The Association of Corporate Treasurers

Interest Representative Register ID: 64617562334-37

Comments in response to
FX Financial Instruments
European Commission,
April 2014

9 May 2014

The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance. Further information is provided at the back of these comments and on our website www.treasurers.org.

Contact details are also at the back of these comments.

We canvas the opinion of our members through seminars and conferences, our monthly e-newsletter to members and others, *The Treasurer magazine*, Treasurers' forum and our Policy and Technical Committee.

General

The ACT welcomes the opportunity to comment on this matter.

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During the implementation stages of EMIR we have noticed that many companies are running behind on their implementation plans, particularly on reporting. We also believe a vast number of smaller companies with very few derivative trades are not complying at all. Enforcement with these millions of smaller companies is not practical so that the EMIR regulation is brought into disrepute by this non-compliance.

Our recommendation is that in interpreting the spot and commercial forward definitions the Commission should take a proportionate risk approach and set the boundaries so that many immaterial users of derivatives are in effect out of scope.

Any delineation between spot and forwards is somewhat arbitrary. Nonetheless we suggest a universal limit of T+7 for spot. We further recommend that the original spirit of MiFID is adhered to namely that derivatives done for commercial purposes are not an investment activity and thus not within MiFID nor within scope for EMIR.

Answers to the consultation questions:

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

For EMIR reporting to be useful to regulators there needs to be consistency across all member states of the definition of a derivative or derivative contract. Spot FX transactions are not derivatives for EMIR purposes and so do not need to be reported. Thus clarifying the definition of an FX spot contract should provide greater uniformity of reporting. We understand ESMA's request for urgent clarification in this context. And thus understand the short consultation period allowed in this case.

If the definition of an FX spot contract that may follow this consultation is to be used in relation to other directives or regulations over and above EMIR we think that that is an important matter that may have wide implications. Accordingly, any application outside or beyond EMIR should be separately consulted on both as to application, extent and any necessary exemptions or modifications that may be necessary in regard to those non-EMIR applications.

(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?

Non-financial corporates use the spot FX market to acquire foreign currency to settle or with a view to settling foreign denominated transactions (such as purchases of overseas goods and services or the acquisition of a foreign business) and for cash management purposes to ensure they have adequate liquidity (i.e. the amount of currency when they need it). In the latter cases a spot transaction can be combined with a forward transaction in the reverse direction to create an FX swap. This can be used, for example, when cash originally held in different currencies is pooled into a central currency for centralised investing but where there is no desire to change the underlying balance of currency assets in exposure terms.

A foreign exchange spot transaction is an agreement between two parties to buy one currency against selling another currency at an agreed price for settlement on the spot date. Whilst the spot date is normally trade plus two banking days there are exceptions, CAD /USD for example works off T + 1 day. Spot is a market convention and transactions for dates different from spot will adjust from the spot rate based on the interest rate differentials between the currency pair.

(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?

The spot foreign exchange market imposes a delivery period, commonly two-days, originally due to the time it would take to move cash/information from one bank to another, possibly cross border and across time zones. It would certainly avoid confusion for the purposes of EMIR compliance if there was a universal convention as to what settlement periods would be excluded from the regulation under the heading of "spot". Given that some regulatory authorities already use the convention that any trades with settlement up to T + 7 are not treated as derivatives we would recommend using this convention uniformly for the purposes of EMIR.

This has the advantage that very short term transactions with minimal risk exposures (whether credit or rate or basis or other) are excluded from the burden of EMIR. This also means that FX deals associated with the various other trades that conventionally work on longer than T+2 settlement would be treated as spot-like and more akin to a settlement transaction than a forward for EMIR purposes.

For many companies short dated FX trades to buy and sell currencies to cover foreign currency invoices (both sales and purchases) may be the only FX they undertake. A broad definition of T+7 would mean a welcome simplification for these companies, allowing them to concentrate on their core economic activity rather than of what for them is really an ancillary admin burden.

As explained above, we do not think that the short consultation period in respect of the urgent request for clarification for EMIR purposes is appropriate for any wide application of a new uniform spot definition in other legislation.

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

A non-deliverable forward contract is the same as a forward FX contract except the counterparties settle the difference between the contracted NDF rate and future spot rate on the agreed notional amount. Hence we are sympathetic to the view that they should be treated as financial instruments, save in the case of NDFs entered into for commercial purposes are explained in our response to Q10.

