FIRST DRAFT

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THE ISSUE OF THE APPLICATION OF THE MIFID TO FORWARD FOREIGN EXCHANGE TRANSACTIONS: THE VIEWS OF [THE FOREIGN EXCHANGE CONTACT GROUP[1]] AND OF THE EFMLG[2]

Executive summary

The implementation of the directive on markets in financial instruments (MiFID) in the various EU Member States has revealed an issue of legal uncertainty regarding the rules which should be applied by credit institutions and investment firms when dealing with forward foreign exchange agreements, a few Member States having already adopted diverging solutions. The [Foreign Exchange Contact Group] and the EFMLG (the Groups) have examined the matter and would like to share their preliminary findings with the European Commission with a view to alerting it on the need to ensure a level playing field in this area across the EU Member States.

The MiFID provides contrasted signals as to whether forward foreign exchange agreements should be considered as falling or not under the scope of the MiFID. However, the Groups are of the view that the subjection of investment firms and credit institutions to the MiFID requirements in relation to the above agreements:

(i) would not correspond to the intentions of the European legislator when drafting the MiFID; and

(ii) would contradict the practices currently prevailing over the major forward foreign exchange markets all over the world and would increase the risk that other markets worldwide gain a competitive regulatory advantage over the EU.

[The Groups] stand at the Commission's disposal in order to discuss further the preliminary analysis and recommendations contained in the attached note.

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[1] The Foreign Exchange Contact Group (FXCG) serves as a forum for discussing industry developments and structural trends of particular importance for the foreign exchange market. The FXCG is composed of around twenty members with leading functions in financial institutions with prominent role in the area of foreign exchange.

[2] The EFMLG is a group of legal experts from the EU banking sector dedicated to analysing and undertaking initiatives intended to foster the harmonisation of laws and market practices and facilitate the integration of financial markets in Europe following the introduction of the euro. The members of the Group are selected, on the basis of their personal experience, amongst lawyers of those credit institutions based in the EU which are most active in the European financial markets, namely the banks of the Euribor and Eonia panels.

THE ISSUE OF THE APPLICATION OF THE MIFID TO FORWARD FOREIGN EXCHANGE TRANSACTIONS

1. Forward foreign exchange agreements: definitions

Foreign exchange transactions can be defined as 'transactions between parties for the purchase by one party of an agreed amount in one currency against the sale by it to the other of an agreed amount in another currency, both such amounts being deliverable on the same value date, and in respect of which transactions the parties have agreed (whether orally, electronically or in writing) the currencies involved, the amounts of such currencies to be purchased and sold, which party will purchase which currency and the value date'[3] [4].

A spot transaction can be defined as 'the purchase of one currency against the sale of another currency, with the delivery and sale normally being completed on the second subsequent business day, which is known as the settlement date or value date' while a forward transaction 'differs from a spot transaction in that the delivery and sale of currencies are completed only on a future value date, the amounts, however, being fixed by reference to the rates of exchange agreed on the deal date'[5].

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[6]. 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[7].

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3 Case C-172/96 *Commissioners of Customs & Excise v. First National Bank of Chicago* [1998] ECR I-04387. Reference is made in the judgment of the European Court of Justice (the Court) to the situation of a bank carrying on 'a wide range of banking activities, including foreign exchange dealing' (paragraph 10). The Court considered that these activities constituted supplies of services effected for consideration within the meaning of the VAT Directive (paragraph 35).

4 Another definition of forward foreign exchange agreements could be the following: '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 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' (See 'Derivatives law and practice' , 'Fx forwards; NDFs', paragraph 14 008).

5 Paragraph 12 of the above ECJ case. With regard to forward foreign exchange agreements, the national court involved pointed out that no money is delivered physically in the form of coin, note or other chattel in the foreign exchange transactions entered into by the bank. What is delivered is the availability of drawing on an account opened with a bank in the currency delivered (paragraph 13).

6 See 'Derivatives law and practice', S. Firth, Thomson Sweet & Maxwell, 2006, paragraph 1.028.

7 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' (See 'Derivatives law and practice', (c) Futures and forwards, paragraph 1.026).

