IRISH BANKING FEDERATION

Financial Services IRELAND

Submission

on the application of MiFID

to

Forward Foreign Exchange Transactions

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Executive Summary

While the issues raised by the application of the Market in Financial Instruments Directive (MiFID) to forward foreign exchange transactions are discussed at some length in the attached paper, it is useful to set out in summary form, the principal legal and factual matters that are of concern to industry.

Factual Background

1 It is common market practice for the clients of credit institutions to enter into agreements for the purchase of a fixed amount of foreign currency, at a fixed price, for delivery during a fixed time-frame. Such agreements are essential in international commerce as they permit clients to conclude orders, and set prices, for goods and services without the risk of currency fluctuations.

2 MiFID defines a "financial instrument" in Section C of Annex 1 to the Directive and it includes, *inter alia*;

> "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."[1]

3. Depending on the meaning of the word derivative this definition could capture all forward foreign exchange transactions irrespective of the reason why the client requires the currency.

Legal Background

MiFID replaces the old Investment Services Directive which was originally introduced in 1993. Since the introduction of the ISD it has been the regulatory practice of firms and of the Financial Regulator/Central Bank to regard commercial forward foreign exchange transactions as falling outside the scope of the ISD regime. They have been able to sustain this position based on the definitions in the Investment Intermediaries Act, 1995 which excluded instruments that were for the purposes of defraying costs arising under a contract for the sale of goods and services. However, as part of the transposition of MiFID this provision is to be repealed.

The United Kingdom has indicated that it intends to continue operating a distinction between contracts that are for commercial purposes and those that are for investment purposes, and will continue to allow firms to operate the "commercial purposes test" set out in the Regulated Activities Order.

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[1] This definition originated in C4 of Section C Annex 1 of MiFID, and is reproduced verbatim by Schedule 1 Part 3 of SI 60/2007 which transposes MiFID into domestic law.

The European Commission has been asked to clarify the circumstances where a contract relating to commodities will be regarded as a "derivative instrument" for the purposes of this definition and has issued guidance that closely mirrors the UK approach.

For the reasons set out below, it is clear that MiFID does not require the application of its provisions to such transactions, and in ordinary circumstances firms would be free to adopt their own interpretation in conjunction with the Financial Regulator. ***The key difficulty is that given the fact that the UK has adopted a legislative approach, and that Ireland previously used a legislative provision, there would appear to be a widespread belief that legislation is legally necessary.*** While the detailed basis for this view is set out in the attached paper, the essential point is that the conscious omission of a legislative provision would be viewed as effecting a change in the legal definition. It is impossible to provide legal advice to the effect that nothing has changed, when the text of the implementing measures clearly have.

Why do commercial agreements fall outside MiFID?

1 They fell outside the ISD and there is no evidence of an intention to change this. After 14 years it is reasonable to assume that the EU Commission are aware that the ISD was not applied to such transactions. If the Commission wished to change this they would have stated this clearly.

2 The recitals to the Directive clearly state that the intention of the Commission is to extend the scope of the Directive, from that which prevailed under the ISD to include the recent development of a "more complex wide-ranging set of services and instruments"[2]. Commercial forward foreign exchange contracts have existed since well before ISD and are in no sense recent developments; their inclusion is not envisaged in the Directive's stated purpose.

3 The central focus of the definition is to capture derivative instruments i.e. contracts that are traded on a secondary market. Commercial forward foreign exchange contracts present none of the regulatory risks created by derivatives. Derivative instruments are typically classed as complex products that are difficult for consumers to understand, and which require the level of consumer protection offered by the Directive. Commercial forward foreign exchange agreements lack this complexity and it is wholly inappropriate to subject them to the complex regulatory requirements imposed by the Directive.

4 Moreover, the specific reference to the circumstances in which foreign exchange services will be captured as "ancillary services" clearly indicates that the Directive is not intended to capture the provision of foreign exchange services *simpliciter*. Essentially the Directive only captures foreign exchange (a) when it is being provided in connection with an investment service, or (b) when it is the subject of a derivative contract for investment purposes.

A failure to exclude commercial forward foreign exchange transactions would create many absurd outcomes. For example, take the case of a client who wishes to arrange a commercial foreign currency payment with half payable immediately (say, on placement of an order) and the second half (on delivery) in thirty days.

