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Consistent Regulatory Treatment for Incidental Foreign Exchange (FX) Transactions Related to Foreign Securities Settlement - <u>"FX Security Conversions"</u>

The Global Foreign Exchange Division (GFXD) of the Global Financial Markets Association (GFMA) was formed in cooperation with the Association for Financial Markets in Europe (AFME), the Securities Industry and Financial Markets Association (SIFMA) and the Asia Securities Industry and Financial Markets Association (ASIFMA). Its members comprise 23 global FX market participants[1], collectively representing more than 90% of the inter-dealer FX 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.

We note the recent exchange of letters between the European Securities and Markets Authority[3] and the European Commission[4] and the request to clarify the treatment of certain FX products in Europe. As part of the clarification and as an interim step, the GFXD asks the European Commission to consider an FX transaction that is entered into solely to effect the purchase or sale of a foreign security – commonly referred to as **<u>"FX Security Conversions"</u>** – to be a bona fide spot transaction in situations where the settlement period is greater than two days.

To do so, we request the European Commission and National Competent Authorities in the EU to confirm that FX Security Conversions are not financial instruments under Section C4 of Annex I of

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, Morgan Stanley, Nomura, RBC, RBS, Société Générale, Standard Chartered Bank, State St., UBS, Wells Fargo and Westpac.
2 According to Euromoney league tables
3 http://www.esma.europa.eu/system/files/2014-184_letter_to_commissioner_barnier_-_classification_of_financal_instruments.pdf
4 http://www.esma.europa.eu/system/files/ares2014513399_ec_response_on_classification_of_financial_instruments.pdf

the Markets in Financial Instruments Directive (MiFID).[5] This would also have the effect of ensuring that FX Security Conversions are not subject to the European Markets infrastructure Regulation (EMIR).[6] The GFXD has continually requested consistent global treatment for FX Security Conversions[7], and this would bring Europe into convergence with the US and Canada.

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Background

Definition FX Financial Instruments under MiFID

Financial Instruments for all asset classes are defined in Section C of Annex I of MiFID, specifically for FX in C4. The text reads as follows:

paragraph C(4): "Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash"

Within the above definition for which FX instruments are included in MiFID, spot FX contracts are understood to not be financial instruments[8] for MiFID and other legislation that draws on MiFID definitions, such as EMIR.

FX Security Conversions are 'spot' transactions

Many of our members act as custodian for the securities of, in the case of broker-dealers, their customers and, in the case of banks, for their customers and those of their affiliated broker-dealers. Due to the increased access and investor interest in foreign markets, growing numbers of these customers are invested in foreign securities. To facilitate the purchase or sale of these foreign securities, bank custodians and broker-dealers, as part of their duties, often enter into a FX transaction that is incidental to and for the sole purpose of effecting the foreign securities transaction.

For example, when a customer wishes to purchase a US dollar-denominated security, the broker-dealer or bank custodian will enter into a corresponding FX transaction to have US dollars on hand to effect the securities transaction. These FX transactions are an integral part of the settlement process. Typically, the settlement cycle for most non-EUR denominated securities is trade date plus three days ("T+3")[9]. Accordingly, the bank custodian or broker-dealer would enter into a FX transaction on a T+3 basis as well. In some securities markets, for example in South Africa, the settlement cycle can take up to seven days (T+7).

To date, regulatory authorities in each of the US[10] and Canada[11] have defined transactions used solely to fund the purchase or sale of a foreign security where the settlement period is greater than T+2 days as a spot transaction and are thus outside the scope of derivatives regulation within those jurisdictions. We urge regulatory authorities in Europe to apply the same treatment to these transactions for purposes of derivatives regulation.

5 Directive 2004/39/EC.
6 Regulation (EU) No 648/2012.
7 http://www.gfma.org/correspondence/item.aspx?id=564
http://www.gfma.org/correspondence/item.aspx?id=532
http://www.gfma.org/correspondence/item.aspx?id=525
http://www.gfma.org/correspondence/item.aspx?id=314
http://www.gfma.org/correspondence/item.aspx?id=281
8 Commission Q&A, ID.191: "Spot market foreign exchange agreements are not considered to be financial instruments for the purposes of MiFID".
9 See www.sec.gov/investor/pubs/tplus3.htm
10 See http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-18003a.pdf (pages 48256-48258).
11 See Canadian Securities Administrators (CSA) CSA Staff Notice 91-302 Updated Model Rules – Derivatives Product Determination and Trade Repositories and Derivatives Data Reporting available at http://www.bcsc.bc.ca/uploadedFiles/securitieslaw/policy9/91-302_%5BMultilateral_CSA_Staff_Notice%5D.pdf; and equivalent from the Ontario Securities Commission (OSC) at http://www.osc.gov.on.ca/en/SecuritiesLaw_rule_20130606_91-506_91-507_rfc-derivatives.htm.

Implications of Not Treating FX Security Conversions as 'spot' market transactions

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. Such transactions result in an exchange of currencies to be used to settle the relevant 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 Conversions 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) or meaningful information to the regulatory authorities (in the form of regulatory reporting). Inconsistent treatment of these transactions globally should be avoided to ensure that the lack of an exclusion for FX Security Conversions from derivatives regulation in some jurisdictions (e.g., Europe) doesn't create unnecessary disincentives from transacting in securities in those jurisdictions by raising their transactional costs relative to other jurisdictions which have excluded them (e.g, in the United States and Canada).

We would also like to reference the letter that the Investment Management Authority (IMA) submitted to you on the treatment of FX Security Conversions, noting specifically that we support their submission.

Developments Surrounding Security Settlement Cycles

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

Conclusion

For the reasons set out above, we strongly urge that regulatory authorities in Europe confirm that FX Security Conversions (defined below) are spot transactions and therefore not included within the definition of a MiFID financial instrument. We provide the potential following definition:

FX Security Conversion Transaction: the purchase, sale or exchange of a foreign currency for the sole purpose of effecting a purchase or sale of a foreign security when the settlement period for such [*FX*] transaction is within the settlement cycle for such foreign security.

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We appreciate the opportunity to share our views on the treatment of FX Security Conversions and any future discussions on the definitions of FX products. Please do not hesitate to contact Mandy Lam (1-212-313-1229, mlam@gfma.org) or Andrew Harvey (44-207-743-9312, aharvey@gfma.org) should you wish to discuss any of the above.

Yours sincerely,

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