In general, the doctrine acknowledges the conceptual similarity between forward foreign exchange agreements and derivatives[8]. For instance, S. K. Henderson describes as follows the historical foundations of this convergence: 'The purchase and sale of foreign exchange has long been used by end-users to hedge their exposure to assets and liabilities expressed in currencies other than their own base currency, to obtain foreign currency to meet their obligations expressed in those currencies and to convert foreign currencies received into their base currency. It is also one of the most traditional of core banking activities, along with the lending of money[9]. Henderson concluded that: 'Gradually, the perception grew that spot and forward foreign exchange transactions were conceptually similar to derivatives and treating them separately for all purposes made little sense'[10].

Lastly, it should be noted that two main kinds of forward foreign exchange agreements can be distinguished, i.e. 'deliverable FX transactions' and 'non-deliverable FX transactions'[11], of which Henderson defines the latter as 'simply cash-settled forward currency contracts'[12].

2. Forward foreign exchange agreements and the MiFID

In the context of the transposition of the directive on market in financial instruments (the MiFID)[13], the question has arisen as to whether forward foreign exchange transactions could fall under the types of financial instruments listed in the MiFID, and, more particularly, whether they could be considered as 'futures', 'other derivative contracts' or 'other derivative instruments' (**2.1**) or whether they could be considered as ancillary services within the meaning of the MiFID (**2.2**). While Member States have provided diverging solutions to this question (**2.3**), the legal qualification entails some consequences with

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8 See, for instance, 'Financial Markets and Exchanges Law', E. Murray, Part III, Chapter 6, 6.03, p.266: "in market terminology a 'financial derivative' is a derivative in relation to which the underlying asset is cash or a financial instrument (for example, a forward foreign exchange contract)".

9 Henderson on Derivatives, Schuyler K Henderson, LexisNexis Butterworths, Chapter I, '3.2 Currency products', pp.54-55. Henderson also pointed out that 'the clear connections between FX trading and currency swaps were made even clearer as forward foreign exchange transactions were effected for longer periods and currency swaps for shorter periods, and as more exotic forms of currency transactions evolved from the classic spot or forward foreign contract'.

10 This view is reflected in the classification proposed in the BIS Triennial Central Bank Survey, December 2007, 'Foreign exchange and derivatives market activity', p.15 since no real dividing line is made between the outright forwards and FX swaps in the 'traditional foreign exchange markets' on the one hand and foreign exchange segment of the OTC derivatives market on the other hand. See also the ECB classification of financial markets instruments (July 2005, pp.11-12) which covers foreign exchange and foreign exchange derivatives under the same heading.

11 See the relevant articles of the ISDA-EMTA-The Foreign Exchange Committee 1998 FX and Currency Option Definitions or the FBE-ESBG-EACB Master Agreement for Financial Transactions, Supplement to the Derivatives Annex, Foreign Exchange Transactions, 2004, which distinguishes 'Foreign Exchange Spot' and 'Foreign Exchange Forward' on the one hand and 'Non-deliverable Foreign Exchange Forward' on the other hand.

12 According to Henderson (3.3. Non deliverable forwards', p.56), there may be a number of reasons for choosing this structure: (i) the parties may wish to eliminate delivery risk; (ii) one of the parties may wish to hedge (or speculate) in a particular currency but lacks the physical presence or banking facilities in the relevant country to enable it to make or receive payments in that currency; (iii) the parties may choose settlement in one currency, usually a liquid and freely exchangeable currency, because of concerns about the convertibility of the other currency or in order to base the contractual relationship and performance in what may be regarded as a legally secure payment centre'.

13 Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, OJ L 145, 30.4.2004, p. 1–44.

regard to the nature and scope of the MiFID obligations applicable to credit institutions and investment firms **(2.4)**.

2.1. Forward foreign exchange agreements and financial instruments

a) The exclusion of forward foreign exchange agreements from the ISD

The investment services and activities covered under the MiFID must relate to any of the financial instruments listed in the relevant Annex of the MiFID[14]. This list of financial instruments includes in particular: 'Options, futures, swaps… and any other derivative contracts relating to securities, currencies, interest rates or yields, or other derivatives instruments,…which may be settled physically or in cash'[15].

