

BN10-07

MiFID Review – Transparency in Foreign Exchange Derivatives

Background

As part of its 2010 review of the Markets in Financial Instruments Directive (MiFID), the European Commission is expected to propose legislation extending transparency requirements into the non-equities markets. The Committee of European Securities Regulators (CESR) will provide technical advice to the Commission in the context of non-equities markets transparency and has consulted on the following markets: Corporate Bonds, Structured Finance products (ABS and CDOs), Credit Default Swaps (CDS) and Derivatives (Interest Rate, Equity, Commodities and Foreign Exchange).

AFME's general position on all aspects of non-equities transparency apart from structured finance is set out in Briefing Paper [BN10-03]. This paper specifically covers the market in Foreign Exchange (FX) Derivatives.

Overview

The FX market is mature, efficient and transparent, and has been proven to function well even in times of significant stress across the wider financial system.

FX derivatives are generally very short dated (average maturity in the order of two weeks) and entail physical delivery (in effect, being deferred spot transactions). This represents the liquid part of the market, as well as the part with the greatest volume. 80% of volume is considered to have a maturity of seven days or less.

Pre-trade transparency is freely available in highly electronic form, with the established commercial data vendors channelling aggregated quotes for spot, forwards, swaps, options and NDFs.

Despite the huge and enthusiastic take up of electronic trading across the FX market, it is estimated that **roughly 50% of the market still executes manually**, i.e. with the involvement of two people, typically over the telephone or via electronic chat. There are several good reasons for this:

1. There are products and contracts for which electronic pricing is not available at all;

2. The client may not wish to subscribe to an electronic platform that supports the type of product the client wants to trade, for example if the client trades infrequently and/or the client judges the platform fees to be too high to justify the expense;
3. The client wants advice or assistance from a market professional in executing a trade or developing an execution strategy; or
4. The client desires direct confirmation from a (human) market maker that their trade has been executed at a given price and size (this was particularly prevalent during the financial crisis).

It would be a mistake to believe that manual execution could easily be eliminated without significantly impairing the market.

AFME's position

Any new regulation must not impede the efficiency of the FX market, as the unintended consequences will be felt well beyond the FX market itself.

There is a genuine risk that the introduction of an on-exchange/anonymous type pre-trade transparency regime would lead to less liquidity in the FX markets. FX Dealers have direct relationships with their clients and, therefore, are more likely to provide them with liquidity even during times of extreme market stress, thus alleviating potential problems in this asset class and, indirectly, other asset classes, as demonstrated during the credit crisis.

Useful Publications

CESR Technical advice to the European Commission in the context of the MiFID review - Non- equity markets transparency

AFME Briefing Note BN10-01: MiFID Review

AFME Briefing Note BN10-02: MiFID Review – Equity Markets

AFME Briefing Note BN10-03: MiFID Review – Non-Equities Transparency

AFME Briefing Note BN10-04: MiFID Review – Transparency in Corporate, Covered and Government Bonds

AFME Briefing Note BN10-05: MiFID Review – Transparency in Credit Default Swaps

AFME Briefing Note BN10-06: MiFID Review – Transparency in Interest Rate Derivatives

AFME Briefing Note BN10-08: MiFID Review – Transparency in Equity Derivatives

AFME Briefing Note BN10-09: MiFID Review – Transparency in Commodity Derivatives

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