Chapter 13

Guidance on the scope of the UK provisions which implemented MiFID

13.4 Financial instruments

Introduction

13.4 **Q27.Where do we find a list of MiFID financial instruments?**

The list in Section C of Annex 1 to MiFID has been onshored in Part 1 of Schedule 2 to the Regulated Activities Order. There are eleven categories of financial instruments in Section C, which have been onshored in Part 1 (C1 to C11, which have been onshored in paragraph 1 to paragraph 11). However, as explained in PERG 13.1 above, for ease of reference we have retained the references to the relevant MiFID provisions in this chapter. Transferable securities (C1) and money market instruments (C2) are defined in article 4. Some financial instruments are further defined in the *MiFID Org Regulation*.

Transferable securities

Q28.What are transferable securities? (C1 and article 4.1(44))?

Transferable securities refer to classes of securities negotiable on the capital markets but excluding instruments of payment. We consider that instruments are negotiable on the capital markets when they are capable of being traded on the capital markets.

Transferable securities include (to the extent they meet this test):

- shares in companies (whether listed or unlisted, admitted to trading or otherwise), comparable interests in partnerships and other entities and equivalent securities;
- bonds and other forms of securitised debt;
- depositary receipts in respect of the instruments above;
- securities giving the right to acquire or sell transferable securities (for example, warrants, options, futures and convertible bonds); and
- securitised cash-settled derivatives, including certain futures, options, swaps and other contracts for differences relating to transferable securities, currencies, interest rates or yields, commodities or other indices or measures.

Examples of instruments which, in our view, do not amount to transferable securities include securities that are only capable of being sold to the issuer (as is the case with some industrial and provident society interests) and OTC derivatives concluded by a confirmation under an ISDA master agreement.

Money market instruments

Q28A. What are money market instruments (C2 and article 4.1(17) of MiFID and article 11 of the MiFID Org Regulation)?

This means those classes of instruments which are normally dealt in on the money market. Examples include treasury bills, certificates of deposit and commercial paper. A money market instrument does not include an instrument of payment.

An instrument is only a money market instrument if it also meets the following conditions:

- it has a value that can be determined at any time;
- it does not fall into sections C4 to C10 of Annex 1 to MiFID (derivatives); and
- it has a maturity at issuance of 397 days or less.

Collective investment undertakings

Q29. What are units in collective investment undertakings (C3)?

This category of *financial instrument* includes *units* in regulated and unregulated *collective investment schemes* and units or *shares* in an *AIF* (whether or not the *AIF* is also a *collective investment scheme*). In our view, in accordance with article 1.2(a) and 2.1(o) of the *Prospectus Directive*, units or *shares* in an *AIF* include shares in closed-ended corporate schemes, such as shares in investment trust companies, and so are also units in collective investment undertakings for this purpose (as well as being. transferable securities). There is *guidance* on what an *AIF* is in chapter 16 of *PERG* (Scope of the Alternative Investment Fund Managers Directive).

Derivatives: general

Q30. Which types of derivative fall within MiFID scope?

The following derivatives fall under MiFID:

- derivative instruments relating to securities, currencies, interest rates, emission allowances or certain other underlyings (see Q31A to Q31S);
- commodity derivatives (see Q32 to Q33C);
- derivative instruments for the transfer of credit risk (see Q31);
- financial contracts for differences (these are included in paragraph 9 of Section C of Annex 1 to MiFID, onshored in paragraph 10 of Part 1 of Schedule 2 of the *Regulated Activities Order*); and
- derivatives on miscellaneous underlyings (see Q34).

The scope of these derivatives does not extend to sports spread bets.

Credit derivatives

Q31.What are derivative instruments for the transfer of credit risk (C8)?

Derivative instruments that are designed for the purposes of transferring credit risk from one person to another. They include, for example, credit default products, synthetic collateralised debt obligations, total rate of return swaps, downgrade options and credit spread products

General financial and emission derivatives (C4): General

Q31A. Which types of financial derivative fall within this heading?

The C4 category of financial instruments covers:

- options;
- futures;
- swaps;
- forward rate agreements; and

- any other derivative contracts;

relating to:

- securities;
- currencies;
- interest rates or yields;
- emission allowances; or
- other derivatives instruments, financial indices or financial measures.

A derivative contract is covered whether it is settled physically or in cash.

General financial and emission derivatives (C4): Treatment of foreign exchange contracts

Q31B. Is every foreign exchange contract caught by MiFID (article 10 of the MiFID Org Regulation)?

No. There are two exclusions:

- There is an exclusion for spot contracts (see the answer to Q31C).
- There is an exclusion for a foreign exchange transaction connected to a payment transaction (see the answer to Q31G).

Technically these exclusions relate to the other "any other derivative contracts" type of C4 derivative contract listed in the answer to Q31A. However in the FCA's view no contract that has the benefit of one of these exclusions could be a C4 future either.

These exclusions do not apply to an option or a swap on a currency, regardless of the duration of the swap or option and regardless of whether it is traded on a *trading venue* or not (recital 13 to the *MiFID Org Regulation*).

Q31C. What is the exclusion for foreign exchange spot contracts mentioned in Q31B?

A contract for the exchange of one currency against another currency is excluded if under its terms delivery is scheduled to be made within a specified number of trading days. The number of trading days depends on the type of contract. For these purposes, there are three types of contract.

The first type of contract is one for the exchange of one major currency against another major currency. The contract is exempt if under its terms delivery is scheduled to be made within two trading days.

The second type of contract is one for the exchange of a non-major currency against either another non-major currency or against a major currency. The contract is excluded if under its terms delivery is scheduled to be made within the longer of:

- two trading days; and
- the period generally accepted in the market for that currency pair as the standard delivery period.

The third type of contract is one used for the main purpose of the sale or purchase of a transferable security or a unit in a collective investment undertaking. The contract is excluded if under its terms delivery is scheduled to be made within whichever is the shorter of the following:

- the period generally accepted in the market for the settlement of that security or unit as the standard delivery period; or

- five trading days.

An example of this third category is as follows. Say that X buys a share in Country P for delivery in four days' time (the standard settlement time in Country P for share purchases). X wishes to pay for the shares (and for associated taxes and costs) in local currency. The exclusion applies if X enters into the contract for the purchase of the local currency four or fewer days before the share settlement date.

