THE APPLICATION OF THE MIFID TO FORWARD FOREIGN EXCHANGE TRANSACTIONS:

EFMLG DRAFT DISCUSSION PAPER

1. Introduction

Section C of Annex I of the MiFID\(^2\) contains the list of financial instruments covered by the MiFID. Under the MiFID, ‘investment services and activities’ means ‘any of the services and activities listed in Section A of the Annex I relating to any of the instruments listed in Section C of Annex I’. The MiFID list of financial instruments is more elaborate than in the context of the Investment Services Directive (ISD)\(^3\) since, as explained in the preparatory documents for the review of the ISD\(^4\), the definition of financial instruments has been adapted so as to ensure more comprehensive coverage on an ongoing basis of the continuously evolving typology of financial instruments, the most substantive change relating to the inclusion of commodity derivatives in the list of financial instruments\(^5\). The MiFID provides that: ‘It is appropriate to include in the list of financial instruments certain commodity derivatives and others which

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5 It is noted that, in order to ensure the uniform application of the MiFID, the Commission may clarify the definitions laid down in paragraph 1 of this Article, which includes the notion of ‘financial instrument’, i.e. those instruments specified in Section C of Annex I.
are constituted and traded in such a manner as to give rise to regulatory issues comparable to traditional financial instruments.

The on-going implementation of the MiFID in the various EU Member States has revealed an issue regarding the interpretation of Section C (4) of Annex I, namely as to whether forward foreign exchange transactions constitute ‘financial instruments’ as specified in Section C of Annex I of the MiFID. This issue was not examined in the context of the adoption of the Commission’s implementing measures for the MiFID and a preliminary investigation indicates a risk of serious legal uncertainty arising from the adoption of diverging solutions by national regulatory authorities in the Member States when implementing the MiFID.

In case forward foreign exchange agreements would qualify as financial instruments under the MiFID, the authorisation provided to the investment firms is valid for the entire Community and investment firms providing forward foreign exchange agreements, would benefit from the European passport, ‘either through the establishment of a branch or the free provision of services’. Should these transactions be considered as financial instruments within the meaning of the MiFID, it might imply a significant extension of applicable rules for certain participants currently active on the foreign exchange market. This would also require more specific examination of the extent to which entities providing investment services to their clients in relation to these instruments would have to comply with all the conditions and procedures for authorisation as well as with all the operating conditions provided for in the MiFID.

2. The legal issue: forward foreign exchange agreements and the scope of the MiFID

2.1. The legal qualification of forward foreign exchange agreements

Section C (4), Annex I of the MiFID includes: ‘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’.

Under a forward foreign exchange contract (‘FX’) contract, the parties agree to exchange two currencies at a specified rate of exchange on a date (agreed at the time of trading) that is later than the settlement date for a spot market transaction. Such transactions enable a party that is due to pay or receive a foreign

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6 Recital 4 of the MiFID.
8 See Article 6(3) of the MiFID.
currency on some future date to lock into current exchange rates, so as to insulate it from the effect of foreign exchange movements in the interim\textsuperscript{11}.

The question therefore arises as to whether forward foreign exchange transactions constitute ‘financial instruments’ as specified in Annex I, Section C of the MiFID, and, more particularly, whether they constitute ‘futures’ or ‘other derivative contracts’ as mentioned in the above Section\textsuperscript{12}. In the event these transactions would be considered as financial instruments, the scope of the obligations imposed to the investment firms providing these services would need to be assessed, for instance, with respect to requirements such as conduct of business obligations or the obligation to execute orders on terms most favourable to the client\textsuperscript{13}.

\textbf{a) Forward foreign exchange agreements and derivative instruments}

The Commission services have indicated that ‘derivatives on currencies are financial instruments’ and that ‘an entity providing investment services to its clients in relation to these instruments will therefore have to comply with MiFID's authorisation and operational requirements’\textsuperscript{14}.

In a response to a UK HM Treasury consultation, the Foreign Exchange Joint Standing Committee (FXJSC) concluded that “FX forwards and FX swaps which go to delivery are not ‘derivatives’ and therefore fall outside of the scope of the MiFID Annex I, Section C”\textsuperscript{15} and that, accordingly, ‘MiFID does not require any change to the current position of FX forwards under English law and regulation’\textsuperscript{16}. Furthermore, the UK FSA specified which types of financial derivatives should fall in its view within the scope of Section C(4), (8) and (9) of Annex I to the 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

\textsuperscript{11} Ibid.