It is of interest to note in this respect that, under the Investment Services Directive (ISD)[16], forward foreign exchange agreements were not considered as 'instruments' or 'services', other than in the context of non-core services[17]. Even more, the ISD pointed out that: 'an investment firm should not be able to invoke the [ISD] in order to carry out spot or forward exchange transactions other than as services connected with the provision of investment services' and that, therefore, the use of a branch solely for such foreign exchange transactions would constitute misuse of the machinery of the directive.[18]

The MiFID does not contain a recital similar to the one included in the ISD and the preparatory documents to the MiFID do not examine the reasons for this difference with the ISD. One possible justification for this absence is that the MiFID list of financial instruments ('the MiFID list') is more detailed than the ISD list[19] and may be considered as covering these types of transactions. The MiFID list of financial instruments includes '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'[20]. It is noted that the expression 'and others' raises ambiguity since it may cover only other commodity derivatives but also other types of derivatives. The assessment of the preparatory documents to the MiFID tends to confirm that the European legislator wished essentially to extend the scope of the MiFID list to commodity derivatives[21] and not, in particular, to 'physically-settled spot or forward exchange or commodities'[22]. However, the MiFID list was gradually expanded to include, for instance, financial instruments such as

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14 Section C of Annex I of the MiFID.

15 Section C (4), Annex I of the MiFID.

16 Recital 7 of the ISD.

17 Under Article 1 (1) of the ISD, an investment service is defined as 'any of the services listed in Section A of the Annex relating to any of the instruments listed in Section B of the Annex that are provided for a third party'.

18 Recital 7 of the ISD.

19 Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field, OJ L 141, 11.6.1993, p. 27.

20 Recital 4 of the MiFID.

21 See, for instance, the 'Revision of the Investment Services Directive (93/22/EEC)', Second consultation, Overview paper, document of services of DG Internal Market, March 2002, p.21. Similarly, the MiFID common position (recital 4) only referred to the inclusion of 'commodity derivatives which are constituted and traded in such a way as to give rise to regulatory issues comparable to traditional financial instruments such as futures, options, swaps and any other derivative contract relating to commodities that can be settled in cash or that is physically settled provided that it is traded on a regulated market or a multilateral trading facility (MTF)'.

22 See the Explanatory memorandum of the Commission's proposal for a Directive of the European Parliament and of the Council on investment services and regulated markets, and amending Council Directives 85/611/EEC, Council Directive 93/6/EEC and European Parliament and Council Directive 2000/12/EC, 19.11.2002, COM(2002) 625 final, IV.3. Commodity derivatives (Annex I, section C), pp.30-31. In the French version,'physically-settled spot or forward exchange or commodities' are referred to as 'contrats sur produits de base ou…contrats de change au comptant ou à terme donnant lieu à une livraison physique'.

'options, futures…and any other derivative contracts relating to… currencies' which are not commodity derivatives, therefore thereby contradicting the initial intention of the Commission.

b) Forward foreign exchange agreements and derivatives on currencies

Should forward foreign exchange agreements fall under the category of derivatives on currencies, the Commission services have clearly indicated that they would be considered as 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'[23]. It is of interest to note in this respect that the Banking Directive[24] classifies forward foreign exchange agreements as derivatives[25].

c) The case of spot forward foreign exchange agreements

For the purposes of 'derivative contracts relating to commodities'[26], 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'[27].

The distinction between spot and forward foreign exchange agreements is usually reflected in the standard market documentation[28]. Moreover, according to the Commission's services, spot market foreign exchange agreements do not constitute financial instruments for the purposes of MiFID[29]. However, although the distinction introduced in the MiFID implementing measures between spot contracts and other derivative contracts relating to commodities can be understood since the MiFID provides for the possibility to adopt implementing measures[30] for these types of contracts, this is not the case for derivatives in currencies.

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23 See http://ec.europa.eu/internal_market/securities/docs/isd/questions/questions_en.pdf, p.48.

24 Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), OJ L 177, 30.6.2006, p.1.

25 Under the Banking Directive, the list of activities subject to mutual recognition includes 'trading for own account or for account of customers in … (b) foreign exchange and (c) financial futures and options' (Annex I). At the same time, the types of derivatives covered under the Banking Directive include the category of 'foreign-exchange contracts and contracts concerning gold', i.e. in particular forward foreign-exchange contracts and currency futures (Annex IV). This classification is of relevance, for instance, in order to determine the exposure value of a derivative instrument listed in the Banking Directive or the exposure value of a securitisation position arising from a derivative instrument or in order to identify the categories of contracts covered for the purpose of cross-product netting.