If a foreign exchange contract falls into the third category (contract for the purpose of purchase of securities) it may also fall into one of the other two categories. As a result there are potentially two maximum delivery periods. Where this is the case, the longer of the two delivery periods applies for the purpose of deciding whether the exclusion applies.

If there is an understanding between the parties to the contract that delivery of the currency is to be postponed beyond the date specified in contract, it is the longer period that is used to calculate the delivery period.

Physical settlement does not require the use of paper money. It can include electronic settlement.

This exclusion only applies if there is a direct and unconditional exchange of the currencies being bought and sold (recital (13) to the *MiFID Org Regulation*). However a contract may still benefit from the exclusion if the exchange of the currencies involves converting them through a third currency.

See the answer to Q31E for what major and non-major currency means and see the answer to Q31F for what a trading day means.

Q31D. How are contracts for multiple exchanges of currency treated under the exclusion for foreign exchange spot contracts mentioned in Q31C?

The exclusion can cover a single contract with multiple exchanges of currencies. In such a contract, each exchange of a currency should be treated separately for the purpose of the exclusion (recital 13 to the *MiFID Org Regulation*).

Q31E. What are the major currencies referred to in the answer to Q31C?

The major currencies for these purposes are the US dollar, euro, Japanese yen, Pound sterling, Australian dollar, Swiss franc, Canadian dollar, Hong Kong dollar, Swedish krona, New Zealand dollar, Singapore dollar, Norwegian krone, Mexican peso, Croatian kuna, Bulgarian lev, Czech koruna, Danish krone, Hungarian forint, Polish złoty and Romanian leu.

All other currencies are non-major currencies for these purposes.

Q31F. What does a trading day mean in the answer to Q31C?

A day is a trading day if it is a day of normal trading in the jurisdiction of both the currencies that are exchanged.

If either of the following conditions is met:

- the exchange of the currencies involves converting them through a third currency for the purposes of liquidity; or
- the standard delivery period for the exchange of the currencies references the jurisdiction of a third currency;

a day is a trading day if it is a day of normal trading in the jurisdiction of both the currencies that are exchanged and also in the jurisdiction of that third currency.

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Q31G. What is the second exclusion for foreign exchange contracts mentioned in Q31B?

A contract is excluded if:

- it is a means of payment (see the answer to Q31H for what this means);
- it must be settled physically (although non-physical settlement is permissible by reason of a default or other termination event);
- at least one of the parties is not a financial counterparty as defined in article 2(8) of *EMIR*;
- it is entered into in order to facilitate payment for identifiable goods, services or direct investment; and
- it is not traded on a *trading venue*.

The table in the answer to Q31M gives some examples of what is and is not covered by the exclusion.

Q31H. What do identifiable and means of payment as referred to in the answer to Q31G mean?

The most straightforward example (Example (1) of what this means is a contract where one of the parties to the contract:

- sells currency to the other party which that other party will use to pay for specific goods or services or to make a direct investment; or
- buys currency from the other party which the first party will use to achieve certainty about the level of payments that it is going to receive:
ofor specific goods or services that it is selling; or
oby way of a direct investment.

See Example (10) in Q31M (Can you give me some more examples of how the means of payment exclusion referred to in the answer to Q31G works?) for an example of the second type of foreign exchange contract in Example (1) (contract to achieve certainty about the level of payments).

The table in the answer to Q31M gives some more examples of what identifiable goods and services means.

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The *MiFID Org Regulation* says that the foreign exchange contract must be a means of payment. Therefore the exclusion requires that not only should the currency contract facilitate payment for identifiable goods, services or direct investment but that it should also be a means of payment. This combined requirement does not mean that there has to be a three-party arrangement between the buyer and seller of goods or services and the foreign exchange supplier. So, for example, if a UK company (A) is buying goods from an exporter in Germany (B) and is paying in euro and A buys the euro forward from a bank (C), there is no need for C to issue some sort of instrument to B (Example (2)).

Instead this combined requirement means that the currency contract that is to be excluded should facilitate the payment in the way described in Example (1) at the start of this answer or that there should be an equivalent close connection between the currency contract and the payment transaction.

Even though there is no requirement for a formal instrument of payment, the exclusion can cover such arrangements. So in Example (2) in this answer, the exclusion may apply to an arrangement that involves bank C issuing a euro letter of credit at the request of A for the benefit of B.

Q31I. What do goods, services and direct investment mean in the answer to Q31G?

The reference to goods and services should be interpreted widely. It can cover, for example, intellectual property (such as computer software and patents) and land.

However, in the FCA's view MiFID investments are only covered by the exclusion if they constitute a direct investment.

In the FCA's view, making a direct investment means making a capital investment in an enterprise to obtain a lasting interest in that enterprise. A lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise, and an investor's significant influence on the management of the enterprise.

The requirement for the investment to be direct does not prevent the investor acquiring an investment in a wholly-owned subsidiary of a holding company by making the investment in the holding company. However this requirement does mean that the investor should acquire its investment from the enterprise or holding company itself rather than by acquiring a stake through the secondary market.

A foreign exchange contract connected to the purchase of a MiFID investment may still be covered by the exclusion for spot contracts if the payment instrument exclusion does not apply. The spot exclusion makes particular provision for purchases of transferable securities and units in a collective investment undertaking (see the answer to Q31C). The result is that the means of payment exclusion does not undermine the specific provisions of the spot contract exclusion dealing with such transactions.

Q31J. How is an agent treated under the means of payment exclusion referred to in the answer to Q31G?

This question is about a foreign exchange contract carried out through agents where:

- at least one of the principals is a non-financial counterparty (see the answer to Q31G for what a financial counterparty means);
- both the agents are financial counterparties; and
- the contract would otherwise meet the exclusion conditions.

If the agents contract with each other on a principal-to-principal basis with back-to-back contracts with their respective clients, the exclusion is not available for the contract between the two agents. It may be available for the contracts between the agent and its client.

If the arrangement is made in such a way that there is a single contract, to which the two principals are party and which is entered into on their behalf by the agents, the exclusion is available.

Q31K. How do I know whether the conditions for the means of payment exclusion described in the answer to Q31G are met?