The first payment is a simple foreign exchange purchase covered as a normal banking transaction, with agreed rates and amounts. If the second is deemed to be a forward foreign currency exchange contract subject to MiFID, **the simple act of agreeing the price for the same service to be provided in 30 days** would require that; (a) the client be classified, including requiring the gathering of information on financial education/knowledge, investment objectives, etc; (b) he be advised of the firm's order execution policy, conflicts of interest policy and his options on changing client classification; (c) he must have a

[2] Recital 2, 2004/39/EC

suitability assessment and appropriateness check on the draft purchase, considering his investment objectives and ability to bear loss; and (d) the firm would also be obliged to keep relevant records for 5 years.

This outcome is patently absurd, as the transaction could be adequately described with simple terms & conditions. This arises from the failure to distinguish between the simple commercial forward FX transaction and speculative investment in foreign currencies using forward contracts, which should properly be subject to MiFID.

Conclusions

1. MiFID was intended to capture a wider range of derivative financial instruments than the ISD, but the purpose of the extended definition was not to capture commercial foreign exchange transactions that have been used without incident for many decades.

2. That by departing from established legislative practice in Ireland, and by diverging from the approach adopted in the only jurisdiction with a comparable legal system the transposing measures have introduced a significant element of legal uncertainty.

3. That the European Court of Justice has held that where a Directive creates legal rights or obligations, a Member State is required to ensure that there is legal certainty about the extent and application of those rights as part of the transposition process.

4. That on foot of the foregoing Ireland is obliged to amend the relevant Statutory Instrument to provide greater legal certainty in respect of the application of MiFID to forward foreign exchange transactions that are entered into for commercial purposes.

5. While this paper has been prepared to deal with the specific issue of forward foreign exchange agreements, the same analysis can be applied in respect of analogous agreements that are entered into for similar purposes. There may be other situations where the introduction of a “commercial purposes” test as advocated below should also be considered.

PART ONE

Financial Instruments

1 Section C of Annex 1 of Directive 2004/39/EC and the equivalent domestic measures define "financial instruments" as including a range of common financial instruments including; transferable securities, money market instruments, units in collective investment funds, financial contracts for difference, and a range of provisions capturing derivative instruments in a variety of assets.

2 The Directive also defines "ancillary services" as including "foreign exchange services where these are connected to the provision of investment services".

3 It is clear, both from the specific language of the definition at paragraph 1 and the general architecture of the Directive that the purpose of the definition is to bring "derivatives" within the meaning of the legislation. The reference to "options, futures, swaps and forward rate agreement…." is clearly illustrative of the type of derivative contracts that the legislation seeks to regulate.

4 Moreover, the specific reference to the circumstances in which foreign exchange services will be captured as "ancillary services" clearly indicates that the Directive is not intended to capture the provision of foreign exchange services *simpliciter*. Essentially the Directive only captures foreign exchange (a) when it is being provided in connection with an investment service, or (b) when it is the subject of a derivative contract for investment purposes.

5 The difficulty is that both agreements entered into for investment purposes (i.e. to be bought and sold), and those that are entered into for commercial purposes adopt the same legal form, the distinction lies in the intention of the client and the purpose for which the currency is required.

6. The essence of derivatives as financial instruments is that they are an agreement to buy or sell a specific asset which is then traded in isolation from the underlying asset in question. They effectively allow investors to acquire a risk exposure to the movement of money markets, commodity markets, interest rates, or currency rates, without having to actually take possession of the underlying asset. These

agreements are then traded in their own right on a secondary or derivative market.

7. The key regulatory risk with derivative instruments is that the amount of capital required to secure this exposure is quite small compared to potential loss or gain resulting from the contract. It only requires the payment of a fee to secure the right to buy or sell the asset in question, but the movement of the relevant market is theoretically unlimited, and any volatility can result in substantial margin calls during the lifetime of the agreement.

8. Moreover, derivative instruments are typically classed as complex products that are difficult for consumers to understand, and which require the level of consumer protection offered by the Directive. Commercial forward foreign exchange agreements lack this complexity and it is wholly inappropriate to subject them to the complex regulatory requirements imposed by the Directive.

