Briefing Note

Review of the Markets in Financial Instruments (MiFID) – Foreign Exchange

BN-11-04 Last updated: July 2011

Introduction

The Markets in Financial Instruments Directive (MiFID) was designed to bring efficiency to the European Equity market through competition and to ensure that investor protection was consistently achieved across national boundaries. The MiFID review has now been significantly expanded and introduces new requirements for non-equity products.

FX trading is a 24-hour market that underpins international trade and investing. The $4 trillion per day market, its ubiquitous nature, and the simplicity of the vast majority of products mean that it has already developed into a highly transparent, liquid and deep marketplace. Market structures have similarly evolved to ensure access, transparent pricing and end user choice. Preserving these aspects are key to ensuring that such end users are able to hedge commercial risks efficiently and in a bespoke manner.

The proposed application of MiFID to FX should be carefully considered in the light of the market's global nature and structure and that many of the objectives of MiFID are already met by the market. We are concerned that a broad expansion of 'equities-style' regulation to capture FX raises the risk of unintended consequences. We urge the Commission to review MiFID's objectives in the specific context of the FX market to ensure that any measures are appropriately and efficiently tailored.

Market structure

Organised trading facility (OTF) and trading of standardised derivatives

The FX market has been at the forefront of electronic trading, developing a range of execution methods including multi-dealer and single dealer platforms. As an Over-The-Counter (OTC) marketplace, these venues take into account the specific nature of the end client, size of order and credit worthiness. The choice of venue for trading in OTC markets should be driven by both the type of contract and type of customer. Any requirements governing market structures and organised trading facilities, to the extent that they are applicable, should preserve the flexibility that exists to trade across existing execution venues.

The definition of an OTF appears to capture a broad range of systems. Whilst in principle we have no objection to a new regime that covers certain additional venues, we would welcome clarity on the purpose and regulatory requirements that would be applied. It is unclear why and how an OTF would be converted to an MTF at an arbitrary volume threshold.

The OTF regime has implications for the trading of 'standardised' derivatives. We are strongly against forcing economic standardisation of FX products in their own right since the main use of the OTC FX market is to allow users to hedge specific future exposures in a tailored manner. To the extent that there are clearing eligible products that are genuinely standardised, it will be important to define 'sufficient liquidity' appropriately. This will determine what products may trade on exchanges or other acceptable venues and which will therefore be subject to, inter alia, any greater transparency requirements. The liquidity assessment should be done on an instrument by instrument basis.

Notwithstanding this, we believe such products should continue to be allowed to trade through existing venues, including single and multi-dealer platforms. Attempting to force trading of contracts onto particular systems or trading venues will reduce investor choice, flexibility and may impact liquidity.

Financial stability and systemic risk reduction

The FX market has evolved to ensure a high level of financial stability through the implementation of risk mitigation techniques that recognise the different characteristics of FX transactions. Settlement risk dwarfs credit risk for FX trades, even in the case of longer dated trades, because there is a single exchange of payments at maturity. Oliver Wyman analysis estimates that settlement risk comprises 94% of the estimated maximum loss exposure in a trade for foreign exchange instruments with maturity of 6 months. This reduces to 89% for instruments with a maturity of 2 years.

CLS Bank was created in 1997 as a global settlement bank to address the concerns surrounding the systemic impact of potential settlement risk failures. By operating a payment versus payment model, whereby payments are processed simultaneously, it eliminates virtually all settlement risk to its participants. CLS Bank settles almost 90% of all inter-dealer FX trades. It has had no settlement failures since it was created. It is regulated directly by the Federal Reserve with the active support of all major central banks. Efforts to extend the reach of CLS Bank are under way, with broad support from both FX dealers and central banks around the globe.

Transparency

Pre-trade transparency

The FX market is highly transparent. Pre-trade transparency has been advanced in the interdealer market, by intense competition among dealer platforms and through the development of electronic trading technology. At present, pre-trade transparency in FX products compares favourably with exchange traded marketplaces in terms of market information, execution speeds and cost, while offering more flexibility and improved choice to the end client.