A financial counterparty (A) selling currency to a client may want to know whether the client (B) is going to use the foreign currency in a way that meets the exclusion conditions. This may be relevant to whether MiFID conduct of business obligations apply.

A non-financial counterparty (A) may sell currency to another non-financial counterparty (B) in circumstances where the currency that A buys is not being used in a way that qualifies for the exclusion. A may therefore want to rely on B using the currency that B purchases in a way that would qualify.

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In each example, the application of the exclusion depends on the use to which the other party is going to put the currency.

In these examples A may rely on B's assurances about the purpose of the currency purchase as long as it has no reason to doubt what B says. Such an assurance could be given in several ways:

Option 1	A may ask B to explain to A what the purpose of the transaction is, leaving it to A to work out whether the exclusion applies.
Option 2	B may tell A that the exclusion applies to the transaction in question (for instance by way of a representation in the forward contract). A should only rely on such an assurance if satisfied that B is sufficiently expert to understand what the exclusion means.
Option 3	B may give A an assurance or representation that applies to all foreign exchange transactions that may take place between them from time to time (which might be included in a master agreement governing all forward currency contracts between them). In this case: o Option 2 (B should have sufficient expertise) applies. o In addition, A should be satisfied that B has procedures in place for B to consider whether the exclusion applies in particular cases. This may include for example a procedure under which B: - should tell A that a particular proposed transaction does not qualify for the exclusion; or - is obliged not to ask A to enter into a contract under that master agreement that will be outside the exclusion.

Where B is an ordinary individual consumer or a small business, A may not be able to rely on B's judgement about whether the exclusion applies. In that case A should decide whether the exclusion applies based on questions A asks B (Option 1).

Q31L. Can a flexible forward come within the means of payment exclusion described in the answer to Q31G?

A forward contract may have a flexible delivery date. For example a forward contract may:

- say that delivery can take place at any point in a two-week period rather than on a fixed date; or
- have an expiry date by which delivery has to be taken but part, or parts, of the delivery can take place before that date.

A flexible delivery date within a defined and reasonably short window can still benefit from the exclusion. If the delivery period is very long, it is doubtful whether the requirement for the contract to facilitate payment for identifiable goods, services or direct investment (see the answer to Q31G) can be met.

These examples provide for delivery of the full amount by the end of the delivery period. There might also be a contract under which the purchaser may choose not to take delivery of part. An example of this kind of foreign exchange contract is as follows:

A UK importer of goods buys from a German seller and has to pay in euro. The importer may not know exactly how much it wants to import during the next quarter but may want to fix its foreign exchange risk in advance. The foreign exchange contract allows the importer to take delivery of no more than it needs to pay the exporter. Any balance not needed to pay for imports is cancelled and is not available to the importer.

In the FCA's view, if the contract meets the conditions of the exclusion (and in particular the need for there to be identifiable goods or services) the exclusion potentially applies.

The requirement for there to be identifiable goods or services means that the maximum amount that can be drawn down under the flexible forward contract should be a reasonable estimate of what is payable under an identified potential payment transaction or transactions. The table in the answer to Q31M gives examples of what a reasonable estimate means.

An argument against the availability of the means of payment exclusion is that a flexible forward contract is an option and that the exclusion is not available for an option. However in the FCA's view, the approach in the answer to Q31B applies. That is, a flexible forward contract that meets all the conditions of the exclusion is not a traditional option but rather a hybrid contract that is in the "any other derivative" contract category listed in the answer to Q31A (Types of C4 derivative contracts), even in the example in which the unused balance is cancelled.

Another argument against the availability of the exclusion for a flexible forward under which the unused balance is cancelled is that it does not meet the requirement for the contract to be settled physically. In the FCA's view this argument is not correct because this requirement is aimed at preventing net cash settlement and does not deal with the cancellation of the contract resulting in there being no need for any kind of settlement.

Q31M. Can you give me some more examples of how the means of payment exclusion referred to in the answer to Q31G works?

Examples of how the means of payment exclusion works	
Example	**Explanation**
(1) A customer wants to hedge its balance sheet because it has a euro exposure but reports financially in sterling.	The exclusion is not available as the foreign exchange contract is not entered into in order to facilitate payment for identifiable goods or services. If, as is likely to be the case, the foreign exchange contract is a swap or a non-deliverable forward, that is another reason for the exclusion not being available as the exclusion does not apply to this sort of contract (see the answers to Q31B and Q31R).
(2) A UK customer (X) of a UK payment institution (Y) has a sterling account with a bank (P) in the United Kingdom and a separate euro bank account with another bank (Q) in the Eurozone. X wishes to pay its supplier in euro in 3 months. X enters into a forward contract with Y and requests that the euro be sent to its euro account with Q rather than directly to the supplier. The sterling that X pays under the foreign exchange contract comes from its account with P. Q makes the payment to the supplier for X.	The exclusion is potentially available as the foreign exchange transaction facilitates payment for identifiable goods, even though Y does not itself pay the suppliers. The exclusion can cover an arrangement in which the firm selling the foreign currency is not the firm that makes the payment on behalf of the customer buying the identifiable goods.