9. It is clear therefore that the types of agreement described at paragraph 3 are not derivatives, and to treat them as such would produce an absurd outcome. As noted in paragraph 4 the Directive specifically captures foreign exchange transactions when these are provided as ancillary services, however ancillary services are subjected to a modified form of regulation. Accordingly without some form a distinction being drawn, one could arrive at a situation whereby foreign exchange that is required for relatively straightforward commercial purposes is subject to higher standard of oversight than foreign exchange that is required for participation in complex investment activities.

10. For the reasons set out below it is submitted that such a distinction can be drawn because the terms of an agreement are inevitably tailored to the needs of a client. As a result the distinction has been accepted and applied by the European Commission, the United Kingdom, and by Ireland under the Investment Intermediaries Act.

PART TWO

Comparative Approaches

Ireland

11. As noted above, the Directive has been introduced to replace the Investment Services Directive (ISD). The equivalent definition in the ISD of "investment instruments" covered;

SECTION B

Instruments

1. (a) Transferable securities.
   (b) Units in collective investment undertakings.
2. Money-market instruments.
3. Financial-futures contracts, including equivalent cash-settled instruments.
4. Forward interest-rate agreements (FRAs).
5. Interest-rate, currency and equity swaps.
6. Options to acquire or dispose of any instruments falling within this section of the Annex, including equivalent cash-settled instruments. This category includes in particular options"[3]

12. The ISD was transposed into Irish law by Investment Intermediaries Act, 1995. The definitions in that Act of "investment instruments" clearly stated that;

> "...this definition shall not be construed as applying to any instrument acknowledging or creating indebtedness for, or for money borrowed to defray, the consideration payable under a contract for the supply of goods or services".

13. This definition specifically recognised the distinction that exists between money that is required for commercial purposes (to pay for goods and services) and agreements that are entered into for investment purposes. This distinction has existed in Irish law for more than 12 years without comment or criticism. At no point has the Commission suggest that the Directive was intended to alter this position. It is reasonable to

[3] COUNCIL DIRECTIVE 93//22//EEC

assume that had the Directive been intended to eliminate this long standing distinction then reference would have been made to it in the recitals.

The Commission

14. While the Commission has not been called upon to address the specific question of forward foreign exchange transactions, they have provided guidance on identifying "other derivative contracts" for the purposes of the Directive.

15. This definition was provided in Article 38 of the Level II Implementing Regulations (Appendix A), in response to calls for further clarification for the purposes of identifying other derivative contracts in commodities. While not directly applicable to forward foreign exchange transactions the explanatory background note, prepared by the Commission states;

    "The exemptions referred to in this Recital, although not exclusive for commodity business, needed to be clarified in this context because of the particular nature of these markets."[4]

16. The recital referred to is number 4 of the Directive which states that; "It is appropriate to include in the list of financial instruments certain 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."

17. It seems clear that the litmus test, in the eyes of the Commission for a "financial instrument" is whether it gives rise to regulatory issues comparable to traditional financial instruments. The definition provided by the Commission clearly states that commercial commodity agreements do not present such risks.

18. Given that forward foreign exchange agreements for commercial purposes also lack any assumption of risk by the client, as outline above at paragraphs 6-7 suggests that there is a clear basis for applying the Commission's reasoning in respect of commodities, *mutatis mutandis*, to commercial foreign exchange transactions.

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[4] http://ec.europa.eu/internal_market/securities/docs/isd/dir-2004-39-implement/reg-backgroundnote_en.pdf

19. Moreover, as is obvious from the extract at paragraph 15, the recital is not just for commodities, and the rationale for the Commission's definition is simply to clarify in one specific context what it assumes to be the case in respect of all other financial instruments.

The United Kingdom

20. The position of forward foreign exchange transactions within the MiFID regime has been considered at length by the UK authorities. The issue was first raised in the consultation paper published by Her Majesty's Treasury (2005) which noted;

    ".. it is not obvious as to what extent, if any, MiFID captures what have hitherto been regarded as commercial foreign exchange forward contracts. As indicated above, we do not believe the directive was intended to push back the boundary between financial services and commercial activity".[5]

21. In its feedback to this public consultation the Treasury clarified its view on this question; "We do not believe that the implementation of MiFID changes the boundaries of UK regulation as it effects foreign exchange forwards."