Wholesale banks compete by distributing live executable prices in spot, forwards, swaps and options. With current technology it is only practicable to broadcast continuously updating prices (real time streaming) in a finite number of contracts. In practice, for most market makers this tends to mean spot FX and the most common FX forwards. All other contracts, which are necessarily infinitely variable in currency exchange, are priced on a Request-for-Quote (RFQ) basis i.e. upon client demand. For all options instruments, however, including those that are highly bespoke, information on key inputs such as spot and forward rates and volatilities is readily available.

For the more liquid instruments such as spot and shorter-dated forwards, market participants may access prices in several ways:

- Via interdealer broker platforms, for example Volbroker (Tradition), eSpeed (BGC), TradeBlade (Tullett), ForexMatch (GFI).
- Via data available from exchanges (CME)
- Via an ECN (dealer-to-dealer platform e.g. Reuters, EBS) that combines the best competing prices from many sources
- Via an aggregator that often acts as a principal, combining best prices and which may even improve upon the best bank price
- Direct with banks and market makers, often when the user wants the much richer functionality available compared with that which is available on general platforms.
- Via market data providers (e.g. Reuters Matching / Bloomberg) which provide numerous sources of indicative prices in spot forwards, swaps options and non-deliverable forwards

For the general public, spot FX rates are readily available from a wide range of free internet sources, for example Oanda, Reuters, FXCM, NetDania and FXall.

AFME believes transparency is not an issue in principle for the FX market, given the high degree of pre-trade transparency outlined above. A formal "regime" does not therefore seem necessary. To the extent that a formal regime is being considered, we would make the following comments:

- Any obligation to make "continuous" prices in FX should take into account the practical constraints regarding the bespoke nature of certain FX products.
- Forcing dealers to make firm pricing in FX products where they do not already do so may impact their willingness to quote prices and provide liquidity to investors.
- Enhanced pre-trade transparency, particularly in less liquid areas of the market, may cause dealers to withdraw liquidity or charge a risk premium as a result of the risk that the market will move against them when trying to hedge in a market where trade details are known to other dealers.

Post-trade transparency

Post-trade transparency is relevant for two groups of users: market participants and regulators. Given the very high levels of pre-trade transparency in the FX market, price discovery is readily available to market participants. For post trade transparency, the highly fungible nature of FX risk means that significant flows in any product are quickly reflected in the pre-trade pricing across all relevant grid points.

On the regulatory side, FX dealers began enhancing regulatory reporting over eight years ago through CLS bank, long before many asset classes. It continues to provide relevant and salient market reporting to over 22 central banks on a regular basis and publish monthly market data and participation reports.

Notwithstanding the above, FX participants are currently working to enhance post-trade reporting through the implementation of a central FX trade repository which will provide greater post-trade regulatory and public reporting in accordance with proposed rules under Dodd Frank in the US and EMIR in Europe. However, in providing further transparency to markets we believe regulators need to be conscious of:

- Avoiding damaging liquidity in less liquid FX instruments. The trade-off between transparency and liquidity is well documented across many asset classes: too much transparency in less liquid areas of the market tends to inhibit market makers from taking on and warehousing risk, to the detriment of end users. This applies across the FX market, particularly in some less liquid areas of the forwards and options markets. Public dissemination of post-trade data must be carefully calibrated to preserve such liquidity and should be reviewed on a product by product basis.
- Avoiding "flash crash" runaway price moves in liquid FX instruments. The rise of automated algorithmic trading, especially in spot FX, has made the markets exceptionally sensitive to price and trade data. As a result, a client executing an order may find the market running away from him before he has completed executing it. Providing real time post-trade data in this environment will give algo engines more data to feed upon and may exacerbate this problem significantly.
- Minimising the reporting burden. We support the proposal to minimise duplication by waiving MiFID reporting obligations for contracts that have been reported to a trade repository under EMIR.