Examples of how the means of payment exclusion works	
Example	**Explanation**
(3) A UK importer has bought €100,000 worth of goods. The supplier has not yet issued an invoice and the sum is not yet due from the importer. However the importer knows the price. It buys the euro forward.	The issue here is whether the forward exchange contract relates to identifiable goods as referred to in the answer to Q31G (What is the second exclusion for foreign exchange contracts mentioned in Q31B?). The exclusion is potentially available. There is no need for the invoice to have been issued or the sum yet to be due.
(4) A UK importer of goods has ordered a specific quantity of an identified type of goods from the supplier. The price will be payable in euro but the euro price has not yet been fixed. The UK importer makes an estimate of the euro price and buys the euro forward.	The issue here is whether the forward exchange contract relates to identifiable goods as referred to in the answer to Q31G (What is the second exclusion for foreign exchange contracts mentioned in Q31B?). The exclusion is potentially available. There is no need for the amount to be paid under the foreign exchange contract to match precisely the amount of the payment that it is facilitating. An estimate is permissible. The goods are specifically identifiable by purchase order.
(5) A UK importer knows that it wants to purchase €100,000 worth of goods from an identified Eurozone supplier in the next quarter but it has not yet entered into a formal contract with the supplier. It buys the euro forward.	The issue here is whether the forward exchange contract relates to identifiable goods as referred to in the answer to Q31G (What is the second exclusion for foreign exchange contracts mentioned in Q31B?). The exclusion is potentially available. There is no need for the contract for the supply of goods to have been entered into at the time of the currency purchase. The goods are specifically identifiable by type, price and supplier and by the purpose for which the importer is buying them.
(6) A UK importer knows that it wants to purchase €100,000 worth of goods from a Eurozone company in the next year, but does not know from which specific supplier it is going to purchase them. It knows which goods it wishes to buy. It buys the euro forward.	The issue here is whether the forward exchange contract relates to identifiable goods as referred to in the answer to Q31G (What is the second exclusion for foreign exchange contracts mentioned in Q31B?). The exclusion is potentially available. The goods are specifically identifiable by type and price and by the purpose for which the importer is buying them.
(7) A UK importer of goods wishes to buy currency in order to allow it	The issue here is whether the forward exchange contract relates to

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Examples of how the means of payment exclusion works	
Example	**Explanation**
to pay for goods in the next quarter. It does not know precisely how many of the goods it will want or what their exact price will be. However it has a sufficiently good idea of the amount of goods to make it unlikely that its estimate will be seriously wrong. It knows this because it has an established practice of buying these sorts of goods.	identifiable goods as referred to in the answer to Q31G (What is the second exclusion for foreign exchange contracts mentioned in Q31B?). The exclusion is potentially available. The exclusion may be available even though the precise details of the goods to be bought are not known yet. The goods are identifiable by reference to an established practice and need.
(8) A firm wishes to import goods for a project and needs foreign exchange to pay for them. It does not know precisely how many of the goods it will buy or what their exact specification or price will be. However it knows broadly what goods it needs. In this example it knows all this because the goods are needed for a specific purpose in a specific project.	The issue here is whether the forward exchange contract relates to identifiable goods as referred to in the answer to Q31G (What is the second exclusion for foreign exchange contracts mentioned in Q31B?). The exclusion is potentially available. The exclusion may be available even though the precise details of the goods to be bought are not known yet. The goods are identifiable by reference to an established project and a particular purpose within that project.
(9) A customer wishes to undertake a sterling/euro conversion to purchase €100,000 in three months. This amount is to cover 20 individual payments of €5,000 which will be drawn down at different times. This type of contract benefits the customer who obtains a better rate by setting up one contract for a larger value than could be obtained on 20 individual low value contracts.	The exclusion is potentially available. See the answer to Q31L (Can a flexible forward come within the means of payment exclusion described in the answer to Q31G?).
(10) An exporter (A) sells goods to a French importer for payment on delivery in euros. A, before the due date for payment for the goods, sells the euro for the equivalent amount in sterling. The foreign exchange contract is made at the applicable forward rate on the date of the currency contract. Settlement of the currency contract is due on the same day as payment for the goods.	The exclusion is potentially available. Recital 10 to the *MiFID Org Regulation* says that a contract to achieve certainty about the level of payments for identified goods is covered by the exclusion.

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Examples of how the means of payment exclusion works	
Example	**Explanation**
A is thereby protected against adverse movements in sterling against the euro.	
(11) A UK importer (A) has bought €100,000 worth of goods from several suppliers. A has a number of purchase contracts with each supplier and each supplier has issued a number of invoices. The due dates for payment on each invoice are quite close together and so A buys €100,000 forward from one provider in a single contract.	The exclusion is potentially available. There is no need for there to be a single currency contract for each contract under which payment arises. Nor do the payment dates under the purchase contracts have to match exactly the settlement dates under the forward contract.
(12) A UK importer (A) has bought €100,000 worth of goods. A buys €100,000 forward from several currency providers.	The exclusion is potentially available. There is no need for A to use a single currency provider.
(13) A UK importer (A) has bought €100,000 worth of goods from several suppliers. A has a number of purchase contracts with each supplier and each supplier has issued a number of invoices. The due dates for some of the invoices are quite close together and so A buys €50,000 forward from one provider in a single contract to meet these payment obligations. The result is that €50,000 is allocated between a number of import contacts in differing amounts and none of the import contracts are covered in full. A decides to meet the other €50,000 from its own resources.	The exclusion is potentially available. The exclusion may apply even where the excluded currency contract is applied to a number of different payment obligations under a number of import contracts. The exclusion is available even if A relies on its own resources for part of the payment transaction.
(14) A UK importer (A) has bought €40,000 worth of goods from one supplier and €60,000 from another. The suppliers have issued invoices but payment is not yet due from A. A buys €40,000 forward to meet the payment on the first and decides to meet the €60,000 due under the other contract from its own resources.	The exclusion is potentially available. There is no requirement that A should cover every contract for goods to which the exclusion might apply.
(15) A UK importer (A) has bought €100,000 worth of goods. The supplier has issued an invoice but the sum is not yet due from A. A buys €200,000 forward. A will use other €100,000 for purposes that do not meet the exclusion conditions.	The exclusion is not available where A uses part of the currency it buys for purposes that do not meet the conditions of the exclusion. The contract should not be treated as partly excluded and partly as a C4 currency derivative. If however A enters into two foreign exchange contracts, each for €100,000, the exclusion may apply to one of them. Also see example (16).