22. This view has also been adopted by the Financial Services Authority, who in their recent "perimeter guidance" on MiFID stated that;

    "We have updated the perimeter guidance text to indicate our view that MiFID does not have the effect of turning spot or forward foreign exchange contracts into investments subject to FSMA regulation, where these investments satisfy the commercial purpose test in article 84(2) RAO. In other words, MiFID does not alter the regulatory perimeter in relation to spot or forward foreign exchange contracts. In our view, MiFID maintains the position under the ISD, at least as a matter of scope, as the provision of foreign exchange services connected to the provision of investment services is an "ancillary service" (previously described as a non–core service under ISD). That said, there are more provisions under MiFID which apply to ancillary services than there were in relation to non-core services under ISD, for

[5] http://www.hm-treasury.gov.uk/media/2E0/CA/ukimplementationeumarkets151205.pdf at para. 3.21

example conflicts of interest."[6]

23. Central to the UK's approach is the application of a "commercial purposes test". The content of this test is set out in Article 84 of the Financial Services and Market Act 2000 (Regulated Activities) Order 2001. While the language used in the Order is quite complex (Appendix B) the test can be summarised as follows;
    - A future is defined broadly as; "**rights under a contract for the sale of a commodity or property of any description under which delivery is to be made at a future date and at a price agreed on when the contract is made**". Accordingly the key elements of a future are;
        - A contract for the sale,
        - Of an asset,
        - For later delivery, but
        - At a price that is set now.

    - The Order then qualifies this by **excluding**;
        - Any contract which is made for commercial and not investment purposes.

    - To assist in distinguishing between commercial and investment contracts the Order creates **three categories**;
        1. A contract is **always made for investment purposes** if;
            - It is made on a recognised investment exchange, or
            - It is traded on a recognised investment exchange, or
            - It contains terms equivalent to those ordinarily traded on a recognised investment exchange.

        2. A contract is **always made for commercial purposes** if;
            - It is **not** made on a recognised investment exchange, and
            - It is **not** traded on a recognised investment exchange, and
            - It does **not** contain terms equivalent to a contract ordinarily traded on a recognised investment exchange, and
            - It provides that delivery must be made within **seven days**,

[6] Financial Services Authority, Perimeter Guidance relating to MiFID Feedback on CP06/9 and CP06/14, March 2007 at para. 3.3

and

- o There is no private understanding between the parties that delivery will occur later than seven days.

3. If a contract does not fall within one of these two extremes, the Order sets out a range of indicia to help identify the nature of the contract.
   - o A contract is **more likely to be commercial** if;
   - o One of the parties produces the product or uses it in his business,
   - o Either the purchaser intends to take delivery, or the seller intends to deliver the product,
   - o The price, the amount and the delivery date are negotiated between the parties and not determined by reference to published prices, standard amounts, or set terms.

   - o A contract is **more likely to be for investment** if;
   - o One or more of the criteria above are absent,
   - o It is expressed to be as traded on an investment exchange
   - o Performance of the contract is ensured by an investment exchange or a clearing house, or
   - o There are arrangements for the payment or provision of margin.

24. It is important to note that the language of Article 38 of the Level II Implementing Regulations (Appendix A) mirrors the approach adopted by this UK provision. It is quite clear that the Commission is aware of, and has regard to, the approach adopted by the UK and has and has allowed it to inform its own position.

PART THREE

A Legislative Solution

25. It is clear from the matters set out above that a clear regulatory distinction exists between forward transactions that are entered into for commercial purposes and those that are entered into for investment. However, the task of reflecting this distinction in domestic measures raises a number of legal issues. The most important of which is whether such an approach is permitted and/or required as a matter of European Law.

Is Ireland ***permitted*** *to draw a distinction?*

26. While the Directive has been adopted as part of the Financial Services Action Plan, is expressed to be a maximum harmonisation measure, and utilised the Lamfalussy process to expedite its enactment and implementation these are matters of procedure and policy rather than law. From a legal perspective the Directive is no different to any other enacted by the European Union, and the normal principles of European Law and interpretation apply. Accordingly it is useful to consider the relevant principles of general application before applying them to the specific circumstances of the Directive.

27. The key characteristic of Directives, as opposed to regulations, is that they impose an obligation of Member States to achieve a particular result, but afford the Member State a margin of appreciation or discretion as to the manner in which to achieve that result. Accordingly the transposition of Directives can rarely be achieved by simply copying the text of the Directive into domestic law verbatim, rather consequential or ancillary measures are ordinarily required to give full effect to the EU's legislative intention.