\textsuperscript{12} See paragraph 4 of Section C, Annex I. In the context of the exercise on the review of commodity and exotic derivatives launched by the Commission (European Commission’s call for evidence, ‘Review of commodity and exotic derivatives and related business as required by MiFID and recast CAD’, 1 December 2006), it might be also of interest to determine the scope of the category of ‘other derivative contracts (…) not otherwise mentioned in this Section, which have the characteristics of other derivative financial instruments’ (Annex I, Section C, paragraph 10).

\textsuperscript{13} Recital 70 of the MiFID implementing Directive provides that ‘transactions involving a customised OTC financial instrument that involve a unique contractual relationship tailored to the circumstances of the client and the investment firm may not be comparable for best execution purposes with transactions involving shares traded on centralised execution venues’. CESR notes in this respect that ‘a firm’s (execution) policy will need at least to address the different classes of instruments for which it carries out orders. Examples of such classes are equities, debt instruments, units of collective investment schemes and derivatives (which would need to be further distinguished between exchange-traded derivatives and OTC products, if appropriate’(CESR/07-320, ‘Best execution under MiFID’, Questions and Answers, p.7). The Commission indicates that: ‘Questions of market practice will help to determine whether it is legitimate for clients to rely on the firm. For instance, in the wholesale OTC derivatives and bond markets buyers conventionally ’shop around’ by approaching several dealers for a quote (…) and in these circumstances there is no expectation between the parties that the dealer chosen by the client will owe best execution’ (Ibid, p.22).

\textsuperscript{14} See \url{http://ec.europa.eu/internal_market/securities/docs/isd/questions/questions_en.pdf}, p.48.

\textsuperscript{15} P. 7 of the letter of the FX JSC to UK HM Treasury, December 2005.

\textsuperscript{16} See also the reply of HM Treasury, 21.6.2006, ‘MiFID implementation in the UK’: ‘In implementing MiFID we are not planning to change article 84 of the Regulated Activities Order (RAO). This means that whether or not such transactions are inside the scope of article 84 will continue to depend on whether or not, based on the tests in the article, they are for commercial or investment purposes. (…) This does not mean, however, that MiFID has no application to foreign exchange forwards. It perpetuates the situation under the ISD where the provision of foreign exchange services in connection with the provision of investment services is an ancillary service (previously described as a ‘non-core service’).
commercial purposes) (...). In our view, neither C4 nor C9 comprise forward foreign exchange instruments unless they are caught by the scope of the Regulated Activities Order. 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.\(^\text{17}\) Ireland has specifically excluded certain categories of forward foreign exchange transactions from the ambit of its MiFID implementing measures, whilst acknowledging that the provision of services in relation to such forward foreign exchange contracts may be an ancillary service where they are connected to the provision of investment services. The European Communities (Markets in Financial Instruments) Regulations 2007, as amended, provides that:

‘For the avoidance of doubt, a forward foreign exchange contract is not a financial instrument unless:

(a) its terms are determined principally by reference to standard or regularly published economic terms, such as price, lot and delivery date,

(b) it is traded, or is expressly stated to be equivalent to a contract that is traded, on a regulated market, an MTF or a third country trading facility that performs a similar function, and

(c) it is cleared or settled through a recognised clearing house or is subject to regular margin calls.

However, the provision of services in relation to forward foreign exchange contracts that are not financial instruments may be an ancillary service where these are connected to the provision of investment services.’

The approach taken to the forward foreign exchange exclusion in the Irish implementing measures of the MiFID reflects that taken in the MiFID implementing Regulation to what constitutes a financial instrument falling within Section C(7) of Annex I to the MiFID\(^\text{18}\).

In other Member States like France, foreign exchange forward transactions fall under the category of financial instruments, under the domestic legislation implementing both the ISD and the MiFID. Under the French Financial and Monetary Code (the Code)\(^\text{19}\), financial instruments comprise forward financial instruments (‘instruments financiers à terme’). These forward financial instruments include: ‘les contrats d’option, contrats à terme ferme, contrats d’échange, accord de taux futurs et tous autres contrats à terme relatifs à des instruments financiers, des devises, des taux d’intérêt, des rendements, des indices financiers ou des mesures financières qui peuvent être réglés par une livraison physique ou en espèces’\(^\text{20}\). The qualification of forward foreign exchange agreements as forward financial instruments matters for the financial institutions in France since this qualification entails, in addition to the benefits of the MiFID

\(^{17}\) FSA Handbook, Perimeter Guidance 13.4, Q30.