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

Non-financial corporates primarily use FX contracts to hedge commercial exposures and for liquidity management - i.e. for non-investment purposes. More and more companies transact their FX requirements on line through various multi-bank platforms. Associated with this is a greater "electronification" of instructions and confirmations and settlements. The historic administrative constraints that drove spot to work off T+2 are now less critical which could imply that spot should be changed to T + less than 2 days.

Despite this theoretical possibility we would continue to argue that for the purposes of defining a derivative, i.e. non-spot, especially for EMIR purposes, T+7 is a suitable pragmatic solution that is likely to avoid unintended consequences including imposition

of unnecessary administrative burdens. Wider application of any uniform definition, beyond EMIR, should be more widely consulted on and in a less urgent manner.

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

Once an FX instrument or contract, spot or forward, has been agreed between the parties its fair value can change as underlying market rates and volatilities change giving rise to varying credit exposure between parties. This applies, of course, to T+2 transactions like any other.

On the day of settlement there is a further performance risk (or settlement risk) in that one party may deliver its currency before receiving settlement from the other currency from the other party that may fail to deliver on time or at all. This can be mitigated by use of Payment versus Payments models such as in CLS Bank.

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

If any national competent authority is required to change its interpretation of the EMIR definitions there should be a lead time of at least 6 months to allow affected users to react and adjust their systems and processes to be able to comply. Counterparties parties such as banks whose whole trade is regulated, have very large compliance and systems functions, their non-financial clients – commercial and industrial counterparties, charities, hospitals, universities, local authorities etc. – are not in that position and probably need at least 6 months to comply.

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

It is notable that in the US FX is excluded from Dodd Frank, as it is in Canada. Presumably this was because their assessment was that the risks and performance of this market, even through the financial crisis, did not justify the burden of additional new regulation.

Clearly financial stability is the overriding objective. Perhaps foreign exchange transactions undertaken for investment purposes or between financial services firms investment might justify that burden. However, it seems clear that similar transactions for commercial purposes for or between non-financial counterparties do not.

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

We have concerns about application beyond the EMIR clarification purposes of the ESMA request and, as explained in response to Q, 1 above, believe that that should be the subject of wider and less hurried consultation.

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

Yes, your consultation has not directly followed up on the question posed by ESMA seeking clarification of whether all FX forwards fall within the definition of a derivative under MiFID. In particular they asked for clarification on FX forwards used for commercial purposes.

We can confirm that different competent authorities take different views on this question and that a consistent approach would be preferable. The Commission's own Q&A on MiFID was quoted by ESMA where it says "*…Thus, FX forward transactions not connected to the provision of an investment service, i.e. commercial FX forward transactions, are not covered by MiFID….*" (See Appendix to this letter.) This past guidance seems very clear and we would hope that any implementing acts will reiterate this distinction. A more in-depth and longer consultation would be necessary if this principle is to be re-considered and the consequences need to be explored at many levels.

A key purpose of EMIR was to control risk and exposures building up in the financial system and to gather information on those exposures. FX forwards done in connection with commercial activity can still create an exposure in the financial party transacting but that exposure will be with (or related to) a commercial party and so does not trigger the same risk of contagion within the financial system. And, of course, commercial and industrial firms are less correlated than financial firms and risk of "contagion" is much lower. In the same way that transactions by NFCs that meet the "objectively measureable as reducing risks" test very sensibly do not count towards the clearing thresholds we would hope that their commercial FX forwards are treated as "different" and less risky.

EMIR and its reporting requirements have provoked criticism that it had no regard to materiality and that even the smallest of companies doing just one low value FX forward deal is officially required to go through the full reporting obligations. For many smaller companies FX is the most likely and only type of derivative transacted. We realise that the current request for clarification should not to be used to rewrite completely the EMIR rules, but even so the Commission should be aware that by clarifying that FX for commercial purposes is not a derivative many, many thousands of businesses would be taken totally outside of EMIR. Even if the admin burden and cost of reporting for companies is modest it is yet another cost and inevitably cumulates with other burdens to have an overall negative impact on efficiency and economic activity. Absolving a vast number of companies from EMIR trade reporting must be beneficial to the European business economy and, importantly, to smaller firms' attitude towards the European Union generally.