Investor protection

The FX market currently self-regulates activity and develops best practices and standards with oversight from central banks, which distinguishes it from other asset classes. For example, the Bank of England Foreign Exchange Joint Standing Committee (FXJSC) and the New York Federal Reserve Foreign Exchange Committee (FXC) issue codes and guidelines covering the following:

Bank of England (FXJSC)	New York Federal Reserve (FXC)
▪ Non-Investment Product Code (NIPS) is a biannual review by market practitioners, the BoE and the FSA to underpin the professionalism and high standards of the FX markets – General standards - Responsibilities fo the firm - Responsibilities of the employee - Roles of principals - Roles of brokers - Use of intermediaries – Trading standards - Fairness on quoting terms - Use of intermediaries - Standardized terms and documentation - Market conventions - Best practice mark-to-market procedures – Controls - Know your counterparty - Fraud - Conflicts of interest – Confirmation procedures – Standardized settlement instructions	▪ Guidelines for FX Trading Activities published biannually updated with the stated goals of – Providing a forum for discussion on developing market efficiencies and transparencies – Highlighting pertinent industry topics – Creating a source of public information on the FX markets – Listing a common set of best practices in the wholesale FX community (end users, corps, intermediaries, banks) - Sales - Know Your Customer - Instrument valuation - Proper Disclosure - Customer confidentiality - Operations - Best practice to minimize operational risk - Best practice on recording transactions, payment instructions, timely reporting, reconciliations - Control Functions - Accounting, Trading, Personnel - Legal and Compliance/Money laundering - Risk Management - Systems Control

In addition ACI - The Financial Markets Association produces a Model Code for foreign exchange. This is an international code of conduct and practice for foreign exchange markets, compiled with input from the Central Banks of the various OECD countries, the UK FSA, the Foreign Exchange Committees in New York, Tokyo and Singapore and ACI representatives and market participants. Further work is being carried out by the FX Market Best Practices Working Group within ECB Operations Managers Group to review, consolidate and update existing best practice guidelines for further release under the ACI Model Code.

Many other foreign exchange industry groups operate under the auspices of central banks, including the Australian Foreign Exchange Committee, the Canadian Foreign Exchange Committee, the European Central Bank Foreign Exchange Contact Group, the Singapore Foreign Exchange Market Committee and the Tokyo Foreign Exchange Market Committee. These FX industry codes, coupled with strong competition, have created rules and standards similar to other asset classes' regulatory regimes. We therefore do not believe that the scope of MiFID need be extended in respect of FX.

Further Documents

MiFID is an extremely complex and comprehensive piece of regulation. AFME has considered the key points relating to specific markets in a series of individual briefing notes:

- BN-11-02 MiFID Review Briefing Note on Equities including market structure issues, venue definition, high frequency trading, etc.
- BN-11-03 MiFID Review Briefing Note on Fixed Income including price transparency
  - BN-11-03A MiFID Review Briefing Note on Rates (yet to be published)
  - BN-11-03B MiFID Review Briefing Note on Credit (yet to be published)
  - BN-11-03C MIFID Review Briefing Note on Securitisation (yet to be published)
- BN-11-05 MiFID Review Briefing Note on Corporate Finance
- BN-11-06 MiFID Review Briefing Note on Compliance including data consolidation, transaction reporting, investor protection, ESMA and Access of Third Party firms.

See also briefing notes covering AFME led initiatives:

- Post Trade Transparency Framework for Fixed Income
- OTC Equity Trading Report

AFME's response to the MiFID Review Consultation can be found here

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About AFME

AFME (Association for Financial Markets in Europe) promotes fair, orderly, and efficient European wholesale capital markets and provides leadership in advancing the interests of all market participants. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association through the GFMA (Global Financial Markets Association). AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

For more information please visit the AFME website, www.afme.eu.