\(^{18}\) As clarified by Article 38(1) of the MiFID implementing Regulation. Section C(7) of Annex I to the MiFID references a category of derivative contracts (relating to commodities) each comprising a ‘contract … having the characteristics of other derivative financial instruments and not being for commercial purposes, which have the characteristics of other derivative financial instruments …’.

\(^{19}\) Article L.211-1-I(4) of the Code.

\(^{20}\) See Article D 211-1 A I, first paragraph of the Monetary and Financial Code (Regulatory part). This provision was introduced by the Decree n° 2007-904 of 15 May 2007 promulgated with a view to enforcing Order n° 2007-544 of 12 April 2007 relative to financial instruments markets. In the context of the recent French implementation of the MiFID, the list of financial instruments contained in the MiFID was included almost verbatim. Compare with the Annex I of the MiFID, Section C(4): ‘Options, futures, swaps, forward rate agreements and 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’.
European passport, specific consequences in terms of netting, these instruments being eligible for both the
prudential and legal netting systems.

b) The distinction between futures and forwards

A future or forward contract is usually defined as ‘a contract under which: (a) each party has the right and
the obligation to acquire or dispose of an asset at a specified price, for settlement at a future date; or (b) one
party has the right to receive a payment if the asset (or and index) increases in value and the other party has
the right to receive a payment if the asset or index decreases in value between two dates’.

Futures are usually considered as being very similar to forward contracts in that they also involve a future, rather than a
current, delivery obligation. However, the term ‘future’ is usually limited to transactions which are entered
into on an exchange.

In other words, they are standard contracts, involving the delivery of specified
amounts on a limited number of predetermined dates. Indeed, futures comprise the majority of all on-
exchange transactions. They can be subdivided into commodity futures, where the underlying asset is a
commodity (such as a metal or other physical goods), and financial futures (where the asset is a financial
instrument).

This distinction might be considered of lesser relevance in the MiFID context since section C (4) of Annex I of the MiFID includes futures and any other derivative contracts relating to currencies.

c) The criterion of being traded on a regulated market and/or a MTF

Section C(6) of Annex I to the MiFID refers to the criterion of being ‘traded on a regulated market and/or an MTF’. Similarly, Section (10) refers to other derivative financial instruments, ‘having regard to whether
these other derivative financial instruments inter alia, are traded on a regulated market or an MTF, are
cleared and settled through recognised clearing houses or are subject to regular margin calls’. This criterion
does not appear in Section C(4) which, as mentioned above, includes ‘futures’ and ‘derivative contracts’
relating to currencies and provides that ‘these instruments may be settled physically or in cash’.

21 The first consequence in terms of netting is of a prudential nature and enables the banks throughout their commercial
relationship with the customer to benefit from favourable rules in terms of calculation of bank own funds allowing the
prudential netting on a day-to-day basis of reciprocal transactions on financial futures entered into with the same client. The
second consequence is of a legal nature and consists, in the case of an event of default, of the possibility to proceed initially to
close-out netting of all forward foreign exchange operations concluded with the client and then, if the need arises, as a second
step to global netting of the balances of forward foreign exchange operations with the balances of operations of a different
nature (securities lending transactions, repurchase agreements). For the French netting system to apply with regard to forward
foreign exchange operations, the latter need to qualify as forward financial instruments (see Article L.431-7 of the French
Monetary and Financial Code, Regulatory Part).

22 See (c) Futures and forwards, para. 1.026 in ‘Derivatives law and practice’, S. Firth, Thomson Sweet & Maxwell, 2006. As in
the case of an option, therefore, a future or forward contract can involve physical or cash settlement. Unlike an option,
however, each party is exposed to movements in the value of the underlying asset or index in either direction.


24 Ibid. One of the characteristics of futures contracts is that, unlike forwards, only a very small proportion of the contracts
actually result in the delivery of the underlying assets, even if the terms of the transaction contemplate physical settlement. This
is because market participants often close out their positions by entering into an offsetting contract before the settlement date
occurs, so that an obligation to deliver an asset under one contract is matched by a right to take delivery of the assets on the
same date under the other. The ability to close out transactions in this way provides a degree of flexibility over the duration of
the derivative-based exposure, even though only a limited number of delivery dates will be available on the exchange (see

25 See paragraph 4 of Section C, Annex I.
2.2. Forward foreign exchange agreements and spot contracts

According to the Commission services, spot market foreign exchange agreements are not considered to be financial instruments for the purposes of MiFID\(^\text{26}\). It is noted that, for the purposes of Section C(7) of Annex I to the MiFID, which relates to ‘derivative contracts relating to commodities’, a spot contract 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’\(^\text{27}\). However, the MiFID implementing Regulation provides that ‘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’\(^\text{28}\).

