

THE REGULATION OF FOREIGN EXCHANGE IN THE UK

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Ministerial Comments in 1988

In January 1988, the Honourable Francis Maude MP, the then Minister for Corporate Affairs, said that it was not the UK Government's intention to include ordinary (i.e., commercial) forward contracts within the definition of investments in UK legislation. This statement was later referred to by the Securities and Investment Board ("SIB") in its Guidance Release No 3/88 entitled "Paragraph 8 of Schedule 1 to the Financial Services Act 1986" (the "Act").

This comment expressed the UK Government's view about the scope of legislation at the time which defined futures contracts as concerns had been raised by practitioners that ordinary (i.e., commercial) forward contracts could be caught within the definition of futures as both futures and forwards 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 set forth indicia of a futures contract; some of which related to the nature of the contract and others to the intention of the parties to the contract. Both were relevant to the decision as to whether the contract was for investment purposes (and covered by the Act) or for commercial purposes (and outside the Act).

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

SIB Guidance 1996

In February 1996, the SIB revisited the issue in its guidance release 1/96 where it stated: "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."

Notwithstanding this SIB guidance, the SIB recognised that the following arrangements or transactions involving FX were deemed to be within the scope of the Act:

1. 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;
2. 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;
3. 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; and
4. 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. 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 FSMA and the RAO in 2001

The wholesale foreign exchange 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") (an excerpt of the RAO is attached as Appendix A). The RAO perpetuates the position under the Act.

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." The RAO qualifies this by excluding any contract which is made for commercial and not investment purposes. The RAO creates three categories distinguishing between commercial and investment contracts:

1. A contract is always made for investment purposes if:
 - (a) It is made on a recognised investment exchange,
 - (b) It is traded on a recognised investment exchange, or
 - (c) It contains terms equivalent to those ordinarily traded on a recognised investment exchange.

2. A contract is always made for commercial purposes if:
 - (a) It is not made on a recognised investment exchange,
 - (b) It is not traded on a recognised investment exchange,
 - (c) It does not contain terms equivalent to a contract ordinary traded on a recognised investment exchange,
 - (d) It provides that delivery must be made within seven days, and
 - (e) 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 categories, the RAO sets out a range of indicia to help identify the nature of the contract.
 - (a) A contract is more likely to be commercial if:
 - (i) One of the parties produces the product or uses it in his business,
 - (ii) The seller delivers or intends to deliver the property or the purchaser takes or intends to take delivery,
 - (iii) 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.

 - (b) A contract is more likely to be for investment if:
 - (i) One or more of the criteria in 3.(a) above is absent,
 - (ii) It is expressed to be as traded on an investment exchange,
 - (iii) Performance of the contract is ensured by an investment exchange or a clearing house,
 - (iv) There are arrangements for the payment or provision of margin.

HMT Implementation of MiFID in 2005 and 2006

In the UK's implementation of MiFID, this issue was 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".

In its feedback to this public consultation in 2006, the Treasury clarified its view on this question by stating that:

“We do not believe that the implementation of MiFID changes the boundaries of UK regulation as it effects foreign exchange forwards.”

FSA Implementation of MiFID in 2007

This view has also been adopted by the Financial Services Authority, who in their March 2007 “perimeter guidance” on MiFID stated in paragraph 3.3 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 noncore services under ISD, for example conflicts of interest.”

In Question 30 of the same perimeter guidance, the FSA clarified which types of financial derivatives fall within the scope of C4, C8 and C9 of Section C of Annex 1 to MiFID by stating:

“The scope of C4, C8 and C9 does not extend to spot transactions, transactions which are not derivatives (such as forwards entered into for commercial purposes) and sports spread bets. In our view, neither C4 nor C9 comprise forward foreign exchange instruments unless they are caught by the scope of the Regulated Activities Order (see PERG 2.6.22BG). A non-deliverable currency forward which is not a “future” for purposes of the Regulated Activities Order because it is made for commercial purposes will likewise fall outside the scope of MiFID.”

The NIPs Code

The exclusion of commercial FX forwards from the definition of “investments” in the RAO and the status of the Non-Investment Products Code (“NIPs Code”) in the UK has meant that in practical terms wholesale foreign exchange trading has remained outside the remit of FSA regulation. As such, participants in the FX market have been guided in their activities by the provisions of the NIPs Code.

The NIPs Code establishes standards of good practice in the wholesale markets in non-investment products consisting of the sterling, foreign exchange and bullion wholesale deposit markets as well as the spot and forward foreign exchange and bullion markets. The NIPs Code applies to broking firms and principals. Principals include firms authorised under the Financial Services and Markets Act 2000 and similar firms operating in the UK 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 NIPs Code and expects management of authorised firms to take due account of it when conducting business in products covered by the NIPs Code.

The NIPs Code was produced by a wide variety of market participants including the Bank of England, the FSA, the Foreign Exchange Joint Standing Committee (“FXJSC”), the Sterling Money Markets Liaison Group and the London Bullion Market Association. The NIPs Code is updated on a semi-annual basis. This is coordinated by the Secretariat of the FXJSC, drawn from staff at the Bank of

England, and involves a wide variety of market bodies who endorse the NIPs Code.

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APPENDIX A – 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 an 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;

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