28. It follows from this basic principle that it is essential that the transposition of a Directive is informed by a clear and precise understanding of the specific outcome that the legislature intends. In the present case the EU hopes to promote a deeper and wider internal market in the provision of financial instruments by providing a common framework of protection for clients of firms providing such products.

29. It is clear that the definition of "financial instruments" under the Directive is wider than that which was previously applied under the ISD. However, it is important that the transposition of the Directive is informed by an understanding of the rationale for, and extent of, this extension.

30. The recitals to the Directive clearly state that the intention of the Commission in

altering the definition of financial instruments under the Directive, is to bring into scope "certain 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". The key point is that the extended definition is intended to capture commodity derivatives, and other derivatives that present comparable regulatory risks. Commercial forward foreign exchange transactions simply do not meet these criteria.

31. The matter is put beyond any real doubt by recital 2 to the Directive- it clearly states that the intention of the Commission is to extend the scope of the Directive from that which prevailed under the ISD to include recent development of a "more complex wide-ranging set of services and instruments".[7] The products in question have been in use for commercial purposes since well before ISD and are in no sense recent developments; their inclusion is not envisaged in the Directive's stated purpose.

32. On this analysis alone, there would appear to be no reason why Ireland is obliged to include such transactions within the scope of the Directive. The lack of a specific carve-out or derogation is immaterial, in so far as the purpose of such a provision is ordinarily to exempt that which would otherwise be included. In the present case the transactions in question simply fall outside the Directive when read from a European Law perspective. It is important to note that the UK has not seen it necessary to notify the Commission of it's decision to continuing its existing practice.

33. It is submitted that support for this view can be found in the determination to this effect by the Financial Services Authority in the UK. While other Member States have yet to publish their own legislation transposing the Directive, it is suggested that the approach they adopt will be of limited value in the Irish context given that the necessity for a specific provision is peculiar to common law jurisdictions for the reasons set out below at para (41-3).

*Is Ireland **required** to draw a distinction?*

34. It is further submitted that this concern and confusion is, of itself, enough to transform the position outlined above from being one that merely permits a distinction to be drawn, to one which obliges the state to provide clear assistance to those affected.

35. There has been substantial litigation before the European Court of Justice concerning

[7] Recital 2, 2004/39/EC

the qualitative nature of the obligation on Member States to effectively transpose Directives into domestic law, and to give practical effect to them. In the case of *European Commission v. Ireland*[8] the Commission took enforcement proceedings against Ireland arising from certain alleged deficiencies in our transposition of certain Directives dealing with waste disposal. In the course of finding against Ireland the ECJ explained that a Member State's obligation includes;

"Ensuring clarity and precision of provisions implementing a directive is particularly relevant where the directive is intended to create rights and duties for individuals. It is a requirement of legal certainty that transposition measures are sufficiently transparent to enable individuals to ascertain the full extent of their rights under the directive (See eg EC Commission v Germany Case C-361/ 88 [1991] ECR I-2567 (para 15) and Commission v France Case C-197/ 96".

As the Directive is one which quite clearly creates rights for the clients of firms, and places positive duties on firms to vindicate those rights, it would appear from the passage quoted above that member states have an obligation arising from the Directive to clarify in domestic law the full extent of those rights, and to allow both clients and firms to clearly identify when they are to apply.

36. However, the concerns that gave rise to this paper are grounded on a concern about how the text of the implementing measures might be interpreted by a Court or the Financial Regulator. This raises far more complex questions regarding the relationship between the principles of European Law described above, and domestic legal principles governing the construction of legislation, the use of secondary legislation, and the constitutional provisions regarding our relationship of the European Union.

Is a legislative solution required?

37. Based on the analysis outlined above it might be argued that the Directive is sufficiently clear in its terms to permit either individual firms, or the Financial Regulator to adopt a non-legislative solution to this problem. The key difficulty with this approach is that it is dependent on the Court or the Financial Regulator being able to give the

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[8] Case C-494/01

implementing provisions the correct interpretation.

38. Ordinarily a domestic regulation that transposes a European measure must be interpreted in light of that EU measure.[9] This is a recognized exception to the principle that statutory language be given its literal meaning. However, the particular legislative history of the Investment Intermediaries Act and the present Directive creates difficulties in this area.