In France, since the implementation of the ISD in 1996, the distinction to be made between spot and forward financial instruments (including in respect of foreign exchange operations) is the following: (i) spot operations are those which settle on their date of conclusion; (ii) forward operations are those, the settlement of which occurs on a date after their date of conclusion. This analysis is reflected in the Master Agreement of the French Banking Federation (FBF Master Agreement) relating to transactions on forward financial instruments\(^\text{29}\). A ‘transaction’ such as a forward foreign exchange transaction is defined in the FBF Master Agreement as ‘any OTC operation on forward financial instruments, settlement of which occurs on a date after its date of conclusion (…), such as a fixed term forward contract, an option, a swap, any combination of the foregoing or any similar contract relating to forward financial instruments’\(^\text{30}\).

2.3. Forward foreign exchange agreements and the ‘commercial purposes’ test

a) The ‘commercial purposes’ criterion in the MiFID

Section C(4) of Annex I of the MiFID does not provide for a ‘commercial purposes’ criterion. This criterion appears only in section C(7) of the same annex which refers to ‘derivative contracts relating to commodities which are not “for commercial purposes”’ and is further detailed in the MiFID implementing Regulation\(^\text{31}\) as follows: ‘a contract which is not a spot contract (…) shall be considered as having the


\(^{27}\) Article 38(2) of the MiFID implementing Regulation, first sub-paragraph.

\(^{28}\) Article 38(2) of the MiFID implementing Regulation, second sub-paragraph.

\(^{29}\) ‘Convention-cadre FBF relative aux opérations sur instruments financiers à terme, August 2001.

\(^{30}\) See Article 2 (‘Definitions’) of the FBF Master Agreement, p.8. Legal opinions on the Master Agreement confirm this analysis.

\(^{31}\) For instance, a legal opinion of 15.11.2002 regarding the above FBF Master Agreement confirms that the ‘Transactions’ covered by the FBF Master Agreement fall under the definition of forward financial instruments in the Code and are consequently eligible for the favourable close out netting system provided for under the Code (Paragraphs 3.2.1 and 3.2.3). Furthermore, the same position is asserted more explicitly in a French legal opinion of 30.12.2003 relating to the European Master Agreement (Paragraph 4.7.2 relative to ‘Derivative transactions’). As regards ‘spot transactions’, the legal opinion stresses that ‘spot transactions which settle on a date subsequent to the date of their conclusion should qualify as transactions on forward financial instruments’. The same opinion specifies that ‘the qualification of forward financial instrument under French law does not depend on the nature of the underlying asset of the relevant transaction but rather on the date of settlement of the transaction which occurs after the date of conclusion thereof’.

\(^{31}\) See Article 38(1), (2) and (4) of the MiFID implementing Regulation.
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.\(^{32}\)

It should be noted that the MiFID implementing above Regulation points out that: ‘The tests for determining whether a contract should be considered as having the characteristics of other derivative financial instruments and not being used for commercial purposes are only intended to be used for the purposes of determining whether contracts fall within Section C(7) or C(10) of Annex I to Directive 2004/39/EC.’\(^{33}\)

b) The ‘commercial purposes’ test in the UK and in Ireland

The UK currently considers that foreign exchange forward transactions entered into ‘for commercial purposes’ do not constitute financial instruments within the meaning of Annex I, Section C of the MiFID.\(^{34}\)

A ‘commercial purposes test’ which was already applied in the context of the ISD continues being used in the framework of the MiFID. In January 1988, the then UK Minister for Corporate Affairs, had indicated 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 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

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\(^{32}\) Article 38(1) of the MiFID implementing Regulation.

\(^{33}\) Recital 24 of the MiFID implementing Regulation.

\(^{34}\) 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 UK 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.’ Ireland has developed a similar approach.
In February 1996, the Securities and Investments Board (SIB) stated: ‘Forex itself is not an investment for the purposes of the [Financial Services] Act [1986] (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 certain arrangements or transactions involving FX were deemed to be within the scope of the Act.

The Regulated Activities Order (the ‘RAO’ in the UK perpetuates the position under the Act. It 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 and creates three categories distinguishing between commercial and investment contracts.

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). The Minister 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.

