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September 10, 2013

Mr. Steven Maijoor
Chair
European Securities and Markets Authority
CS 60747
103 Rue de Grenelle
75345 Paris Cedex 07
France

Re: *Discussion Paper on the Clearing Obligation under EMIR*

Dear Mr. Maijoor:

The Investment Company Institute ("ICI")[1] and ICI Global[2] appreciate the opportunity to provide comments on the discussion paper issued by the European Securities and Markets Authority ("ESMA") on the clearing obligation under the European Market Infrastructure Regulation ("EMIR").[3] The Discussion Paper addresses various aspects of the clearing obligation, including the procedures for the determination of the classes of over-the-counter ("OTC") derivatives to be subject to the clearing obligation. The Discussion Paper also discusses issues with respect to the clearing obligation for specific types of derivatives. In this letter, we provide our views on one particular type of derivative that should not be subject to mandatory clearing– foreign exchange ("FX") forwards and swaps, including non-deliverable forwards ("NDFs").[4]

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[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds ("ETFs"), and unit investment trusts ("UITs"). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $15.4 trillion and serve over 90 million shareholders.

[2] ICI Global is the global association of regulated funds publicly offered to investors in leading jurisdictions worldwide. ICI Global seeks to advance the common interests and promote public understanding of global investment funds, their managers, and investors. Members of ICI Global manage total assets in excess of US $1 trillion.

[3] *Discussion Paper, The Clearing Obligation under EMIR*, European Securities Markets Authority (July 12, 2013), *available at* http://www.esma.europa.eu/system/files/2013-925_discussion_paper_-_the_clearing_obligation_under_emir_0.pdf ("Discussion Paper").

[4] We, along with the American Bankers Association, and the ABA Securities Association, have filed a petition with the Commodity Futures Trading Commission ("CFTC") requesting exemptive relief from certain aspects of the swap regulatory regime (including mandatory clearing requirement) for NDFs. *See* Letter from Karrie McMillan, General Counsel, ICI, Dan Waters, Managing Director, ICI Global, Cecelia Calaby, Executive Director and General Counsel, ABA

U.S. funds that are regulated under the Investment Company Act of 1940 ("ICA") and non-U.S. regulated funds publicly offered to investors (collectively, "Regulated Funds") use swaps and other derivatives in a variety of ways. Derivatives are a particularly useful portfolio management tool in that they offer Regulated Funds considerable flexibility in structuring their investment portfolios. Uses of swaps and other derivatives include, for example, hedging positions, equitizing cash that a Regulated Fund cannot immediately invest in direct equity holdings, managing a Regulated Fund's cash positions more generally, adjusting the duration of a Regulated Fund's portfolio, or managing a Regulated Fund's portfolio in accordance with the investment objectives stated in a Regulated Fund's prospectus. Given that many swaps businesses are conducted across multiple jurisdictions, ICI and ICI Global members engage in derivatives transactions that involve an EU counterparty. To employ OTC derivatives in the best interests of fund shareholders, ICI and ICI Global members have a strong interest in ensuring that the derivatives markets are highly competitive and transparent and are regulated consistently worldwide.

Risk Profile of FX Forwards and Swaps Market is Markedly Different from Other Derivatives Markets

As noted in the Discussion Paper, EMIR recognizes that 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."[5] We agree that the risk profile for the FX forwards and swaps market is markedly different from other derivatives markets and makes mandatory clearing of these FX derivatives unnecessary. First, the FX forwards and swaps market is highly transparent and liquid.[6] Second, unlike other derivative instruments, counterparties exchange the full amount of the relevant currencies on pre-determined terms that are, normally, clear and straightforward and do not change during the lifetime of the contract. Because the payment obligations on FX forwards and swaps are fixed and predetermined, FX forwards and swaps participants know their own and their counterparties' payment obligations and the full extent of their exposure throughout the life of the contract. Third, FX forwards and swaps are predominantly short-term instruments with more than 98 percent of the market maturing in one year or less and 68 percent of the market maturing in one week

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Securities Association, and Timothy E. Keehan, Vice President and Senior Counsel, American Bankers Association, to Melissa Jurgens, Secretary, CFTC, dated February 26, 2013, *available at* http://www.ici.org/pdf/27057.pdf (petition for exemptive relief for NDFs so that they are regulated in the same manner as FX forwards and swaps).

