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FINANCIAL MARKETS
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CONSULTATION DOCUMENT

FX FINANCIAL INSTRUMENTS

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COMMISSION SERVICES NON-PAPER FX FINANCIAL INSTRUMENTS - CONSULTATION

I. INTRODUCTION

The exchange of foreign currency (FX) is the keystone of a global economy and also the world's largest and most liquid market. However concerns have been raised about whether the regulation of FX activity is adequate and applied on a consistent basis. This consultation paper seeks views on where the boundary lies between what is an FX financial instrument and what is not, specifically the definition of a spot FX instrument. Once a contract is considered a financial instrument for the purposes of Directive 2004/39/EC (MiFID), then activity in that instrument may give rise to authorisation and other obligations under MiFID. Moreover, since the definition of financial instrument in MIFID is used in a wide variety of other legislation, the classification of an FX contract as a financial instrument will bring them within the ambit of this legislation, in particular EMIR and its reporting obligations.

II. BACKGROUND

EU LEGAL FRAMEWORK & DEFINITIONS

Financial instruments for the purposes of MiFID are defined in Section C of Annex I of MIFID. Point (4) of Section C of Annex I refers to "*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*". Article 39(2) of Regulation (EC) No 1287/2006 (MiFID L2) provides a specification of what constitutes a spot contract for the purposes of commodities, but not for FX contracts. The majority of Member States do not have a definition of a forward or delineate a boundary for FX spots in their legislation (5 have legislation, 13 do not - although 7 of these apply supervisory practices that delineate between spots and forwards) and in the minority of cases where they have, the approach adopted has differed[1]. As a result this provision is not currently being applied on a harmonised basis across the Union. Article 4(2) of MiFID allows the Commission to issue implementing regulations to clarify definitions in order to take account of developments on financial markets, and to ensure the uniform application of MiFID. It is the Commission's intention to do so in respect of the definition of a spot FX contract. The definition of FX spot contracts has important implications not only as regards authorisation requirements under MIFID, but also as regards the scope of application of other pieces of EU financial regulation including EMIR, CRD4 and MAR.

Question:

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

[1] See ESMA's letter of 14 February 2014 to the Commission on the clarification of the definition of derivative under EMIR

III. ISSUES FOR DISCUSSION

A. FOREIGN EXCHANGE MARKET

Trading in foreign exchange markets is the largest financial market in the world with turnover increasing to $5.3 trillion per day in April 2013, from $3.3 trillion in April 2007. The rise in FX turnover appears to be the result of, at a macro level, the increasing diversification of international asset portfolios (rather than increased interest in FX as an asset class) and, at a micro level, the increased share of market trading has reduced internalisation of order flows by dealers and increased "hot potato trading"[2]. The US dollar is the most actively traded currency, and was on one side of 87% of all transactions with the Euro second (33%). More than 50% of foreign currency trading in the world takes place in Europe, the majority of which takes place in the United Kingdom.

Table 1 Counterparties to FX Contracts($bn daily turnover

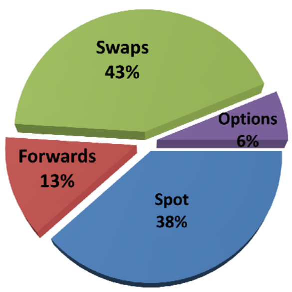
	All FX	Spot	Forwards
Reporting dealers	2,070	675	182
Other financial institutions	2,809	1,183	402
official sector	53	12	8
Non-financial customers	465	188	96
Of which: prime brokered	874	598	116
Of which: retail-driven	185	78	24

Source BIS Triennial Central Bank Survey April 2013

Transactions in foreign exchange are performed to fulfil 4 principle functions: (1) as a **means of Payment,** either in the **real economy –** to facilitate the payment for goods, services or direct investment; or the **financial sector** – to effect payment for financial market activity (2) **Hedging**: transactions may be used to hedge foreign currency risk for financial assets or commercial contracts; (3) **Investment / speculation**: foreign currency may be invested in as an asset and (4) **Monetary and FX policies:** central banks may undertake foreign exchange transactions as part of their monetary policies functions.