26 Section C(7) of Annex I to the MiFID.

27 Article 38(2) of the MiFID implementing Regulation, first sub-paragraph. 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' (Article 38(2) of the MiFID implementing Regulation, second sub-paragraph).

28 As an example, the distinction made between spot and forward financial instruments is reflected in the FBF Master Agreement of the French Banking Federation relating to transactions on forward financial instruments, which defines a 'transaction' such as a forward foreign exchange transaction 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' (Article 2 ('Definitions'), p.8).

29 See http://ec.europa.eu/internal_market/securities/docs/isd/questions/questions_en.pdf, p.48.

30 See Article 4(2), second subparagraph, first indent of the MiFID.

d) The commercial purposes test

For the category of derivative contracts relating to commodities, the MiFID list includes an express distinction between the contracts which are and those which are not 'for commercial purposes'[31]. However, it is noted that this distinction is not provided for Section C(4) of the Annex and the applicable tests are only intended to be used in the context of derivative contracts relating to commodities[32].

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

The notion of ancillary services to investment services under the MiFID includes 'foreign exchange services where these are connected to the provision of investment services'[33]. The Commission indicates in this respect that the provision of foreign exchange services as an ancillary service applies only to those cases where those services are connected to the provision of investment services[34] and mentions, as an example, that, when an 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[35].

2.3. The diverging approaches taken by EU Member States

The information available to the EFMLG[36] indicates that Member States, when transposing the MiFID, have developed contrasted approaches with regard to the legal qualification of forward foreign exchange agreements and their subjection to MiFID requirements.

- In the *UK*, it was argued that FX forwards and FX swaps which go to delivery are not derivatives and therefore fall outside of the scope of the MiFID[37] and that, accordingly, the MiFID does not require any change to the current position of FX forwards under English law and regulation. 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 1 to the MiFID and considered that the scope of these sections does not extend to spot transactions and transactions which are not derivatives (such as forwards entered into for commercial purposes). In the FSA's view, neither Section C(4) nor Section C(9) comprise forward foreign exchange instruments unless they are caught by the scope of the Regulated Activities Order (RAO). The FSA considers that a non-

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31 This criterion appears only in Section C(7) of Annex I of the MiFID and is further detailed in Article 38(1), (2) and (4) of the MiFID implementing Regulation. A contract which is not a spot contract is considered as having the characteristics of other derivative financial instruments and not being for commercial purposes if it satisfies a number of conditions listed in the MiFID implementing Regulation.

32 See the recital 24 of the MiFID implementing Regulation. 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 however does not appear in Section C(4) of Annex I. This criterion alone is not decisive to distinguish between different types of forward foreign exchange agreements under the MiFID.

33 See Annex I, Section B(4).

34 Section B(4) of Annex I.

35 See http://ec.europa.eu/internal_market/securities/docs/isd/questions/questions_en.pdf., p.48.

36 It is noted that the EFMLG did not perform a systematic review of the implementation of the MiFID in the 27 Member States on this issue.

37 P. 7 of the letter of the FX JSC to UK HM Treasury, December 2005.

deliverable currency forward which is not a 'future' for purposes of the RAO because it is made for commercial purposes will likewise fall outside the scope of MiFID.[38] In the UK, a 'commercial purposes' test which was already applied in the context of the ISD continues being used in the framework of the MiFID and 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. The RAO defines '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.'[39] The RAO qualifies this by excluding any contract which is made for commercial and not investment purposes. It was also argued by market participants 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[40]. The UK FSA is of the view that 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, although, in its view, 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.[41]

- *Ireland* has specifically excluded certain categories of forward foreign exchange transactions from the ambit of its national 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[42]. In particular, 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 The excluded categories of transactions are determined therefore not by reference to a general 'commercial purpose' test but, instead, by reference to criteria of the nature set out for derivative contracts related to commodities[43].

- In *France*, forward foreign exchange transactions fall under the category of financial instruments, under the domestic legislation implementing the MiFID.[44] It is noted that the qualification of forward foreign exchange agreements as forward financial instruments entails, in addition to the benefits of the MiFID European passport if MiFID were to be interpreted as encompassing such transactions, specific

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38 FSA Handbook, Perimeter Guidance 13.4, Q30.
39 Article 84 of the RAO.
40 P. 7 of the letter of the FX JSC to UK HM Treasury, December 2005.
41 Paragraph 3.3 of the FSA perimeter guidance, March 2007.