[5] *See Discussion Paper*, Section 5.2 (paragraph 139), *supra* note 3.

[6] *Determination of Foreign Exchange Swaps and Foreign Exchange Forwards under the Commodity Exchange Act*, 77 FR 69694, 69700 (Nov. 20, 2012) *available at* http://www.gpo.gov/fdsys/pkg/FR-2012-11-20/pdf/2012-28319.pdf ("U.S. Treasury Exemption") ("the market for foreign exchange transactions is one of the most transparent and liquid global trading markets").

or less.[7] As a result of having short maturities, FX forwards and swaps contracts pose significantly less counterparty credit risk than other derivatives.

Settlement Risk of FX Forwards and Swaps is Adequately Eliminated

The primary risk of FX forwards and swaps is settlement risk, and the predominant way of settling FX forwards and swaps ensures that the risk is essentially eliminated. Settlement risk is the risk that one party to an FX transaction pays out the currency it sold but does not receive the currency it bought. In this situation, a party's FX settlement exposure equals the full amount of the purchased currency.

Settlement risk is virtually eliminated when an FX transaction is settled using a "payment-versus-payment" ("PVP") settlement system, of which CLS Bank International ("CLS") is the most widely used.[8] One of the key risk mitigants utilized by a PVP settlement system is a simultaneous PVP settlement of matched payment instructions. The combination of simultaneous exchange of settlement payments and other risk management processes typically used by PVP settlement systems represents sufficient protection for FX forwards and swaps counterparties.

Mandatory clearing would not be the appropriate mechanism to address settlement risk. We agree with ESMA that "clearing specifically addresses counterparty credit risk, and may not be the optimal solution for dealing with settlement risk."[9] In fact, requiring clearing for these FX derivatives would "disrupt the existing settlement process by introducing additional steps between trade execution and settlement that pose significant operational challenges."[10] The risks and operational challenges of mandating central clearing would significantly outweigh the benefits by undermining the safety and

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[7] FX forwards and swaps are predominately short-term transactions. In contrast, interest rate swaps and credit default swaps generally have maturity terms between two and thirty years, and five to ten years, respectively. *U.S. Treasury Exemption*, *id.* at 69697 (citing BIS data).

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

[9] *See Discussion Paper*, Section 5.2 (paragraph 139), *supra* note 3.

[10] *U.S. Treasury Exemption*, *supra* note 6 (U.S. Treasury determined that the "operational challenges and potentially disruptive effects" on the FX swaps and forward market associated with adding a central clearing requirement "significantly outweigh the marginal benefits that central clearing would provide").

efficiencies of the existing FX swaps and forwards markets.[11] Moreover, we are concerned that requiring that these instruments be subject to a clearing obligation with its attendant margin requirements by clearinghouses and clearing members could drain significant liquidity from global markets as a whole (given the volume of FX trading) and could threaten practices in the FX forwards and swaps market that help limit risk and ensure that the market functions effectively.[12] Regulators also have a long history and extensive experience in monitoring the FX forwards and swaps market and its major market participants.

Opportunity for Regulatory Arbitrage Should Be Avoided

We believe that imposing a clearing obligation on FX forwards and swaps may result in regulatory arbitrage and market fragmentation. As ESMA is aware, in November 2012, the U.S. Department of the Treasury ("U.S. Treasury") issued a written determination exempting FX forwards and swaps from the definition of "swap," in accordance with the applicable provisions of the Commodity Exchange Act ("CEA").[13] The U.S. Treasury determined that FX forwards and swaps should not be regulated as swaps under the CEA and should be exempted from the definition of the term "swap" because of the distinctive characteristics of these instruments. Unlike most other swaps, FX forwards and swaps have fixed payment obligations, are settled by exchange of actual currencies, and are predominantly short-term instruments. As a result of the U.S. Treasury's exemption, FX forwards and swaps will not be subject to mandatory clearing under the CEA.[14] We believe not subjecting FX forwards and swaps to a clearing requirement in the European Union would assist with international convergence for this type of OTC derivatives and reduce the opportunity for regulatory arbitrage.

