response to this question.

20. Do you have any comments/suggestions regarding the standardisation of documentation facilitating the submission of transactions, including clients' transactions, for central clearing? If you do, please pro-vide specific details.

Please see our response to Question 6 above. To ensure the level of standardisation achieved to date in the NDF market is preserved, any clearing mandate for NDF contracts should be sufficiently clear that it only applies to standardised contracts which incorporate industry standardised currency templates in the form published by EMTA (*i.e.*, without modification). This would ensure the clearing mandate does not encompass instruments with non-standard terms. Faced with limited liquidity, CCPs would find it difficult to manage the default of a clearing member responsible for transactions in varying currencies and maturities. For NDFs, any recommendation of a clearing mandate should not apply to contracts that have not adopted the relevant currency template in the form published by EMTA as those contracts would have different economic terms.

We also agree with the comments made by ISDA in its comment letter in this regard.

21. Do you have any proposals regarding the need to standardise any other documentation? If you do, please provide specific details.

We have no comments in response to this question.

22. Do you have any suggestions regarding the introduction of a collateral requirement for non-centrally cleared OTC derivatives? If you do, please provide specific details.

We support the CBR's interest in establishing margin requirements for uncleared derivatives to reduce the build-up of systemic risk arising from this activity.

However, we urge the CBR, in adopting any uncleared margin regulations in the future, to ensure that the regulations are harmonised and consistent with those in other jurisdictions, and comparable with the standards for margin requirements for non-centrally cleared derivatives established in the International Margin Framework[28] (which establishes minimum standards for margin requirements for non-centrally

[28] http://www.bis.org/bcbs/publ/d317.htm

cleared OTC derivatives), in particular, the exemption of physically-settled FX forwards and swaps from initial margin requirements.[29]

Application of uncleared margin standards to FX products

We respectfully request the CBR to support the International Margin Framework by ensuring Russian regulations are consistent with it by not applying initial margin requirements to deliverable FX forwards and swaps. As indicated in the International Margin Framework, these products merit exclusion from the scope of the margin requirements due to their unique characteristics. Physically-settled FX forwards and swaps have been excluded from initial margin in line with the International Margin Framework in all jurisdictions which have proposed or finalized margin (collateral) requirements for non-centrally cleared OTC derivatives.

We would also urge the CBR consider excluding physically-settled FX forwards and swaps from the scope of variation margin provisions as well. The International Framework excepts physically-settled FX forwards and swaps from its margin requirements entirely, but does state that standards apply for variation margin for physically-settled FX forwards and swaps, citing the 2013 BCBS Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions[30] (BCBS FX Supervisory Guidance).[31]

In our view, a preferable approach to variation margin for physically-settled FX forwards and swaps would be to establish any variation margin requirement for such FX swaps and forwards via reference to the BCBS FX Supervisory Guidance, rather than include these FX products within the full scope of any CBR variation margin provisions. Physically-settled FX forwards and swaps are excluded from both initial and variation margin requirements under the final US Prudential Regulators' Rules and final US CFTC Rules. The uncleared margin proposals in Japan, Singapore and Canada also exclude physically-settled FX forwards and swaps from both initial margin and variation margin requirements.

For example, in Singapore the Monetary Authority of Singapore in its October 2015 Policy Consultation on Margin Requirements for Non-Centrally Cleared OTC Derivatives states that physically-settled FX forwards and swaps are exempted from the margin requirements, but that entities are expected to appropriately manage the risks associated with such FX transactions, referencing the BCBS FX Supervisory Guidance.[32] In Canada, physically settled FX forwards and swaps are excluded from the entirety of the uncleared margin requirements,[33] however the Office of the Superintendent of Financial Institutions Canada (OSFI) has separately issued an Advisory which establishes OSFI's expectations regarding the management of FX

[29] With variation margin to be implemented either by way of supervisory guidance or national regulation. International Margin Framework, p.7.

[30] http://www.bis.org/publ/bcbs241.pdf

[31] http://www.bis.org/bcbs/publ/d317.htm, see p.7.

[32]
http://www.mas.gov.sg/~/media/MAS/News%20and%20Publications/Consultation%20Papers/Policy%20Consultation%20on%20Margin%20Requirements%20for%20NonCentrally%20Cleared%20OTC%20Derivatives%201Oct.pdf (Footnote 7)

[33] See http://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/e22.aspx#01

settlement risk by banks, on the basis of the BCBS FX Supervisory Guidance.[34] In the US, the BCBS FX Supervisory Guidance is adopted by way of a Federal Reserve System Supervisory Letter.[35]

We suggest that physically-settled FX forwards and swaps be excluded from the scope of any CBR margin provisions in their entirety, and that any variation margin obligations for physically-settled FX forwards and swaps be addressed instead via the CBR's adoption of the recommendations in the BCBS FX Supervisory Guidance.

Margin for intra-group transactions

We also would support the CBR exempting intra-group transactions from any margin requirements. Inter-affiliate swaps provide an important risk management tool, allowing entities within a corporate group to transfer risk to the group entity best placed to handle it.

23. Do you have any comments/ suggestions regarding the described approach to the provision of information to the trade repository on a standardised OTC derivative, which has been submitted for central clearing? If you do, please provide specific details.

We agree with the CBR proposal that cleared trades should be reported only by the CCP, however we would like to raise one question. In FX, the trade flow is as set out in diagram 4 of the Consultation Paper, where there is an original bilateral trade between the counterparties before the trade is novated into two separate trades with the CCP. In the case of this bilateral trade, is the reporting party required to indicate that the trade is intended for clearing? We note that the current deadline for trade reporting to CBR is T+3, whereas the bilateral trade would be novated for clearing within a much shorter timeframe.

Conclusion

For the reasons set forth above, we strongly recommend that the CBR follow a similar approach to that taken in other global jurisdictions by not mandating a clearing obligation for physically-settled FX swaps and forwards.

Our view is that introducing CCPs into the deliverable FX market without ensuring that they only bear risks that they can properly manage would clearly increase, rather than decrease, potential systemic risk, especially in times of crisis. The CBR should also take into consideration that the predominant risk for deliverable FX products is settlement risk, rather than mark-to-market risk and. Adoption by the CBR of this view would be consistent with the emerging views of regulators globally and in recognition of international convergence on the treatment of deliverable FX forwards and swaps, with respect to clearing requirements.

Additionally, we recommend delaying any mandatory clearing obligation for NDFs or FX options at this time. While voluntary clearing can of course continue to occur, mandatory clearing of NDFs has not been implemented in either the US or Europe at this time. For the reasons we have detailed in this letter, and for the sake of global harmonization, therefore, we suggest that the CBR engage with international regulators to stay aware of how other jurisdictions are progress their thinking around mandatory clearing of FX products before initiating any such mandated regime in Russia.

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[34] See http://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/adv-prv/Pages/FXSR.aspx

[35] See http://www.federalreserve.gov/bankinforeg/srletters/sr1324.htm

Similarly, for uncleared margin, for the sake of global harmonization we urge the CBR to consider the way in which other jurisdictions have thought about and treated mandatory uncleared margining of FX products in their rules and regulations, when assessing the appropriateness and specifics of any such regime in Russia.

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We appreciate the opportunity to share our views on the Consultation Paper issued by the CBR. Please do not hesitate to contact Victoria Cumings on +1 212-313-1141, email vcumings@gfma.org should you wish to discuss any of the above.

Yours faithfully,

James Kemp
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