FOREIGN EXCHANGE JOINT STANDING COMMITTEE

RESPONSE TO TREASURY CONSULTATION DECEMBER 2005

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Introduction

The FX JSC

The Foreign Exchange Joint Standing Committee (FX JSC) was established in 1973 under the auspices of the Bank of England. It is a forum for banks and brokers to discuss broad market issues and the focus of the FX JSC's regular work remains issues of common concern to the different participants in the foreign exchange market. The Bank of England provides the FX JSC's Chairman and the FX JSC includes senior staff from many of the major banks operating in the foreign exchange market in London, as well as from voice- and electronic-brokers, corporate users of the foreign exchange market, the Financial Services Authority (FSA) and representatives from the British Bankers' Association, the Association of Corporate Treasurers and the Wholesale Market Brokers' Association.

A core role of the FX JSC is to maintain the Non-Investment Products Code (NIPs Code). The NIPs Code sets out standards of good practice in the wholesale markets in Non-Investment Products, specifically the sterling, foreign exchange and bullion wholesale deposit markets, and the spot and forward foreign exchange and bullion markets. The Code was drawn up by a wide cross-section of market participants, including the Bank of England and FSA, and work to maintain the Code is co-ordinated through the FX JSC, the (Sterling) Money Markets Liaison Group and the Management Committee of the London Bullion Market Association.

The FX JSC established a working group on the Markets in Financial Instruments Directive (MiFID) in late 2005 to facilitate liaison with the FSA and HM Treasury on MiFID-related impacts to the FX market; and to brief and provide guidance to the FX JSC on MiFID and its implementation in the UK. As a result of the work done by the MiFID working group, the FX JSC would like to take advantage of this consultation process to highlight a number of issues of relevance to the FX market.

Foreword

The FX JSC welcomes the opportunity to comment on draft legislation implementing MiFID issued in December 2005 by HM Treasury. In particular, we welcome the inherent recognition by HM Treasury in its December 2005 consultation paper of the value of providing responses that are sometimes not specifically requested in the consultation document.

We recognise the inherent uncertainty that exists at this level of implementation given a number of implementing initiatives in progress including the fact that at this level of the Lamfalusy process there is still a significant amount of further development ahead. We also look forward to the FSA consultation document due to be released imminently which is likely to address a number of the issues raised here in more detail and the Directive’s final implementing measures which are still pending. In particular, we will be interested in whether the FSA intends to include as perimeter guidance an appropriately updated version of the 1996 SIB guidance referred to below.

We note the general policy in the Executive Summary of the Consultation Document that aspires to ensure minimal change is made to the structure and the language of the Regulated Activities Order and proposes to make minimum changes in respect of the way the boundaries of financial regulation are drawn. We are pleased with the Commission’s desire to ensure a greater degree of consistency in implementation than was the case with the ISD and its wish to avoid the problems of differing interpretation that characterised the implementation of the ISD. Our views in this paper have taken these into account and are consistent with these policies.

The main purpose of this response is twofold; firstly, we seek to highlight the current regulatory treatment of the foreign exchange spot and forward market in the UK and the way in which this market is regulated within the EU. Secondly, this paper seeks to provide an analysis of why the FX JSC supports maintaining the status quo in relation to the extent to which foreign exchange forward transactions (and swaps) are included in the list of “financial instruments” contained in Sections 4-10 of Section C of Annex 1 of MiFID. From a UK perspective any uncertainty in this area would pose significant obstacles to the planning for MiFID.

Throughout this note we consider references to ‘forwards’ to cover ‘FX swaps’ which are equivalent to a spot and a forward combined and which are settled by the delivery of the currency concerned so as to fall outside the definition of a contract for differences.

Regulation of FX in the UK

The importance of the FX Market to the UK

The foreign exchange market is the largest market in the world by turnover with the UK accounting in 2004 for 31% of total turnover, followed by the United States (19%), Japan (8%), Singapore (5%), Germany (5%), Hong Kong SAR (4%), Australia (3%) and Switzerland (3%). In the 2004 BIS tri-annual survey, The FX market average daily turnover was estimated at $1.9 trillion. Of the business transacted in the UK, the FX JSC semi-annual survey suggests that around 68% of total turnover results from forward FX transactions as defined in this note. Any changes to the way in which such a market is regulated, could severely impact on FX market activity in the UK and therefore an appropriate level of consultation is essential.

Ministerial Comments in 1988

As far back as 1988 in a statement made on 20 January, the then Minister for Corporate Affairs – the Honourable Francis Maude MP – said that it was not the Government's intention to include ordinary (i.e. commercial) forward contracts within the definition of investments in UK legislation. This statement was referred to in SIB's Guidance Release No 3/88 entitled 'Paragraph 8 of Schedule 1 to the Financial Services Act 1986' (the “Act”).