The Commission's explanation of MiFID given in its Q&A, which we copy in our Appendix, does explain that as *an exception* Member States may decide to include commercial FX forwards in MiFID. We believe that this exception should be removed and the general principle of FX forwards contracted for commercial purposes not being subject to MiFID should be applied consistently throughout the Union.

The Commission is often portrayed in the media as unresponsive to the real world and interested only in imposing unnecessary bureaucracy on businesses. A simplification now would help redress that view.

Intra-group FX forwards

The EMIR rules on derivatives are for most purposes also applied to intra-group derivatives and this is very difficult to explain to companies on rational grounds. The logic for this has long been a puzzle to corporate treasurers and during the evolution of EMIR we and other treasury associations argued that regulating intra-group transactions served no function in reducing system risk but rather brought many thousands of firms into regulation for the first time, burdening an already over-stretched supervisory system.

It is normal in groups of companies to have a central treasury section that executes any external FX deals required to manage group FX risk. The FX risk itself will often arise in an operating subsidiary and from its commercial activity. In order to offer that subsidiary a hedge against that commercial risk the centre will execute an internal derivative with the subsidiary. Thus exposures are concentrated at the centre where they are managed with external deals after netting off complementary positions. For this sort of operating subsidiary those internal commercial FX forwards are very likely to be the only "derivatives" they transact. If commercial related FX forwards were not treated as EMIR derivatives across the whole of Europe a vast number of group entities would be completely taken out of the EMIR reporting rules. We suggest that this is another substantial economic benefit with no detriment to the systemic risk in the financial markets. This treatment already applies in the UK under the FCA definitions.

It is worth noting that within MiFID (Article 2(b)) there is an exemption from MiFID that applies to "persons which provide investment services exclusively for their parent undertakings, for their subsidiaries or for other subsidiaries of their parent undertakings." An interpretation that commercial FX forwards are outside the MiFID definitions and hence EMIR, would have a practical effect for many that was very similar to the MiFID exemption.

Appendix

Extract from: European Commission Your questions on MiFID

Foreign exchange – application of MiFID
Re Annex I, Section B(4) and Annex I, Section C(4) of Directive 2004/39/EC

http://ec.europa.eu/internal_market/securities/docs/isd/questions/questions_en.pdf page 126

Question
Are foreign exchange (FX) forwards under MiFID regulation or are they out of scope?

Comment or answer
Even if FX forwards are qualified as a financial instrument in section C of Annex I to MiFID, their intermediation will be subject to MiFID requirements only in the case there is an investment service or activity performed in the sense of MiFID. In this respect, Annex I section B(4) of MiFID lists “foreign exchange services where connected to the provision of investment services” as an ancillary service, not as an investment service. Thus, FX forward transactions not connected to the provision of an investment service, i.e. commercial FX forward transactions, are not covered by MiFID. The qualification of FX forwards as a financial instrument is not important if there is no investment service or activity performed in the sense of MiFID.

The fact that FX forwards are considered as an ancillary service also ensures that there should not be a problem with the functioning of the MiFID passport for investment firms. According to MiFID provisions on cross-border provision of services and establishment of branches, it is not possible to provide an ancillary service cross-border, using the MiFID passport, on a standalone basis. This means that only when that service is provided together with an investment service and/or activity it will be covered by the MiFID passport. In this respect, credit institutions have already a broad passport for foreign exchange activities under paragraph 7(b) of Annex I to the 2006/48/EC on the taking up and pursuit of the business of credit institutions.

Moreover, some of the exemptions included in Article 2 of MiFID would exempt most corporations operating FX forwards from the application of MiFID provisions.

However, those Member States who would like to see commercial FX forwards covered by MiFID-alike provisions, could apply them through their national law, as it is the case in some Member States.

The Association of Corporate Treasurers

The Association of Corporate Treasurers (ACT) is the leading professional body for international treasury providing the widest scope of benchmark qualifications for those working in treasury, risk and corporate finance. Membership is by examination. We define standards, promote best practice and support continuing professional development. We are the professional voice of corporate treasury, representing our members.

Our 4,600 members work widely in companies of all sizes through industry, commerce and professional service firms.

For further information visit www.treasurers.org

Guidelines about our approach to policy and technical matters are available at http://www.treasurers.org/technical/manifesto.

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