Examples of how the means of payment exclusion works	
Example	**Explanation**
(16) A UK importer (A) has bought €100,000 worth of goods. The supplier has issued an invoice but the sum is not yet due from the importer. A buys the €100,000 forward. Later A buys another €100,000 forward.	The exclusion is not available for the second contract. The first contract should be taken into account when deciding whether A may rely on the exclusion for second contract. See the answer to Q31N (How do the examples in the table in the answer to Q31M apply to an exporter or importer with a large portfolio of contracts?) for an example of where the exclusion can apply in similar circumstances.
(17) A UK importer (A) has bought €100,000 worth of goods. The supplier has issued an invoice but the sum is not yet due A. A decides to meet the payment out of its own resources. Later A changes its mind and buys the €100,000 forward.	The exclusion is potentially available. The currency contract and the contract generating the payment obligation do not need to be entered into at the same time.
(18) A UK importer (A) has bought €100,000 worth of goods. The supplier has issued an invoice but the sum is not yet due from A. A buys the US dollar equivalent of €100,000 forward.	The exclusion will not generally be available because the currency contract is not a means of payment facilitating the payment due from A to the supplier. This is because the payment is due in euro and so the dollar contract is not sufficiently connected to the payment transaction.
(19) A farmer's farm payment under the EU basic payment scheme will be €10,000 and will be paid in sterling. The payment will be made in three months' time. In order to fix the sterling amount they will receive, the farmer wishes to book a forward with a currency provider to sell €10,000 and buy sterling in three months' time.	The issue here is whether the forward exchange contract relates to identifiable goods and services as referred to in the answer to Q31G (What is the second exclusion for foreign exchange contracts mentioned in Q31B?). The exclusion may not be available. This is because the payment may not be linked to any specific goods or services being sold or bought by the farmer. However it is possible that the farmer is going to use the payments under the scheme to purchase goods or stock for their farming business. If there is an identifiable payment transaction in accordance with the examples in this table the exclusion will potentially be available. If the exclusion is not available it is unlikely that the farmer will be carrying on MiFID business for the reasons described in the answer to Q7 (We provide investment services to our clients. How do we know whether we are an investment firm

Examples of how the means of payment exclusion works	
Example	**Explanation**
	for the purposes of article 4.1(1) MiFID?).
(20) An overseas student is given a grant by their home country in their local currency to study at a UK university, payable in six months' time. As the fees are payable in sterling, the student wishes to book a forward with a currency provider to sell their home state currency and buy sterling in six months' time. They wish to enter into the forward contract to guarantee the amount of sterling they will receive.	The issue here is whether the forward exchange contract relates to identifiable goods and services as referred to in the answer to Q31G (What is the second exclusion for foreign exchange contracts mentioned in Q31B?). The exclusion may be available because the grant helps the student to pay for the UK university's fees. The exclusion is still available if some of the grant is to meet living costs and the student has not yet decided what exactly they will need to buy (see the answer to Q31Q (holiday spending money) for more on this).
(21) A hedge fund manager has investors in the UK and a fund which is made up of euro denominated securities. The value of the fund to the investor will fluctuate due to the market value of the securities but it will also go up or down in accordance with the euro/sterling exchange rate. The fund manager seeks to hedge this risk by purchasing a forward contract to sell euro and buy sterling for three months in the future. The purpose of the trade is to ensure the investors will not be subject to currency volatility affecting the value of their investment.	The exclusion is not available because the currency transaction is not linked to any payment for specific goods, services or direct investment.
(22) A UK importer (A) wishes to buy some machinery from a Eurozone seller in three months for €500,000. A enters into a three-month forward for the purchase of €500,000 using sterling. However, the machinery purchase is delayed and A asks to extend the forward contract. This may involve A paying more money for the euro depending on the exchange rate at the date of the contract extension.	The fact that the currency forward is later amended by mutual consent to match the changed payment date for the machinery does not prevent the exclusion from applying as long as the amended version meets the exclusion conditions in the light of the changed circumstances. If the foreign exchange provider refuses to amend the contract the exclusion is not lost as long as the exclusion conditions were met at the time the foreign exchange contract was entered into.

Examples of how the means of payment exclusion works	
Example	**Explanation**
(23) A UK importer (A) wishes to buy some machinery from a Eurozone seller in three months for €500,000. A enters into a three-month forward for the purchase of €500,000 using sterling. The machinery purchase falls through but A wants to extend the contract length as they have identified replacement machinery with a similar price.	The answer to (22) applies. As explained in the answer to (7), the exclusion may be available for the proposed new machinery contract even though the precise details are not yet known.
(24) A UK importer (A) wishes to buy some machinery from a Eurozone seller in three months for €500,000. A enters into a three-month forward for the purchase of €500,000 using sterling. However, the machinery purchase is delayed and the specifications are changed. The currency contract therefore no longer facilitates payment under the machinery contract. A decides to close out the existing currency contract. A also enters into a new forward contract with another currency provider that matches the revised machinery contract.	The exclusion is potentially available for the close out contract and also for the new currency contract. If A decides to meet the payment due under the revised machinery contract out of its own resources, the exclusion is still potentially available for the close out contract.
(25) A customer is due to receive an inheritance in euro and is advised of the amount but, owing to the need to complete probate, the funds will not be released for a number of months. The customer wishes to ensure that there is no depreciation in value of the inheritance in sterling terms and enters into a euro-sterling forward.	The exclusion is not available because the foreign exchange contract is not linked to any specific goods, services or direct investment.
(26) A UK parent company wishes to inject capital in euro into a European subsidiary in four months' time and enters into a forward contract to purchase the euro.	The exclusion is potentially available as the foreign exchange contract is made to facilitate a direct investment in the subsidiary.
(27) A customer asks a UK payment institution to make a payment to a family member living abroad. The payment is to be made in the currency of the country where the family member lives. The customer buys the foreign currency on a forward basis.	The exclusion is not necessarily available. The exclusion is only available if the family member is going to use the currency for a purpose that comes within the exclusion.
(28) A UK firm (A) has employees abroad. A pays them in local currency. A buys forward the currency with which it will pay its employees.	The exclusion potentially applies.

Q31N. How do the examples in the table in the answer to Q31M apply to an exporter or importer with a large portfolio of contracts?

This question deals with the fact that the examples in the table in the answer to Q31M have relatively simple facts, where the purchaser of the foreign currency only has one or a few payment obligations. In many cases a seller or buyer of goods will have frequent payment transactions for which it needs foreign exchange and it may not wish to meet this need by having a separate currency contract for each import or export contract.

The exclusion can still apply in these cases. This is because, as the examples in the table in the answer to Q31M illustrate, there is some flexibility in the amount and timing of currency contracts, the ability to estimate currency needs, the ability to close out currency contracts and the use of different currency providers.