NDFs Should Be Provided Same Regulatory Treatment as FX Forwards and Swaps

For the same reasons we discuss above for FX forwards and swaps, we also urge ESMA not to require clearing of NDFs. In restricted markets where one of the relevant currencies is incapable of

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[11] *See* Letter from Karrie McMillan, General Counsel, ICI, and Cecelia Calaby, Executive Director and General Counsel, ABA Securities Association, to Elizabeth M. Murphy, Secretary, SEC, and David A. Stawick, Secretary, CFTC, dated July 22, 2011.

[12] In the final policy framework establishing minimum standards for margin requirements for non-centrally cleared derivatives, the BCBS and the International Organization of Securities Commissions determined not to apply margin requirements to physically settled FX forwards and swaps. *Margin Requirements for Non-Centrally-Cleared Derivatives*, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, September 2013, *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD423.pdf

[13] *U.S. Treasury Exemption*, *supra* note 6. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act") authorizes the Secretary of the Treasury to issue a written determination that FX swaps, FX forwards or both should not be regulated as swaps under the CEA.

[14] FX forwards and swaps continue to be subject to regulatory reporting, business conduct standards, and anti-fraud and anti-manipulation provisions of the CEA.

delivery or impracticable to deliver, many market participants with cross border businesses, including Regulated Funds, use an NDF to achieve the same economic result as an FX forward. Specifically, because of currency controls or local law restrictions in certain foreign jurisdictions, market participants use an NDF to access emerging markets and currencies and close out the trade at maturity by delivering the net value of the underlying exchange denominated in a pre-determined deliverable currency. NDFs are commonly used by Regulated Funds to hedge currency risk involving restricted currencies, and NDFs are the only product available to efficiently and effectively hedge that risk.

Like FX swaps and FX forwards, NDFs are predominantly short-term in duration. Imposing central clearing on NDFs would introduce similar challenges as with the FX swaps and FX forwards markets – adding capital costs to a market that is short-term in nature and functioning efficiently. Further, unlike deliverable FX forwards, NDFs only involve the delivery of the net change in value between the time the trade was entered into and the time it is settled. Therefore, as a pure financial instrument, NDFs entail significantly less credit risk than a deliverable FX forward, where gross amounts are delivered at settlement.

We urge ESMA not to treat NDFs differently from FX forwards, as doing so would result in unequal regulatory treatment of functionally identical products.[15] Differential treatment of NDFs would potentially lead to distortions of existing markets and create incentives for market participants to direct NDF transactions to offshore jurisdictions they perceive to be preferable from a regulatory (and thus economic) point of view. It would also lead to increased costs in hedging currency risk in restricted markets to the detriment of market participants that invest in the economies of countries with restricted currencies.

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We appreciate the opportunity to share our views on the unique characteristics and different risks profiles of FX swaps and forwards, including NDFs, that should dissuade regulators from imposing a mandatory clearing obligation on these instruments. If you have any questions on our comment letter, please feel free to contact the undersigned or Sarah Bessin at 202-326-5835, Jennifer Choi at 202-326-5876, or Giles Swan at 011-44-203-009-3103.

Sincerely,

[15] If NDFs become unduly costly to execute, market participants would be forced to select from the following options, none of which are attractive: (i) forego the protections afforded by these products (which introduces the risks that the hedge was otherwise meant to address); (ii) reduce their participation in the emerging markets (thus foregoing a strategy otherwise viewed by management as attractive); or (iii) in some cases, seek to execute NDFs in markets that would exempt these instruments from the clearing requirement.

/s/ Karrie McMillan

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