42 See the European Communities (Markets in Financial Instruments) Regulations 2007, as amended.

43 The criteria adopted for excluding certain types of forward foreign exchange agreements in the Irish transposition measures of the MiFID correspond to the criteria listed in Article 38(1) of the MiFID implementing Regulation in application of Section C(7) of Annex I to the MiFID.

44 The list of financial instruments contained in Annex 1, Section C(4) of the MiFID was included almost verbatim in the French implementation measures of the MiFID. Under Article L.211-1-I(4) of the French Financial and Monetary Code (the Code) and Article D. 211-1 A I, first paragraph of the Code (Regulatory part), financial instruments comprise forward financial instruments ('instruments financiers à terme'). These forward financial instruments include: 'les contrats d'option, contrats à terme ferme… et *tous autres contrats à terme relatifs à* des instruments financiers, *des devises*….

consequences in terms of netting, these instruments being eligible for both the prudential and legal netting systems. In particular, for the French netting system to apply with regard to forward foreign exchange operations, the latter need to qualify as forward financial instruments[45].

2.4. Consequences for the application of the MiFID.

Under the MiFID, investment firms authorised and supervised by the competent authorities of a Member State may freely perform investment services and/or activities relating to financial instruments as well as ancillary services[46] in the entire Community either through the establishment of a branch or the free provision of services, provided that such services and activities are covered by the authorisation provided by competent authorities[47]. The MiFID also defines inter alia the conditions and procedures for authorisation[48] and the operating conditions for investment firms[49] as well as the rights of investment firms[50]. The operating conditions for investment firms include, for instance, rules on conflicts of interest and the provisions to ensure investor protection (including the conduct of business obligations when providing investment services to clients and/or, when appropriate ancillary services or the best execution rules). The MiFID applies to investment firms. However, a number of provisions listed in the directive also apply to authorised credit institutions, when providing one or more investment services/activities[51]. This also includes the obligation to comply with provisions to ensure investor protection. As regards ancillary services, they may only be provided together with an investment service and/or activity[52] and the MiFID indicates in principle which requirements should apply when providing such ancillary services.

3. Comparative approach: overview of the US and UK markets

According to the Bank for International Settlements (BIS), the activity in the foreign exchange segment of the OTC derivatives market is dominated by traditional instruments such as outright forwards and FX swaps[53]. These relatively simple instruments account for 90% of turnover in FX derivatives[54]. In terms of geographical distribution, the turnover in OTC derivatives was more concentrated in a small number of financial centres than trading in the FX spot market. 59 per cent of total turnover took place in only two countries (i.e. the UK and the US) compared to just over half in the traditional FX market. The BIS survey

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45 See Article L.431-7 of the Code.

46 Ancillary services are defined as ‘the services listed in Section B of Annex I’ (see Article 4(1) (3) of the MiFID).

47 Article 31(1) of the MiFID. As regards the establishment of a branch, under the MiFID, Member States must ensure that investment services and/ or activities as well as ancillary services may be provided within their territories in accordance with the MiFID and Directive 2000/12/EC through the establishment of a branch provided that those services and activities are covered by the authorisation granted to the investment firm or the credit institution in the home Member State (Article 32(1) of the MiFID).

48 Title II, chapter I of the MiFID.

49 Ibid.

50 Ibid.

51 Article 1(2) of the MiFID.

52 Articles 31(1) and 32(1) of the MiFID.

53 BIS Triennial Central Bank Survey, December 2007, Foreign exchange and derivatives market activity in 2007, p.15.

54 With an average daily turnover of $2.1 trillion.

confirms London's role as the largest international centre for OTC derivatives trading. The international role of the United Kingdom is underlined by the fact that most transactions do not involve the domestic currency[55]. By contrast, activity in the US reflects the pre-eminent role of the US dollar in global financial markets, with transactions denominated in other currencies playing only a subordinate role.[56].

It is of interest to note that the two most important markets for FX forwards in the world are to a large extent unregulated. In the UK, due to 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'), 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[57]. In the US, OTC FX forwards, including non-deliverable forwards, are not generally regulated unless they are offered to or entered into with retail counterparties by unregulated entities[58].