Payment instruments are not typically considered financial instruments and are usually subject to payments infrastructure and payments regulatory oversight. Determining the purpose of a transaction is however difficult. It might be inferred from the counterparties; currently the large majority of FX trading is by financial institutions with non-financial counterparties only accounting for only 9% of turnover by counterparty. However financial institutions may conduct trades as a means of payment, on behalf of non-financial counterparties and conversely non-financial counterparties may use FX for investment purposes. MiFID therefore generally uses activities and counterparties to define exemptions and classifies a contract as a financial instrument by looking at the type or characteristics of instruments. A variety of financial instruments are used to perform FX transactions such as swaps, options, forwards and spots. FX swaps were the most actively traded FX instruments in April 2013, at $2.2 trillion per day, followed by spot trading at $2.0 trillion and forwards accounting for $680bn per day.

Graph 1 Share of FX instruments in daily trading (BIS)



Question:

[2] http://www.bis.org/publ/qtrpdf/r_qt1312e.htm

- **(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?**

B. SETTLEMENT AND DELIVERY

Spots are contracts for the purchase of a currency for immediate delivery. This immediacy means an FX contract can only be used to buy/pay for a currency and not for investment or hedging purposes. Therefore they are not usually classified as financial instruments. Forwards by contrast are contracts for the purchase of a currency for delivery at a later specified date. Because the price of the currencies can vary over time, a loss or a gain may arise, meaning that the forward can be used for investment or hedging purposes. However such a contract may also be used to effect payment for, for example, an export contract.

> **A spot contract** is a "single outright transactions involving the exchange of two currencies at a rate agreed on the date of the contract for value or delivery (cash settlement) within two business days".
>
> **An outright forward** is a "contract to exchange a predetermined amount of one currency for another at an agreed date in the future, based upon a rate of exchange determined at the trade date of the contract".
>
> Source BIS April Triannual Report

In practice, though, the delivery and settlement of a spot transaction does not take place immediately, for technical reasons or as a result of market practice, and normally takes place a number of days thereafter. It is therefore necessary to determine how long "immediate" is and at what point a spot becomes a forward.

Table 2 Settlement periods

	$ bn	Share
Spots 2 days	2,046	75%
Forwards Up to 7 days	271	10%
Forwards 7 days to 1 year	378	14%
Forwards Over 1 year	31	1%
Total	2,726	100%

Source BIS Triennial Central Bank Survey April 2013

Two business days delivery appears to be the most widely used delineation for a spot contract. Where Member States have determined a delineation for spots, either in legislation or as a matter of supervisory practice, the majority adopt a 2 day delineation and/or look at standard market practice. However, cut off periods up to 7 days are also applied in the Union. Nonetheless, in practice settlement periods can be shorter – in September 2013 CLS introduced same day settlement for USD/CAD pairs and T+1 settlement is common. On the other hand, settlement is frequently cross border and so differing bank or official holidays may extend settlement periods. In addition, particular currency pairs may require longer a settlement period or require conversion into two legs of more common currencies – typically dollars.

Means of settlement may also differ; while for a spot or "*outright*" forward, settlement is by way of exchange of the relevant currencies, for non-deliverable forwards there is no physical settlement but instead, based on the price movement of two currencies, a net cash settlement will be made by one party to the other – usually in dollars. This netting process may mean that they cannot be used for payment.

Questions:

- **(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?**

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

C. FX MARKET DEVELOPMENTS

The trading of an instrument may also provide useful background and is used, in certain cases, in MIFID to determine whether a contract is a financial instrument. One of the most significant developments in FX trading since the 1990s has been the establishment of electronic trading platforms (such as EBS and Reuters). Electronic trading now dominates and 64% of spot FX trades are conducted electronically. Nonetheless voice trading remains significant, in particular for trading more complex derivatives - 62% of the options deals are done by phone.[3] The availability of electronic platforms and reduced trading costs have in turn encouraged the participation of a wider variety of market participants. This has meant that the FX market has become less dealer-centric with the market share of reporting dealers falling to 39% from 63% in the late 1990s. In addition these changes have also been accompanied by increased use of HFT and algorithmic trading. Algorithmic trading at EBS grew between 2007 and 2013 from 28% to 68% of volume and of this, around 30–35% of volume is HFT-driven.[4] Another notable change has been the introduction of retail-oriented platforms (eg FXCM and OANDA) from around 2000. Retail FX trading has since grown quickly and accounted for 3.5% and 3.8% of total and spot FX turnover, respectively in 2013, although growth in this segment may now have slowed[5].