However the requirements of the exclusion still apply, including the need to show that the currency contract is a means of payment that is entered into in order to facilitate payment for identifiable goods, services or direct investment. This means that it will be necessary to look at all the importer or exporter's incoming and outgoing payments and currency resources each time the importer or exporter enters into a new currency contract to see whether the exclusion is available for that new currency contract.

Say:

- a UK importer (A) has bought €100,000 worth of goods under a contract with a Eurozone supplier (Contract P);
- the supplier has issued an invoice but the sum is not yet due from A;
- A buys the €100,000 forward; and
- later A buys another €100,000 forward.

When A enters into the second currency contract, changes to Contract P or to A's payment profile may mean that:

- the new currency contract will better facilitate the payment obligation under Contract P and the first currency contract will facilitate another identified payment obligation; or
- the first contract no longer facilitates the payment under Contract P and A needs the new currency contract to allow it to make the payments due under Contract P.

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When deciding whether the exclusion applies to the second currency contract entered into by A there is no need to treat the first currency contract as tied to the payment under Contract P just because the payment due under Contract P justified the application of the exclusion when A entered into the first currency contract. Instead it is necessary to look again at all A's incoming and outgoing payments and currency resources at the time A enters into the second currency contract (including both currency contracts).

Q31O. I am a payment services provider under the Payment Services Regulations. How do the spot contract and means of payment exclusions referred to in the answers to Q31C and Q31G apply to me?

(See ■ PERG 15 (Guidance on the scope of the Payment Services Regulations 2009) for the Payment Services Regulations)

This answer only relates to a payment service provider authorised under the *Payment Services Regulations*. It does not cover, for example, banks that are subject to the conduct of business requirements of those Regulations.

The *Payment Services Regulations* allow you to provide foreign exchange services that are closely related and ancillary to your payment services. That right does not allow you to provide foreign exchange derivative services that would otherwise require authorisation under MiFID. You therefore need to consider the availability of MiFID exclusions for your foreign exchange business.

The most common sort of foreign exchange contract you are likely to carry out is where you execute a payment for your customer that involves a currency conversion. For example, you may make a payment for your customer in euros from the customer's sterling payment account to a payee's payment account. The foreign exchange part of this transaction is separate from the payment part of the transaction (see Q12 in PERG 15.2 (We provide electronic foreign exchange services to our customers/clients. Will this be subject to the PSD regulations?)).

The foreign exchange part of this example may involve a MiFID C4 derivative if it has a forward element. However in practice it is likely that such foreign exchange transactions will fall outside MiFID because the spot exclusion applies.

The following are examples of how the delivery period should be calculated for the MiFID spot exclusion. They are all based on a payment being made in one currency funded from a payment account in another currency.

- If your customer asks for the payment to be made immediately, the delivery period starts on the date of request.
- If your customer asks for the payment to be made some time after the request and the foreign exchange conversion is to be carried out at the spot rate on the transfer date, the delivery period starts on that transfer date.
- If your customer asks for the payment to be made some time after the request and the foreign exchange conversion rate is fixed on the date the customer gives you your instructions, the delivery period starts on that instruction date.
- The date on which the payment is received by the payee's payment services provider should normally be treated as the delivery date.
- If you debit your customer's payment account after receipt by the payee's payment services provider and the foreign exchange conversion rate is fixed on the debit date, the availability of the exclusion is based on the gap between the debit date and the payment to the payee's payment services provider.

If your customer wants to make a foreign currency transfer some time in the future and buys the foreign currency from you in advance at the spot rate and immediately credits it to a payment account with you, the spot exclusion should apply.

If the delivery period is too long for the spot contract exclusion to apply, the means of payment exclusion is potentially available because you are not a financial counterparty for the purposes of that exclusion.

However, the means of payment exclusion only applies if the payment by your customer meets the requirements about identifiable goods, services or direct investments described in the answer to Q31G.

Q31P. Can a non-deliverable forward come within the exclusion for spot foreign exchange contracts in the answer to Q31C or the means of payment exclusion in the answer to Q31G?

No.

A non-deliverable forward is a cash-settled foreign exchange contract relating to a thinly traded or non-convertible foreign currency against a freely traded currency. The first currency may be non-convertible for example because of exchange controls or restrictions on currency dealing. On the contracted settlement date, the profit or loss is adjusted between the two counterparties based on the difference between the contracted rate for the non-deliverable currency and the prevailing spot rate. The price for the convertible currency may be expressed in terms of a second convertible currency.

As settlement is for the difference between an exchange rate agreed before delivery and the actual spot rate at maturity, a non-deliverable forward is not a spot contract, regardless of the settlement period (recital (12) of the *MiFID Org Regulation*), and the means of payment exclusion is also not available. See the answer to Q31R about why settlement for a difference does not come within either exclusion.

Q31Q. How is holiday spending money treated under the spot contract and means of payment exclusions referred to in the answers to Q31C and Q31G?

One way of buying holiday currency is for the holidaymaker to order currency to be collected, for example, a week after the order, to be paid for at the currency seller's spot rate on the day of collection. This contract is not a MiFID investment either because it does not fall into the category C4 type of derivative in the first place or because the spot contract exclusion described in the answer to Q31C applies.

Another way of buying holiday money is for the holidaymaker to order currency to be collected, for example, a week after the order, to be paid for at the currency seller's spot rate on the day the currency is ordered. This type of contract is potentially within the C4 type of derivative. However the means of payment exclusion is potentially available. The holiday can be treated as identifiable goods or services even though the holidaymaker may not know what restaurant they are going to eat at or what tourist attractions they are going to visit.

In either case the seller of the holiday money may agree to buy back any unused currency at a price fixed at the same time as the rate at which the holidaymaker is to buy the currency is fixed and linked to the original rate. Such an arrangement may also benefit from the means of payment exclusion. This is because the promise to buy back the currency is so closely connected to the original purchase that it can be seen as being an integral part of the same transaction.

These answers are relevant to whether the currency seller requires authorisation under MiFID. The holidaymaker will of course not require authorisation because a holiday-maker buying holiday money is not acting on a professional basis in the way described in the answer to Q7.

Q31R. How does netting affect the exclusions for foreign exchange contracts in the answers to Q31C and Q31G?

A foreign exchange contract may involve a valuation of the currencies being bought and sold for the purposes of settlement and a single payment being made.

