Deutsches Aktieninstitut

European Commission's consultation paper on FX financial instruments

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Introduction

Deutsches Aktieninstitut[1] welcomes the opportunity to comment the EU Commission's consultation paper on FX financial instruments. We represent the view of non-financial companies using FX derivatives almost exclusively for risk-mitigating purposes and FX spot markets for payment purposes.

According to EMIR non-financial companies have to comply with a number of requirements (e.g. reporting, risk mitigating techniques like timely confirmation and portfolio reconciliation etc.) which regularly refer to the definition of financial instruments in general and FX derivatives in particular. An appropriate delineation between FX spot and FX forward instruments is, therefore, essential in order not to extend the requirements of the derivative market regulation to FX spot markets. Otherwise, administrative burden would be increased inappropriately and severe legal uncertainty would be created.

[1] Deutsches Aktieninstitut represents the entire German economy interested in the capital markets. Its about 200 members are listed corporations, banks, stock exchanges, investors and other important market participants. Deutsches Aktieninstitut keeps offices in Frankfurt am Main, Brussels and in Berlin.

Responses to the questions

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

Yes.

Since the adoption of several legislative packages concerning derivative markets (e.g. EMIR, CRD IV / CRR) an EU-wide common understanding of the term “derivative” has become necessary.

For non-financial companies using derivatives for risk mitigating purposes this holds especially true for the obligations according to EMIR. Differing definitions would create different compliance duties for non-financial companies, depending on the country where the non-financial company is domiciled. This would contradict the objective to create a regulatory level-playing-field among European corporates.

Furthermore, derivative transactions of non-financial companies with counterparties in different member states, external transactions with banks or intra-group transactions with subsidiaries, would be more complex due to differing definitions. To comply with different derivative definitions would increase regulatory costs.

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

From a non-financial perspective the FX spot market is used to facilitate payments for goods and services, to effect payments for financial market activity and exchange of foreign currencies. These transactions are closely linked to the commercial and treasury financing activities.

In general, contracts traded on the FX spot markets should not be considered as financial instruments independent of their use or purpose. This is in line with the current regulatory practice assuming that spot contracts “are not usually classified as financial instruments” (see the consultation paper on p. 4). Therefore, the different purposes for the use of FX spot markets, e.g. the payment or the investment function as described in the consultation paper, should not be a criterion to consider some contracts as financial instruments and others not.

Regulators should be aware that the interplay of different purposes / uses is crucial for the efficiency of the FX spot market. Transactions between intermediaries and end-users which are intended to fulfil e.g. the payment function are highly dependent on sufficiently liquid markets. Liquidity is provided by trading activities of other

market participants which use the FX spot market for investment purposes only. Decreasing transaction costs for end users are the result.

(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?

We agree with the consultation paper that many spot contracts are settled within two business days. Nevertheless, the settlement period can be shorter, which – of course – should be covered by the definition "spot" as well.

The definition should also take into account that the settlement of some currencies usually takes longer than two business days. For this case a flexible approach should be applied which considers as criterion the common market practice, e.g. spot convention tables.

Thus, the delineation between spot and forward already adopted in Art. 38 para. 2 Regulation (EC) No 1287/2006 for specific commodity contracts should also be applied for FX contracts regarding the settlement regime ("A spot contract […] means a contract 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 […] as the standard delivery period.") The term "within" should refer to a settlement period which could be even shorter than two days.

Last but not least, the definition should also take into account that the settlement period may extend due to the fact that bank or official holidays differ from country to country.

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

No.

In some cases NDFs are used as a substitute for FX spot transaction, e.g. if physical delivery of a currency is impossible due to regulatory reasons (e.g. convertibility restrictions). Therefore, NDFs should only be regarded as financial instruments if the settlement period exceeds two days or the standard delivery period generally accepted in the market (see our answer on question 3 above).

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

Corporate end-users generally share the view of the consultation paper that the increased use of electronic trading in FX markets may have beneficial effects. Elec-

tronic market platforms increase price transparency and allow for straight through processing including the trade confirmation process. However, this should not lead to more efforts by regulators or legislators to push even more transactions on electronic platforms in order to limit OTC trading.

Regulators should be aware that non-financial companies necessarily have to trade certain derivatives OTC in order to best reflect the firm-specific hedging needs. As a result non-financial companies' OTC derivatives are often not standardised in terms of maturity, volume or underlying so that they are not suited for electronic trading. Restricting inappropriately or even banning OTC trading would seriously harm the corporate risk management with derivatives.

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

Yes.

The FX market is very important for non-financial end users and other market participants, therefore an adequate transition period for harmonized rules would be essential to avoid disruptions.

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

Regulatory treatment of derivatives varies among jurisdictions. E.g., under the Dodd Frank Act FX forwards and swaps are exempted from the clearing obligation. This creates a competitive disadvantage for companies domiciled in the EU with the "stricter" regulatory regime.

Furthermore, divergent approaches generally lead to additional costs for multinational corporates as they have to implement different compliance procedures and have to monitor regulatory developments of different markets.

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

As stated in the consultation document the MiFID definition of financial instruments is used in the recent benchmark proposal of the EU-Commission. This draft regulation includes potential bans to use derivative benchmarks from non-EU jurisdictions that are deemed to be not equivalent to the EU legislation. As these indices are an important part of many derivative contracts it is likely that a ban would lead to the situation that EU market players are not able to further hedge the respective non-EU currency risks anymore. That would be a serious problem for exporting companies which are the backbone of the real economy in the EU. Therefore, instead of a ban we would prefer a declaration of the index provider that the

index was not developed according to European law. Also, we would like to encourage the EU Commission to carefully evaluate the cross reference to the definition of financial instruments in the proposed benchmark definition so that it is ensured that the FX (derivative) market will not be affected negatively.

Another relevant issue in EMIR is the handling of the FX spot components in FX swaps. FX swaps consist of a short leg and a long leg, which together can be interpreted as a combination of a FX spot and a FX forward transaction. A problem comes up with the EMIR reporting requirements and the duty to identify the trades via a Unique Trade Identifier (UTI). Although the reporting takes place as if there were indeed two separate deals, there is so far no common standard regarding the allocation of the UTI: some banks allocate UTIs to both sides of the trade, some only to the long leg, some use the identical one for both sides, while trade repositories mostly require two UTIs. We think it is misleading to allocate a UTI to a component of the transaction (short leg/FX spot) which is not covered by EMIR and that in most cases is settled almost in the moment the UTI is allocated. Hence, to achieve conformity with MiFID, we believe that FX swaps should only be allocated a UTI for the long leg. This would reduce administrative efforts and finish the varying treatments currently seen in the markets.

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