This comment was issued to express the UK government’s view about the scope of legislation at the time which defined futures contracts. In particular concerns had been raised by practitioners that ordinary (commercial) forward contracts could be caught within the definition of futures. Mr Maude made it clear that this was not the intention of the government. The problem was that futures and forwards both envisaged delivery of property of currency at a future date – although in the case of futures it was usually the intention of one or both of the contracting parties to take the profit or loss before the delivery date. The legislation therefore set a number of indications which distinguished a futures contract. Some of those indications related to the nature of the contract and others to the intention of the parties. Both were relevant to the decision whether the contract was for investment purposes (and covered by the Act) or solely for commercial purposes and therefore excluded.

He continued that on the foreign exchange (and bullion) market, forward contracts were generally made solely for commercial purposes by both contracting parties and did not therefore fall within the provisions of the Act. However the government could not exclude currency in its entirety because there were many futures contracts based on currencies such as contracts on the Chicago Mercantile Exchange and LIFFE which were offered to investors for investment purposes.

It is therefore evident that the issue today is not new and as far back as 1988 guidance has been sought to distinguish between the activity in the wholesale FX markets and the regulated markets. What is certain is that is that the government guidance stated that the wholesale market for spot and forward FX fell outside of the provisions of Financial Services regulation.

SIB Guidance 1996

In February 1996, the SIB revisited the issue in its guidance release 1/96. The departure point in this guidance was; "Forex itself is not an investment for the purposes of the Act. Hence, the Act does not apply to persons such as banks and bureaux de change who simply buy and sell forex in the course of their business. Neither does the Act apply to the ordinary inter-bank forex dealing activities of banks where the contracts concerned can clearly be seen to be commercial."

Despite this quote, the SIB recognised that certain arrangements or transactions involving FX were deemed to be within the scope of the Act in the following specified circumstances.

a) Discretionary management of FX

FX transactions that took place under a discretionary management agreement pursuant to which a person managed assets, which comprised or included or could at the discretion of that person comprise or include investments, belonging to another was deemed to constitute investment business.

b) Derivatives

Options, futures and contract for differences in FX such that any person who dealt or arranged deals in, managed or advised on such investments was deemed to be conducting investment business.

c) Collective Investment Schemes

Where FX was the property or part of the property underlying a collective investment scheme such that any person who established, operated or wound up such a scheme was deemed to be conducting investment business.

d) Speculative FX trading

FX services where the principal and common purpose was speculating on and taking profits from movements in currency exchange rates was considered to be investment business. On this point there was a clear distinction made between speculative FX services and other FX-related services of a non-speculative nature such as in the context of hedging of risks or the efficient management of securities portfolios.

The SIB's view was that transactions were likely to be for speculative reasons if they had the following characteristics:

- they purported to involve only spot or up to 7 days forward contracts;
- customers had no need or desire to take delivery of currency and, in the majority of cases had no capacity to make or take delivery;
- contracts were never seen through to delivery;
- customers were allowed to close open positions by entering into offsetting transactions;
- customers dealt on margin or credit thereby increasing the risk/reward potential for a given initial outlay; and
- customers requested 'rolling over' the contract repeatedly.

The SIB concluded that speculative FX services were subject to financial services regulation but that wholesale FX trading was not.

The FSMA, the RAO and the FX Market in the UK

In the UK, the FX wholesale market has remained outside the remit of FSA Regulation as a result of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 Statutory Instrument 2001 No 544 (the "RAO"). The RAO replicates the position under the Financial Services Act 1986 so that dealings in FX fall within the scope of regulation in the circumstances described above and, importantly, FX transactions entered into for commercial purposes are not investments.

Article 84 of the RAO replicated the definition of futures as "rights under a contract for the sale of a commodity or property of any other description (including currency) under which delivery is to be made at a future date and at a price agreed on when the contract is made". Article 84 provides an exclusion for rights under any contract, which is made for commercial and not investment purposes and repeated the indicia as to when a contract is to be regarded as made for investment purposes. A contract is to be regarded as made for investment purposes if it is made or traded on a recognised investment exchange. On the other hand, an FX forward contract entered into by parties who agree to deliver the currencies at maturity is deemed to be for commercial purposes and falls outside of this provision. The major difference between a futures contract and a forward is that futures are traded on an exchange but forwards are traded OTC: forwards are negotiated bilaterally but futures are standardised and specified by the exchange (only the price is negotiable).

The relevance of the NIPs Code.