The spot contract exclusion described in the answer to Q31C requires there to be exchange and delivery. The means of payment exclusion described in the answer to Q31G requires there to be physical settlement delivery. Therefore neither exclusion applies to a contract involving this type of netting. An instrument that provides for a single payment like this is more like a swap, which is outside the scope of the exclusions.

The fact that a foreign exchange contract provides for early termination and netting on default does not mean that the exclusions cannot apply. Similarly, the existence of force majeure provisions dealing with bona fide inability to settle physically does not prevent a contract from benefiting from the exclusions.

The parties to a foreign exchange contract may also have entered into other foreign exchange or financial contracts with each other. The result may be that the parties exchange multiple cash flows during a given day. In order to reduce operational and settlement risks they may agree to net those cash flows into one payment for each currency (payment netting). For example the parties may each have to make and receive multiple payments in sterling, euro and US dollars on the same day. The result of payment netting is that there will only be three payments to be made on that day, one in each of the three currencies. This sort of payment netting is compatible with the exclusions.

Q31S. I enter into my foreign exchange contracts on a trading venue. What exclusions or exemption can I rely on?

The spot contract exclusion described in the answer to Q31C may be available.

The means of payment exclusion described in the answer to Q31G will not be available.

If neither exclusion is available, and the contract is a C4 derivative, you may find the own account exemption described in the answer to Q40 helpful. Although that exemption is usually unavailable to those who have direct electronic access to a *trading venue*, this is not the case where the contract is for hedging purposes.

Commodity derivatives

Q32. Which types of commodity derivative fall within MiFID scope?

Broadly speaking, the following commodity derivatives fall within the scope of MiFID:

- a derivative relating to a commodity derivative, for example, an option on a commodity future (C4);
- cash-settled commodity derivatives (as explained in more detail in Q33A) (C5);
- physically settled commodity derivatives traded on certain markets or facilities (as explained in more detail in Q33B) (C6); and
- other commodity derivatives capable of physical settlement and not for commercial purposes or wholesale energy products traded on an *EU OTF* that must be physically settled (as explained in more detail in Q33C) (C7).

The definition of commodity derivative in MiFIR also includes derivatives falling into paragraph C10 of Section A of Annex 1 to MiFID, onshored in paragraph 10 of Part 1 of Schedule 2 of the *Regulated Activities Order* (see the answer to Q34 for this type of derivative).

Q33.What is a commodity for the purposes of MiFID?

"Commodity" means any goods of a fungible nature that are capable of being delivered, including metals and their ores and alloys, agricultural products and energy such as electricity (article 2.6 of the *MiFID Org Regulation*). The fact that energy products, such as gas or electricity, may be "delivered" by way of a notification to an energy network (such as notifications under the Network Code or the Balancing and Settlement Code) does not prevent them being "capable of being delivered" for these purposes. If a good is freely replaceable by another of a similar nature or kind for the purposes of the relevant contract (or is normally regarded as such in the market), the two goods will be fungible in nature for these purposes. Gold bars are a classic example of fungible goods. In our view, the concept of commodity does not include services or other items

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that are not goods, such as currencies or rights in real estate, or that are entirely intangible.

Q33A. Can you tell me more about category C5 commodity derivatives?

This type of commodity derivative is one that must be settled in cash or one that provides for settlement in cash at the option of one of the parties. A derivative that only allows a party to opt for cash in the event of default or termination is not included.

Q33B. Can you tell me more about category C6 commodity derivatives?

This type of commodity derivative is one that:

- can be physically settled; and
- is traded on a *UK* regulated market, a *UK* MTF or a *UK* OTF.

The category C6 type of commodity derivative excludes a wholesale energy product traded on a *UK* OTF that must be physically settled. The *MiFID Org Regulation* defines physical settlement in more detail.

Article 6 of the *MiFID Org Regulation* has special definitions for what types of oil, coal and wholesale energy products are included in the C6 category of commodity derivative.

A contract that can be physically settled but which is not traded on a regulated market, MTF or OTF might still fall within the C5 or C7 category of commodity derivative even though it falls outside category C6.

Q33C. Can you tell me more about category C7 commodity derivatives (recital 5 to, and article 7 of, the MiFID Org Regulation)?

This type of commodity derivative is one that meets all the following conditions:

- It can be physically settled.
- It is not a C6 commodity derivative.
- It is not a spot contract. A spot contract means one under the terms of which delivery is scheduled to be made within the longer of the following periods:
  - two trading days; or
  - the period generally accepted in the market for that commodity, asset or right as the standard delivery period.

For these purposes a contract is not a spot contract where, irrespective of its explicit terms, there is an understanding between the parties to the contract that delivery of the underlying is to be postponed and not to be performed within the spot period described earlier in this answer.

- It meets one of the following criteria:
  - it is traded on a third country trading venue that performs a similar function to a regulated market, an MTF or an OTF (an "equivalent third country trading venue"); or
  - it is expressly stated to be traded on, or is subject to the rules of, a *UK* regulated market, a *UK* MTF, a *UK* OTF or an equivalent third country trading venue; or
  - it is equivalent to a contract traded on a *UK* regulated market, *UK* MTF, *UK* OTF or equivalent third country trading venue. Equivalence is judged by reference to the price, the lot, the delivery date and other contractual terms such as quality of the commodity or place of delivery.

- It is standardised so that the price, the lot, the delivery date and other terms are determined principally by reference to regularly published prices, standard lots or standard delivery dates.

Certain contracts entered into with or by an operator or administrator of an energy transmission grid, energy balancing mechanism or pipeline network are excluded from the C7 category of commodity derivative.

The category C7 type of commodity derivative also excludes a wholesale energy product traded on an EU OTF that must be physically settled. The *MiFID Org Regulation* defines physical settlement in more detail.

Miscellaneous derivatives (C10)

Q34. What types of derivatives fall into the C10 category?

There is a miscellaneous category of derivatives in C10, which is supplemented by articles 7 and 8 of the *MiFID Org Regulation*. These relate to:

- climatic variables;
- freight rates;
-
- inflation rates or other official economic statistics;
- telecommunications bandwidth;
- commodity storage capacity;
- transmission or transportation capacity relating to commodities, whether cable, pipeline or other means;
- an allowance, credit, permit, right or similar asset which is directly linked to the supply, distribution or consumption of energy derived from renewable resources;
- a geological, environment or other physical variable;
- any other asset or right of a fungible nature, other than a right to receive a service, that is capable of being transferred;
- an index or measure related to the price or volume of transactions in any asset, right, service or obligation; or
- an index or measure based on actuarial statistics.

