

EMIR and FX instruments

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The existing problem

- ❑ Definition of **settlement period** for **fx spot vs. fx forward**
- ❑ In the EU legislation it is not clear which settlement period delimits fx spot from fx forward.
- ❑ Different EU jurisdictions are interpreting the rule differently, which may have several implications.
- ❑ Implications:
 - EMIR: fx spot are not subject to EMIR obligations (reporting, clearing, margin, portfolio reconciliation, daily valuation, etc.)
 - MIFID: fx forwards are considered financial instruments, not fx spot.
 - CRR: capital charges related to counterparty risk in relation to fx forward; not fx spot.
 - Other European legislation refers to financial instruments as defined in MIFID.

EMIR definition

- ❑ “Derivative” or “derivative contract” definition under EMIR cross-refers to MIFID definition of financial instruments (points (4) to (10) of Section C of Annex I of MIFID Directive).

(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

(9) Financial contracts for differences.

- ❑ Fx Spot are not considered financial instruments, as confirmed by the European Commission in its MIFID Q&A:

Spot market foreign exchange agreements are not considered to be financial instruments for the purposes of MiFID (ID 191).

Spot foreign exchange transactions are not considered financial instruments under MiFID irrespective of the purpose of the operation, i.e. commercial or otherwise. (ID 885)

Definition of Fx Spot vs. Forward

- ❑ Luxembourg regulator (*Commission de Surveillance du Secteur Financier (CSSF)*) announcement on 12 February 2014 (up to 7 days or for commercial purposes EMIR would not be applicable until further clarification)

- ❑ On 14 February 2014 letter from ESMA to the European Commission inviting it to adopt an implementing act clarifying the definition of currency derivatives in relation to:
 - (i) the frontier between spot and forward;
 - (ii) their conclusion for commercial purposes.

Transposition of MIFID in Member States differs in relation to financial instruments:

- Differences on the settlement or delivery date;
- Differences due to the commercial nature of the transaction

which leads to a different application of EMIR.

Definition of Fx Spot vs. Forward (cont.)

- On 26 February 2014, the European Commission answered ESMA's letter:
 - Agrees that fully consistent transposition through out the Union of the relevant MIFID provisions defining derivative contracts is required;
 - DG MARKT to urgently assess the options for action to ensure consistent application of the legislation.
 - Preliminary views:
 - ✓ Spot vs. forward: need to differentiate spot vs derivative (forward) – delivery periods.
 - ✓ The notion of “commercial purpose” and point (4) of Section C of Annex I to MIFID.

Definition Fx Spot vs. Forward (cont.)

- ❑ Consultation Document on FX Financial Instruments dated 10 April 2014.
- ❑ 6th Meeting of the Expert Group of the European Securities Committee (EGESC) on 28 April 2014:

Presentation and discussion on the preparation of a delegated act under MIFID I pertaining to the delineation between foreign exchange spot derivative contracts.

Further work scheduled for the next EGESC meeting in June 2014.

- ❑ MIFID II: no amendments to this regard on points (4) and (9) of Annex I Section C”.
- ❑ Letter of EBF dated 9 May 2014:
 - Proposes a common T+2 definition for fx spot, with exceptions (ej: contingent transactions that settles up to T+7; currency pairs which settles later than T+2)
 - Transition period for implementation
 - Majority of members agree that NDFs should be considered as financial instruments
 - Favours a global common approach to the issue

Treatment of FX Spot under Dodd-Frank Act

- ❑ Bona Fide FX Spot Transactions are not within the definition of “swap” under the Commodities Exchange Act and hence outside the scope of the DFA.
- ❑ In order to be considered a bona fide FX spot transaction if (i) it settles within the customary timeline on the relevant market for the currency (generally T+2, but potentially longer depending on the currency); (ii) settles via an actual delivery of the currencies; and (iii) it is not used to avoid applicable foreign exchange regulatory requirements.
- ❑ An agreement (a “Securities Conversion Transaction”) for the purchase or sale of an amount of a relevant currency equal to the price of a security referenced in such currency will also be considered a bona fide FX Spot transaction if (i) the security and the purchase/sale of the currency are executed at the same time and (ii) the delivery of the security and the currency also coincide.