39. The legislative framework both in Ireland and the UK seems to indicate a longstanding belief by draftsmen that this matter is one which should be resolved by way of legislation, and this further strengthens the view that a simple guidance note or statement would not be adequate. After more than 30 years of operating such a distinction, a litigant would face significant difficulty in convincing a Court that the absence of a legislative provision was without significance.

40. The conscious omission of a provision similar to that in the Investment Intermediaries Act, or the United Kingdom's RAO, could be interpreted by a Court as evidence of a legislative intent to abolish this distinction. The "draftsman is presumed to know the law" and a provision which repealed or disapplied the relevant section of the IIA, without re-enacting something similar would be seen as evidence of a legislative intent to alter the law.

41. This difficulty is, in all likelihood, peculiar to common law jurisdictions in that our entire system of law is built on the principle of *stare decisis* (let the decision stand) which obliges Courts to follow their previous decisions, and those of higher Courts. This is fundamentally different to the approach in civil jurisdictions where Courts typically enjoy greater freedom to apply a written code to the facts of an individual case, and while they typically follow previous decisions in similar cases they are not as tightly bound to do so, and their decisions do not necessarily bind other courts.

42. Common Law judges simply do not have the power to introduce by way of interpretation that which ought to have been done by legislation. In effect an Irish Court would be asked find that irrespective of the differences between the Irish and UK

[9] *Nathan v. Bailey Gibson Ltd.* [1998] 2 IR 162

law that in substance they produced the same result. The Courts have been confronted with this dilemma in the past in a range of circumstances, the most notable of which relates to the criminal law defence of diminished responsibility. This was introduced in the UK by way of legislation in the 1950s, and in several cases the Irish Courts were invited to develop our law to provide a similar defence, and each case they refused on the basis that it would amount to judicial law making.[10]

43. Similarly it is not open to a Court to, of its volition, promulgate a detailed test to distinguish between commercial and investment transactions. Rather, in the case of a litigation taken by an aggrieved client, a Court would be required to resolve the case based on it's specific facts. Through time, such cases might provide guidance on the correct application of the Directive, however the costs (both direct and indirect) of such an approach would be enormous.

Conclusions

44. It is submitted that from a European Law perspective that forward transactions entered into for commercial purposes are not intended to fall within the definition of financial instruments for the purposes of the Directive. This view finds support from a number of sources;

- The fact that the transactions lack the regulatory risks that the directive is intended to address,
- The fact that Ireland excluded them for many years under the ISD,
- The existence of a clear exclusion under the law of the only other Member State to operate a common law system,
- The stated explanation for the extension of the relevant definition does not apply, and
- The assumption on the part of the Commission, when providing guidance in respect of commodities, that none was required in respect of other activities.

It has also been argued that there is a sustainable argument to the effect that Ireland is obliged to clarify the exact application of the Directive, by providing in domestic law a mechanism for ascertaining which transactions are to be captured.

[10] *The People (DPP)* v *Joseph O' Mahony* [1984] ILRM 244.

45. It is impossible to advise with any certainty how a Court might chose to interpret the provisions as they currently stand, and as a result it is extremely difficult for a firm to correctly apply the Directive. Given the significance of the issue to such firms, and the State's obligation to provide legal certainty, it is submitted that the State is obliged to introduce a measure to clarify the matters raised in this paper.

APPENDIX A – Article 38 Level 2 Implementing Directive

Derivative financial instruments
Article 38

(Article 4(1)(2) of Directive 2004/39/EC)

Characteristics of other derivative financial instruments

1. For the purposes of Section C(7) of Annex I to Directive 2004/39/EC, a contract which is not a spot contract within the meaning of paragraph 2 of this Article and which is not covered by paragraph 4 shall be considered as having the characteristics of other derivative financial instruments and not being for commercial purposes if it satisfies the following conditions:

(a) it meets one of the following sets of criteria:

(i) it is traded on a third country trading facility that performs a similar function to a regulated market or an MTF;

(ii) it is expressly stated to be traded on, or is subject to the rules of, a regulated market, an MTF or such a third country trading facility;

(iii) it is expressly stated to be equivalent to a contract traded on a regulated market, MTF or such a third country trading facility;

(b) it is cleared by a clearing house or other entity carrying out the same functions as a central counterparty, or there are arrangements for the payment or provision of margin in relation to the contract;

(c) it is standardised so that, in particular, the price, the lot, the delivery date or other terms are determined principally by reference to regularly published prices, standard lots or standard delivery dates.