C10 derivatives must also meet at least one of the following criteria:

- the contract is settled in cash or may be settled in cash at the option of one or more of the parties, otherwise than by reason of default or other termination event; or
- the contract is traded in a *regulated market*, an MTF, an OTF or a non-EEA trading venue that performs a similar function; or
- the contract meets the following criteria in the answer to Q33C:
  - o it is not a spot contract;
  - o it meets the requirements about trading on (or being stated to be traded on), being subject to the rules of or being equivalent to contracts traded on, certain trading venues;
  - o standardisation; and
  - o it does not fall within the exclusion about transmission grids, energy balancing mechanisms or pipeline networks.

All these criteria are explained in more detail in the answer to Q33C.

A contract of insurance or reinsurance is not a C10 commodity derivative (recital 6 to the *MiFID Org Regulation*). Neither is a contract falling under one of the other paragraphs of section C of Annex 1 to MiFID, onshored in part 1 of Schedule 2 of the *Regulated Activities Order*.

Emission allowances

Q34A. How are emission allowances treated?

They are covered in the following ways:

•Regulation 5(8) of the *UK auctioning regulations* deems as an investment service or activity the reception, transmission and submission of a bid for a financial instrument on an *auction platform* by an *investment firm* permitted to carry on these activities under the regulations.

•The *UK auctioning regulations* regulate bids for allowances in the form of two-day spot contracts or five-day futures.

•The *UK auctioning regulations* allow the following to bid:

–aircraft operators and others referred to in (5) below;

–*MiFID investment firms* (other than *collective portfolio management investment firms*) and *UK* credit institutions and similar *third country investment firms*; and

–a person exempt under article 2(1)(j) of MiFID as onshored in Part 1 of Schedule 3 to the *RAO* (see Q44 to Q45 for more on this exemption).

• An *emission allowance* is itself a financial instrument (C11).

• An option, future, swap, forward rate agreement or any other derivative contract relating to *emission allowances* is included as a C4 derivative.

It is not always clear how all this overlapping legislation fits together but in the FCA's view, it works like this (for ease of reference the phrase 'MiFID authorisation' is used to refer to *UK* requirements onshoring MiFID):

(1) An emission allowance auctioned as a five-day future or a two-day spot contract is regulated under either the *EU* auction regulation or the *UK auctioning regulations*.

(2) The five-day future auction product is a financial instrument and is regulated under MiFID as onshored by Part 1 of Schedule 2 to the *RAO*. It is included under C4 and C11.

(3) The two-day spot contract product is also a financial instrument. It is included under C11. It is therefore also regulated under MiFID as onshored by Part 1 of Schedule 2 to the *RAO*.

(4) In the FCA's view an *emission allowance* (including when auctioned under the *EU auction regulation* or the *UK auctioning regulations*) will not come within C1.

(5) The *UK auctioning regulations* provide certain exemptions for aircraft operators and operators of plant and other installations. These exemptions continue to apply whether or not a MiFID exemption, as onshored in Part 1 of Schedule 3 to the *RAO* is available, but only for bidding activities covered by the *UK auctioning regulations*.

(6) Thus for example, regulation 16 of the *UK auctioning regulations* enable business groupings of operators in (5) to be eligible to apply for admission to bid. The MiFID exemption in (12) below may not cover all such persons but they are still entitled to submit bids under the *UK auctioning regulations*.

(7) The mere fact of being exempt under MiFID, as onshored in Part 1 of Schedule 3 to the *RAO* does not allow someone to bid under the *UK*

auctioning regulations. The *UK auctioning regulations* regulate who can and cannot bid.

(8) The *UK auctioning regulations* cover the reception, transmission and submission of a bid. This corresponds to the MiFID activities of the reception and transmission of orders in relation to one or more financial instruments, execution of orders on behalf of clients and dealing on own account.

(9) Therefore the *UK auctioning regulations* activities of receiving, transmitting and submitting a bid are all also covered by MiFID, whether the *emission allowance* is auctioned as a five-day future or a two-day spot contract. However, a person exempt under (5) is not subject to MiFID when bidding (subject to (10)).

(10) If a person who is allowed to bid under the *UK auctioning regulations* or is authorised under MiFID (because for example it wants to carry out other activities for which it needs MiFID authorisation), MiFID will apply to its bidding activities.

(11) The MiFID investment services and activities that apply to a product covered by the *UK auctioning regulations* are not limited to the bidding activities listed in paragraph (8) of this list. All the MiFID investment services and activities apply to *emission allowances* auctioned as a financial instrument . Therefore, for example, giving personal recommendations about emission allowances (including bids) is covered by MiFID. Anyone wishing to carry out such activities will need to be authorised as a MiFID firm, unless some other exemption is available.

(12) Article 2.1(e) of MiFID as onshored in Part 1 of Schedule 3 to the *RAO* exempts an operator with compliance obligations under the *trading scheme order 2020* from MiFID.

   (a) The exemption covers some of the same ground as the exemption in the *UK auctioning regulations* described in (5) to (7) above. However this overlap neither extends nor narrows the effect of the *UK auctioning regulations* exemption.

   (b) The article 2.1(e) exemption also covers activities not covered by the *UK auctioning regulations*. So, for example, the article 2.1(e) exemption covers buying and selling the underlying *emission allowance* or the five-day future or two-day spot auction product in the secondary market.

   (c) See the answer to Q35A for more details about the conditions of the exemption.

(13) An *EU firm* will be carrying on the *regulated activity* of *bidding in emissions auctions* if they bid from the *UK* on an *EU auction platform*.

Structured deposits

Q34B. How are structured deposits covered?

Article 1.4 of MiFID applies certain provisions of MiFID to an investment firm or credit institution that sells or advises on *structured deposits*.

A *structured deposit* is not a financial instrument. This means, for example, that a firm does not become a *MiFID firm* by advising on or selling them.