4. Preliminary findings

One essential ambiguity relating to the legal qualification of forward foreign exchange agreements under Community legislation is that, while trading in foreign exchange constitutes a core banking activity, derivatives on currencies belong to the list of financial instruments under the MiFID[59]. As mentioned above, the assessment of the preparatory acts of the MiFID tends to indicate that the European legislator did not necessarily intend to subject investment firms (and credit institutions) providing forward foreign exchange agreements to all the requirements of the MiFID. Moreover, the dominant markets for FX forwards in the world, i.e. the US and the UK are to a large extent unregulated and not excluding forward foreign exchange agreements from the scope of the MiFID would increase the risk that other markets worldwide gain a competitive regulatory advantage over the EU[60]. Against this background, an amendment of the MiFID would be warranted in order (i) to remedy the current legal uncertainty created by the diverging approaches taken by national legislators and (ii) to clarify that forward foreign exchange agreements should not be covered by the MiFID.

As regards the method for introducing these amendments, the possibilities offered by the recourse to implementing measures in this case are unfortunately very limited[61]. Alternatively and although there is no

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55 Only about 21% of all trades in FX derivatives had one leg denominated in pound sterling.

56 Pp.18-20. Outside the United Kingdom and the United States, most trades took place in Europe (18%).

57 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.

58 FX forwards do not generally implicate the US securities laws and are generally eligible for an exclusion from regulation under the US commodities laws which regulate commodity futures and options.

59 The distinction between futures and forwards is not decisive in the context of our present assessment since Section C (4) of Annex I of the MiFID includes both 'futures' and 'any other derivative contracts relating to currencies'.

60 The Lamfalussy report of 15 February 2001 on the regulation of European securities markets stressed that an efficient European regulatory process for financial services and capital markets was crucial for the whole of the European Union and all its citizens but also for strengthening both the international competitiveness of the European Union in the global economy and for releasing its entrepreneurial potential, p.71.

61 See Article 4(2) of the MIFID which provides comitology only with regard to derivative contracts mentioned in Sections C7 and C10 of Annex I of the MiFID.

specific provision in the MiFID providing for a general review of the directive, the Commission is expected to report on a number of MiFID-related issues in 2008. The Commission might wish to seize this opportunity to examine the above matter and consider possible amendments to the MiFID.

Before any future clarification of the MiFID and in the meantime, a distinction should be made between credit institutions and investment firms, when carrying on activities relating to forward foreign exchange agreements. It should be examined whether the activity of derivatives on currencies/forward foreign exchange agreements should not be considered as covered by the list of activities already subject to mutual recognition under the Banking Directive, i.e. trading in foreign exchange[62]. Therefore, the requirements imposed by the MiFID with regard to the provision of services and activities relating to derivative currencies would not affect the obligations and rights of credit institutions active in this field to the extent these credit institutions already benefit from the European passport under the Banking Directive when trading in foreign exchange. As regards services supplied by investment firms in relation to forward foreign exchange agreements and unless they are considered as ancillary services under the MiFID, for which case specific provisions would still need to apply, investment firms would need to benefit from the European passport provided by the Banking Directive to carry on these activities without having to comply with the MiFID requirements. Pending possible amendments to the MiFID and in view of the above preliminary analysis, the Commission might wish to consider mandating the Committee of European Securities Regulators (CESR) and the Committee of European Banking Supervisors (CEBS) to reach a common understanding on the above issues[63].

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In view of the above, the Groups consider that an amendment to the MiFID would be necessary to clarify the issue of the applicability of the MiFID to forward foreign exchange agreements. In the meantime, the Groups would recommend that the Commission mandates the CESR and CEBS with a view to examining how to ensure an uniform application of the MiFID with respect to forward foreign exchange agreements and sufficient legal certainty on this issue.

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[62] See Annex I of the Banking Directive which provides the list of activities subject to mutual recognition and Article 23 of the Banking Directive.

[63] This common understanding could take the form of a Commission's declaration (see the Commission's declaration incorporated in the draft summary record of the 43rd meeting of the European Securities Committee of 26 June 2006, Working document ESC/35/2006). In this declaration, the Commission indicated that: 'In the interests of uniform, effective and proportionate regulation for investment firms and credit institutions, a common approach to the parallel requirements of Directive 2000/12/EC, and Directive 2004/39/EC should be adopted to the extent that those requirements overlap'.