2. A spot contract for the purposes of paragraph 1 means a contract for the sale of a commodity, asset or right, under the terms of which delivery is scheduled to be made within the longer of the following periods:

(a) two trading days;

(b) the period generally accepted in the market for that commodity, asset or right as the standard delivery period. However, a contract is not a spot contract if, irrespective of its explicit terms, there is an understanding between the parties to the contract that delivery of the underlying is to be postponed and not to be performed within the period mentioned in the first subparagraph.

3. For the purposes of Section C(10) of Annex I to Directive 2004/39/EC, a derivative contract relating to an underlying referred to in that Section or in Article 39 shall be considered to have the characteristics of other derivative financial

instruments if one of the following conditions is satisfied:

(a) that contract is settled in cash or may be settled in cash at the option of one or more of the parties, otherwise than by reason of a default or other termination event;

(b) that contract is traded on a regulated market or an MTF;

(c) the conditions laid down in paragraph 1 are satisfied in relation to that contract.

4. A contract shall be considered to be for commercial purposes for the purposes of Section C(7) of Annex I to Directive 2004/39/EC, and as not having the characteristics of other derivative financial instruments for the purposes of Sections C(7) and (10) of that Annex, if it is entered into with or by an operator or administrator of an energy transmission grid, energy balancing mechanism or pipeline network, and it is necessary to keep in balance the supplies and uses of energy at a given time.

APPENDIX B – Regulated Markets Order 2001

Futures

84. -(1) Subject to paragraph (2), rights under a contract for the sale of a commodity or property of any other description under which delivery is to be made at a future date and at a price agreed on when the contract is made.

(2) There are excluded from paragraph (1) rights under any contract which is made for commercial and not investment purposes.

(3) A contract is to be regarded as made for investment purposes if it is made or traded on a recognised investment exchange, or is made otherwise than on a recognised investment exchange but is expressed to be as traded on such an exchange or on the same terms as those on which an equivalent contract would be made on such an exchange.

(4) A contract not falling within paragraph (3) is to be regarded as made for commercial purposes if under the terms of the contract delivery is to be made within seven days, unless it can be shown that there existed an understanding that (notwithstanding the express terms of the contract) delivery would not be made within seven days.

(5) The following are indications that a contract not falling within paragraph (3) or (4) is made for commercial purposes and the absence of them is an indication that it is made for investment purposes –

(a) one or more of the parties is a producer of the commodity or other property, or uses it in his business;

(b) the seller delivers or intends to deliver the property or the purchaser takes or intends to take delivery of it.

(6) It is n indication that a contract is made for commercial purposes that the prices, the lot, the delivery date or other terms are determined by the parties for the purposes of the particular contract and not by reference (or not solely by reference) to regularly published prices, to standard lots or delivery dates or to standard terms.

(7) The following are indications that a contract is made for investment purposes –

(a) it is expressed to be as traded on an investment exchange;

(b) performance of the contract is ensured by an investment exchange or a clearing house;

(c) there are arrangements for the payment or provision of margin.

(8) For the purposes of paragraph (1), a price is to be taken to be agreed on when a contract is made-

(a) notwithstanding that it is left to be determined by reference to the price at which a contract is to be entered into on a market or exchange or could be entered into at a time and place specified in the contract; or
(b) in a case where the contract is expressed to be by reference to a standard lot and quality, notwithstanding that provision is made for a variation in the price to take account of any variation in quantity or quality on delivery.

Contracts for differences etc.

85. -(1) Subject to paragraph (2), rights under

(a) a contract for differences; or
(b) any other contract the purpose or pretended purpose of which is to secure a profit or avoid a loss by reference to fluctuations in
(i) the value or price of property of any description; or
(ii) an index or other factor designated for that purpose in the contract.

(2) There are excluded from paragraph (1)-

(a) rights under a contract if the parties intend that the profit is to be secured or the loss is to be avoided by one or more of the parties taking delivery of any property to which the contract relates;
(b) rights under a contract under which money is received by way of deposit on terms that any interest or other return to be paid on the sum deposited will be calculated by reference to fluctuations in an index or other factor;