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BVI position on the EU Commission Consultation Document on FX Financial Instruments

BVI[1] gladly takes the opportunity to present its views on the EU Commission consultation document on FX financial instruments.

BVI supports the initiative taken by the EU Commission to clarify and harmonize the definition of FX spot transactions which should be applied within the EU. Only a consistent approach to FX spot transactions and the appropriate delineation from forwards both within the EU Member States and globally will improve legal and operational certainty for all market participants.

We take the view that FX transactions used as FX security conversions[2] are spot transactions and should therefore not be considered as a MiFID financial instrument. This should also apply for settlements of other commercial transactions/activities (e.g. payments in a foreign currency for property rented abroad or acquisitions of foreign entities, increases of capital of foreign branches etc.).

We would like to make the following detailed comments:

(1) Do you agree that a clarification of the definition of an FX spot contract is necessary?

Yes, a clarification of the definition of an FX spot contract is necessary.

The EMIR reporting obligation illustrates clearly that a different treatment/definition of FX spot transactions within the EU Member States will result in different reports of the same FX product to the trade repositories (TR). The inconsistent handling/reporting of FX spot transactions as derivatives to TRs enhances legal and operational uncertainty for all financial (e.g. investment fund management companies) and non-financial counterparties. Furthermore, it creates an additional burden in the reconciliation process on the level between the TRs and between the counterparties.

A consistent definition and approach of an FX spot and the appropriated delineation from forwards within the EU Member States is clearly necessary in order to improve legal certainty for all market participants and the national competent authorities.

[1] BVI represents the interests of the German investment fund and asset management industry. Its 81 members currently handle assets of EUR 2.0 trillion in both investment funds and mandates. BVI enforces improvements for fund-investors and promotes equal treatment for all investors in the financial markets. BVI`s investor education programmes support students and citizens to improve their financial knowledge. BVI`s members directly and indirectly manage the capital of 50 million private clients in 21 million households. (BVI's ID number in the EU register of interest representatives is 96816064173-47). For more information, please visit www.bvi.de.
[2] Definition of FX transaction for the purpose of EMIR: FX transactions are FX securities conversions which are used for the purchase, sale or exchange of a foreign currency by a party for the purpose of effecting a purchase or sale of a foreign security, as well as to convert dividend payments and other payments received through corporate actions of the foreign issuer into local currency.

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(2) What are the main uses for and users of the FX spot market? How does use affect considerations of whether a contract should be considered a financial instrument?

German investment fund management companies, acting as agents for the client on behalf of the regulated investment funds (e.g. UCITS, AIFs), mainly use FX spot transactions in the context for a purchase or sell of an asset traded in a foreign currency (e.g. equities, government and corporate bonds, real estate investments, fund units). FX transactions are also used by investment funds in order to convert dividend payments and other payments received through corporate actions of the foreign issuer into fund currency. Furthermore, FX payments are used for the settlement of other commercial transactions.

German investment fund management companies can either execute the FX transactions themselves or instruct broker/dealers to process a FX transaction (e.g. spot and forwards). Furthermore, management companies may also instruct the custodian bank of the investment fund to execute FX transactions.

We are of the view that FX transactions used as FX security conversions and FX payments used for the settlement of other commercial transactions are spots and should therefore not be included within the definition of a MiFID financial instrument. This should also apply to FX transactions used to offset a possible negative balance of a foreign exchange account of an investment fund.

FX transactions, used as security conversions, are solely used to conclude a transaction in an asset which currency is denominated other than the fund base currency. Security conversion transactions cannot be used for speculative purposes in order to obtain profits from changes in FX rates.

Such FX spot transactions should not be treated as derivatives and therefore should not be subject to the EMIR reporting obligation. A possible classification of such FX transaction as derivatives would only increase the reporting burden, the operational complexity and cost for the investment fund management companies and their counterparties with no additional benefit for the investors and the regulators.

(3) What settlement period should be used to delineate between spots contracts? Is it better to use one single cut-off period or apply different periods for different currencies? If so, what should those settlement periods be and for which currencies?

Please see our answer above. FXs spots used as security conversions or in the context for the settlement of other commercial transactions should not be considered as derivatives. A harmonized settlement period definition within the EU should be introduced in order to delineate between FX spots and forwards beyond the usage of spots as security conversions or settlement of other commercial transactions.

We prefer that the prevailing market standard applied for the settlement periods of FX transactions is used to classify spot contracts. However, as a fallback position, a classification of FX spot transactions with a maximum settlement period of seven business days could also be taken into consideration. A harmonized settlement cycle will ensure that such FX spot transactions will not be treated as derivatives and should therefore not be subject to the EMIR reporting obligation.

The introduction of a single cut-off period should be carefully calibrated and has to incorporate existent FX market practices. Furthermore, a possible framework for a single cut-off period within the EU also has to clarify the scope of currency pairs which should be covered by a future regulation, especially the interaction for non-liquid currencies outside the EU.

The introduction of a framework for different cut-off periods for separate currencies could increase the operational complexity and the appropriated workload in the back offices for all market participants (e.g. investment fund management companies).

(4) Do you agree that non-deliverable forwards be considered financial instruments regardless of their settlement period?

We agree that non-deliverable forwards (e.g. INR) should be treated as financial instruments regardless of their settlement period. However, it could be taken into consideration that in the specific case of non-deliverable forwards with a short settlement period used to prolong an existing hedge with a cut-off seven days should not be classified as financial instrument.

(5) What have been the main developments in the FX market since the implementation of MiFID?

FX products are traded more and more over electronic systems and less via phone. Furthermore, market infrastructure providers (e.g. CLS) are used in order to enhance operational efficiency and to mitigate counterparty and settlement risk.

(6) What other risks do FX instruments pose and how should this help determine the boundary of a spot contract?

Legal and operational risk could also be considered for FX instruments in order to determine the boundary of a spot contract. The liquidity risk of FX spot transactions is significantly higher than for FX swaps. Therefore, any future regulation should take this into consideration in order to classify an FX spot transaction from forwards.

(7) Do you think a transition period is necessary for the implementation of harmonised standards?

Yes, a transition period is necessary to implement a harmonized approach as the operational infrastructure (e.g. trading and back office systems) and the legal procedures need to be adapted to the new standards.

(8) What is the approach to this issue in other jurisdictions outside the EU? Where there are divergent approaches, what problems do these create?

The CFTC exempts FX spot transactions which are related to the settlement of a securities transaction from the Dodd Frank requirements.[3] We think that in the context of the EMIR reporting obligation the renewed definition of financial instruments also has to take into consideration this aspect in order to have a harmonized approach globally. Otherwise, a different treatment/definition of FX spot transactions between the US and Europe could result in different reports of the same FX contracts to TRs.

A different global approach of FX spot contracts could also lead to the situation that the trading of FX instruments would take place in markets where the regulation is not as stringent as in other countries.

(9) Are there additional implications to those set out above of the delineation of a spot FX contract for these and other applicable legislation?

An additional implication could effect the calculation of the default risk which is defined in the OTC-framework contracts (Deutscher Rahmenvertrag für Finanztermingeschäfte/ISDA Master Agreement).

(10) Are there any additional issues in relation to the definition of FX as financial instruments that should be considered?

No comment.

[3] http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/13-13.pdf, please see footnote 12.