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; 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; 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 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.

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.

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, or
(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.

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.
As indicated in paragraph 2.1(a) above, Ireland has specifically excluded certain categories of forward foreign exchange transactions from the ambit of its MiFID implementing measures. The excluded categories of transactions are determined not by reference to a general ‘commercial purpose’ test but, instead, by reference to criteria of the nature set out in section C(7) of Annex 1 of the MiFID as clarified in the MiFID implementing Regulation (see paragraph 2.3(a) above).

2.4. Foreign exchange services connected to the provision of investment services

Under the MiFID, the notion of ancillary services includes ‘foreign exchange services where these are connected to the provision of investment services’. HM Treasury in the UK believes 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’\(^{42}\). The UK FSA, in its ‘perimeter guidance’ on the MiFID has 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 Financial Services and Markets Act 2000 regulation, where these investments satisfy the commercial purpose test in Article 84(2) RAO [FSMA (Regulated Activities) Order 2001 (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 example conflicts of interest.’\(^{43}\)

The exclusion, contained in Irish legislation implementing MiFID, of certain forward foreign exchange transactions from the ambit of that legislation specifically acknowledges that the provision of services in relation to excluded forward foreign exchange contracts may be an ancillary service where they are connected to the provision of investment services.

The Commission indicates in this respect that section B(4) of Annex I lists the provision of foreign exchange services as an ancillary service which applies only to those cases where those services are connected to the provision of investment services. The scope of the ancillary service is therefore restricted only to operations related to transactions which form part of an investment service. For example, when an

\(^{40}\) 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.

\(^{41}\) See Annex I, Section B(4).

\(^{42}\) P. 7 of the letter of the FX JSC to UK HM Treasury, December 2005.

\(^{43}\) Paragraph 3.3 of the FSAP perimeter guidance, March 2007.
investment firm is given an order to purchase foreign shares and those shares can only be purchased in a
currency the client does not own, the firm may engage in foreign exchange operations in order to be able to
execute the order\textsuperscript{44}.

3. Preliminary findings

The question arises of whether forward foreign exchange transactions constitute ‘financial instruments’ as
specified in Section C of Annex I of the MiFID and more particularly of whether they constitute ‘futures’
or ‘other derivative contracts’ as mentioned in the paragraph C(4) of that section, irrespective of whether
forward foreign exchange transactions go to delivery or not. The Commission services have however
indicated that: (i) ‘derivatives on currencies are financial instruments’; (ii) ‘an entity providing investment
services to its clients in relation to these instruments will therefore have to comply with MiFID's
authorisation and operational requirements’ and (iii) ‘spot market foreign exchange agreements are not
considered to be financial instruments for the purposes of MiFID’\textsuperscript{45}. It should be also noted that section
C(4) of Annex I of the MiFID does not provide for a ‘commercial purposes’ criterion, a criterion which
appears only in section C(7) of the same annex. Lastly, the MiFID implementing Regulation points out that
the tests for determining whether a contract should be considered as having the characteristics of other
derivative financial instruments and not being used for commercial purposes are only intended to be used
for the purposes of determining whether contracts fall within Section C(7) or C(10). They do not therefore
apply to Section C(4).

In the event forward foreign exchange agreements would qualify as financial instruments under the MiFID,
entities providing investment services to their clients in relation to these instruments would have to comply
with all the conditions and procedures for authorisation as well as with the operating conditions provided
for in the MiFID. The extent to which requirements such as the obligation to execute orders on terms most
favourable to the client would also apply to such instruments should however be examined. In the event
forward foreign exchange agreements would not qualify as financial instruments under the MiFID, it would
need to be assessed whether forward foreign exchange agreements qualify as ‘ancillary services’ within the
meaning of the MiFID.

In the event they would be considered as foreign exchange services connected to the provision of
investment services, these agreements would need to be covered by an authorisation granted to the entity
providing these services for the provision of one or more core investment services. If the provision of
forward foreign exchange services would not qualify as ancillary service within the meaning of the MiFID,
the entities providing such services would not be subject to the provisions of the MiFID.

\textsuperscript{44} See \url{http://ec.europa.eu/internal_market/securities/docs/isd/questions/questions_en.pdf}, p.48.
\textsuperscript{45} Ibid.
Against this background, the Commission should urgently examine how to ensure a uniform application of the MiFID with respect to forward foreign exchange agreements and sufficient legal certainty on this issue.

The EFMLG is invited to discuss these preliminary findings and the need for further action.