Given that standard commercial FX forwards clearly fall outside the regulated regime in the UK, participants in the FX market have been guided in their activities by the provisions of the NIPs Code. Its provisions are intended as guidance on what is currently believed to constitute good practice in these markets. The exclusion of commercial FX forwards from the definition of "investments" in the RAO and the status of the NIPs Code in the UK has meant that in practical terms wholesale Foreign Exchange trading has remained outside the remit of FSA regulation.

The Code sets out for management and individuals at broking firms and principals, standards of good practice in the market. The spirit of the Code applies equally to business transacted via electronic or traditional media. Principals include firms authorised under the Financial Services and Markets Act 2000 and similar firms operating in the United Kingdom under the EU passport arrangements, as well as other companies and institutions, local authorities and other public bodies which operate in the wholesale markets covered by the NIPs Code. While its provisions are intended only as guidance, where appropriate its provisions are consistent with the relevant parallel provisions in the FSA Handbook. The FSA has contributed to the development of the Code and expects management of authorised firms to take due account of it when conducting business in products covered by the Code.

There is a process in place for updating the Code on a semi-annual basis, which is co-ordinated by the Secretariat of the FX JSC, drawn from staff at the Bank of England; this involves a wide variety of market bodies who endorse the Code (such as the Chartered Institute of Public Finance and Accountancy, and Building Societies Association) as well as the relevant trade associations described in the introduction.

MiFID

The MiFID consultation process has once more raised the issue of how the wholesale foreign exchange market will be regulated. There are concerns in the market that forward foreign exchange contracts might be treated as investments for the purposes of UK implementation of MiFID, resulting in a significant extension of regulation. This concern has appeared each time there has been a change in legislation relevant to the financial markets and, as we have seen over the past 18 years at least, guidance has been sought and obtained which has been consistent with regards to FX.

MiFID Level 1

I. Annex I Section C (Financial Instruments)

MiFID Annex I Section C lists all financial instruments. There is an express inclusion in this list (paragraph (4)) of options, futures, swaps, forward rate agreements and any other derivative contracts relating to currencies. However we aim to focus on what is not included in this paragraph. The focus in this section appears to be on derivatives of all types, including both OTC derivatives and exchange-traded derivatives. However, FX forwards are not derivatives within the normal meaning of that term. Moreover, as we have noted above, guidance over the years in the UK has suggested that transactions executed in the wholesale foreign exchange market have characteristics that differentiate them from the futures markets. The level 1 text of MiFID clearly distinguishes between instruments that "are traded on a regulated market or an MTF, are cleared and settled through recognised clearing houses or are subject to regular margin calls" and other contracts which do not have these characteristics. This is consistent with the SIB guidance and the NIPs code in the UK. MiFID Recital (4), which refers to "commodity derivatives *and others* which are constituted and traded in such a manner as to give rise to regulatory issues comparable to traditional financial instruments" (emphasis added), and Annex I, C (7) which deals with commodity derivatives reinforces this distinction. Forward FX transactions do not give rise to regulatory issues comparable to traditional financial instruments, are not traded on recognised investment exchanges and are not subject to margin calls or cleared by recognised clearing houses. Consistent with historical precedence in the UK, we conclude that the difference between listed FX futures contracts traded on exchange and the wholesale FX market should be maintained. Our interpretation of these sections of the MiFID level 1 texts leads to the conclusion that FX Forwards and FX Swaps which go to delivery are not "derivatives" and therefore fall outside of the scope of MiFID Annex I Section C. Accordingly, MiFID does not require any change to the current position of FX forwards under English law and regulation.

II. Annex I Section B (Ancillary Services)

MiFID Annex I Section B includes foreign exchange services connected to the provision of investment services in its list of ancillary services at paragraph (4). This has been interpreted to mean any FX transaction entered into in connection with any investment business is within the scope of MiFID. For instance, an order to sell Sterling and purchase US Dollars in order to pay for US securities will be subject to FSA oversight. Conversely an order to sell Sterling and purchase US dollars in order to pay for commercial goods will be out of scope. A comparison with the equivalent provisions of the ISD reveals that the texts are exactly the same. There are two conclusions to be drawn here. First, the sections dealing with ancillary activities in both the ISD and MiFID are identically worded and, therefore, the status quo in relation to foreign exchange as an ancillary activity should be maintained. Second, we assume that the inclusion of foreign exchange services in Section B was done intentionally in order to exclude it from the list of Financial Instruments in Section C.

Conclusion

On the basis of the analysis set out above, we consider that the wholesale FX transactions described do not need to be treated as investments for the purposes of UK implementation of MiFID. If this were not the case, it would result in a significant extension of regulation of the foreign exchange market without having addressed the impact that would have.