Question:

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

D. FX RISKS

The classification of a contract as a financial instrument under MiFID also brings that contract within the ambit of other financial services legislation. Generally, the objective is to address the risks this instrument poses to investors, firms or the system as a whole, whether through prudential, conduct or transparency/reporting requirements.

Spot and FX derivative transactions are subject to three main risks - counterparty credit risk, market risk and settlement risk. Counterparty credit risk is the risk that the counterparty will default before settlement while market risk is the risk that the value of the contract changes over time before settlement. Clearly the longer the settlement period, the greater these risks. Settlement risk is the risk that, having paid for the currency being sold, a counterparty defaults and does not pay for the currency bought. This is an event risk that is independent of settlement duration. Due to their short duration, settlement risk is the main risk for spots and short term forwards.

[3] http://www.bis.org/publ/qtrpdf/r_qt1312e.htm
[4] BIS http://www.bis.org/publ/mktc05.pdf
[5] http://www.bis.org/publ/qtrpdf/r_qt1312e.htm

To address this settlement risk, the private sector and central banks, created CLS Bank (CLS) which settles all the main FX products; spot, forwards, swaps and non-deliverable forwards[6]. The 17 currencies covered by CLS account for nearly 94% of FX market turnover and CLS settles over three quarters of inter-dealer trades and 93% of FX forwards and swaps traded globally[7]. Nonetheless, given the size of the FX market, this still leaves large value of FX transactions that are between institutions that are either not one of the 63 direct members of CLS or that settle by other means[8]. For non CLS settled transactions, other settlement arrangements are used e.g. PVP. These only permit payment of currency once the other currency is paid and so effectively eliminate settlement risk.

Question:

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

E. Transition Periods and International Aspects

Just as the delineation and regulation of FX differs amongst EU Member States, different approaches are taken internationally. These differences may create obstacles for market participants in respect of cross border transactions. For regulators the delineation of a spot helps determine the regulatory perimeter and so creates the possibility of conflicts when deciding third country or mutual recognition regimes. Moreover, given the different approaches in Member States, an adjustment period may be necessary before a harmonised approach is implemented.

Questions:

- **(7) Do you think a transition period is necessary for the implementation of harmonised standards?**
- **(8) What is the approach to this issue in other jurisdictions outside the EU? Where there are divergent approaches, what problems do these create?**

F. Regulatory Implications of classification as a financial instrument

The classification or non- classification of an FX contract as a financial instrument has implications for a wide variety of existing and forthcoming European legislation, in particular:

MiFID: The scope of MiFID is applied to investment firms providing investment services and activities relating to any of the financial instruments in Annex C. Classification of an FX contract as a financial instrument may therefore bring an entity within the authorisation requirement and subject them and this activity to other obligations such as the investor protection and algorithmic trading regimes.

EMIR: Article 2(5) of Regulation (EU) No 648/2012 (EMIR) defines a derivative as including, inter alia, a contract within the scope of Section C4 of Annex I of MIFID. Inclusion of FX contracts as a financial

[6] http://www.cls-group.com/About/Pages/default.aspx
[7] US Treasury 2012 http://www.treasury.gov/press-center/press-releases/Documents/11-16-2012%20FX%20Swaps%20Determination%20pdf.pdf
[8] http://www.economist.com/news/finance-and-economics/21586540-cls-keeps-market-safe-settlement-risk-needs-add-more

instrument would mean that (1) mandatory reporting of transactions into trade repositories would be required; (2) FX contracts may be taken into account for the calculation of the clearing threshold; (3) A clearing obligation and bilateral risk mitigation techniques for non-centrally cleared transactions may be required under level 2 measures.

CRD: The Regulation on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 uses financial instruments as defined in MiFID.

CSDR: the proposal for Regulation on improving securities settlement in the EU and on central securities depositories (CSDs) uses the notion of financial instruments as defined by MiFID.

Market Abuse: the scope of the Regulation on insider dealing, the improper disclosure of inside information and market manipulation's is defined by reference to financial instruments as defined in MiFID.

Benchmarks proposal: The scope of proposal for a Regulation on indices used as benchmarks in financial instruments and financial contracts[9] is defined by reference to financial instruments.

Questions:

- **(9) Are there additional implications to those set out above of the delineation of a spot FX contract for these and other applicable legislation?**
- **(10) Are there any additional issues in relation to the definition of FX as financial instruments that should be considered?**

[9] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52013PC0641&from=EN