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Study on the new financial products traded on the Forex Market

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Abstract: *This paper puts forward an analysis of the new trends in terms of foreign currency transactions and, implicitly, the new financial products traded on the Forex market with a view to identify the category they belong to, namely foreign currency transactions or foreign exchange derivative transactions. Also, the implications of including the new products traded on the Forex market into one of the two categories have been taken into account, both in terms of market microstructure and in terms of investor-wise implications.*
Thus, the analysis showed that, by changing the destination of the amounts deposited by clients into the settlement account of the Forex services provider, i.e. from amounts deposited in order to cover the equivalent of purchased foreign currencies into amounts deposited in order to cover any price difference, financial products such as currency pairs and rolling spot Forex acquire features similar to those of derivatives (such as Contracts For Difference - CFDs).
Further, acknowledging these financial products of the Forex market (currency pairs and rolling spot Forex) as derivatives would determine a series of transformations of the microstructure of the market they are traded on, changes that would contribute to a better protection of investors and to improved monitoring and prevention by the supervisory authorities of the potential risks induced by such transactions on the financial market.

Key-words: *currency pairs, rolling spot Forex, Forex market, CFD*

1. Introduction

Over the last few years, there has been an increase in offers coming from Forex services providers to conduct transactions with Forex market specific products, such as: *CFDs, FX forward contracts and "rolling spot" contracts*. Also, such Forex operations have been gaining importance because:

- The *Forex market* is attracting important financial flows from the capital market (financial instruments market) and, implicitly, these new Forex products are competing with the derivatives recognized by MiFID (*e.g.*: futures contracts on EUR/USD);

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- Unauthorized entities supplying such products compete with the authorized financial entities (lending institutions/investment firms), which are subject to a stricter regime in terms of rules of conduct and prudence to be observed;
- The constant growth of the volumes recorded on the *Forex market* over the recent years, yielded the issue of suitability of these new financial products for retail investors and the issue of whether these investors benefit from a regime similar to the one offered by authorized agents when trading Forex financial products.

In consideration of the above issues, we are going to analyze the microstructure of the *Forex market* in view of identifying whether spot transactions with *currency pairs* are part of the category of derivatives *(such as foreign currency CFDs, forward Forex)* of whether they are part of the forex spot transactions.

2. The market microstructure

A. Financial instruments

On the Forex market, foreign currency transactions are conducted by means of the following types of financial assets: *CFD, Forward Forex, spot Forex with currency pairs, and rolling spot Forex*. The first two financial assets belong to the category of derivatives, according to the provisions of MiFID[2], whereas the spot transactions with currency pairs and the rolling spot Forex transactions, at first sight would belong to the category of spot transactions.

At a closer look though, spot Forex transactions with currency pairs and rolling spot Forex transactions, rather take, due to their economic function, the characteristics and risks incurred by investors, the form of derivative transactions.

Further we analyze the characteristics of Forex spot transactions with currency pairs and of rolling spot Forex transactions, and compare their characteristics to those of CFDs/futures contracts, which are recognized by MiFID as derivatives.

Currency pairs display the characteristics of two operations, equal and opposite, mandatorily carried out in the same foreign currencies, within a very short

[2] article 4 par. 1 section 49 of the Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU - *"derivatives" means derivatives as defined under article 2 par. (1) section 29 of the Regulation (EU) no. 600/2014;* Regulation (EU) No. 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) no. 648/2012 – *"derivatives" means the financial instruments defined under article 4 par. (1) section 44 point (c) of the Directive 2014/65/EU and mentioned in section C points 4-10 of Appendix I to such directive;*

period of time (one trading day). By mandatorily carrying out the two operations, equal and opposite, there is a possibility for that client to deposit into the settlement account, when initiating operations, only the possible price difference that could occur within a trading day.

This possible price difference that could occur within a trading day is established by the Forex services provider depending on the historical fluctuations recorded by such currencies (historical volatility) to which certain additional margins are added to cover any negative difference and/or fees.

When the Forex services provider accepts only the price difference relevant to the opposite operations, the client now has the possibility, using the same amount of money that would have allowed buying a certain quantity of foreign currency, to initiate *intra-day* operations for a much larger quantity (hundreds/thousands of times larger). Thus, by using the client's amounts only to cover the negative difference that could occur after carrying out opposite operations, the following effects are obtained:

- The client's aim is no longer actually to buy the foreign currency as in the case of *spot* foreign currency operations, but merely to benefit from the positive price differences recorded by a foreign currency as opposed to another foreign currency during a trading day;
- When the Forex services provider accepts only the price difference relevant to the opposite operations, a multiplier is formed (lever effect) – the amount of money held by the client in the Forex services provider's settlement account is much lower than the value of the initiated foreign currency operations;
- The amount deposited into the Forex services provider's settlement account is no longer used to purchase a certain quantity of foreign currency, but to secure the good performance of the obligations devolving on the client as a result of carrying out the opposite transactions in the event that the price evolves to the detriment of the position opened on the client's behalf (acting as a margin/collateral account);
- The settlement no longer takes place by actually exchanging the currencies, but merely by calculating the difference in money (cash settlement); thus, the physical delivery intention no longer exists as in the case in foreign currency *spot* transactions.

If the position rolling option is added to these spot transactions on *currency pairs*, in terms of economic effects we would obtain the effects of a *foreign currency CFD*, save that, in terms of accepted designations, we would be in the presence of rolling spot Forex products. Thus, we could assert that the elements defining a *rolling spot Forex* product are similar to those of a *foreign currency CFD* and that, implicitly, they are similar to those of any foreign currency derivative.

A ***CFD*** **(*contract for difference*)** is an agreement between a buyer and a seller to settle the value difference of an asset, recorded between the time of signing the contract and the time of liquidation (closing of the initial position). Being a maturity-free derivative, the closing of positions can only be achieved by carrying out a transaction that is equal and opposite to the initial one. In terms of collateral (the level of margins deposited by the parties involved in the transaction), the margins are adjusted on a daily basis by marking to market based on the reference price of the underlying asset established on the spot market (the spot market of the underlying asset of the *CFD*).

In reference to *futures* contracts, we can say that the *CFD* is a maturity-free *futures* contract, where the marking to market is conducted during its entire existence (as long as the position is open) only at the reference price of the underlying asset established on the spot market. As opposed to a *CFD*, the marking to market of a futures contract is conducted on a daily basis at the reference price of the underlying asset established on the *futures* market; on the maturity of the futures contract the marking is conducted at the reference price of the underlying asset established on the spot market (the spot market of the underlying asset of the *futures* contract).

The above indicate that the following elements characterizing foreign currency derivatives are also present in the *rolling spot Forex* contracts:

- The existence of the underlying asset, based on which the contract yield is calculated, as well as the foreign currency;
- The rollover/closing of the position and reopening it – thus indirectly obtaining the "lack of maturity";
- The existence of margin accounts and, implicitly, of collaterals for the good performance of the obligations that could derive from these transactions;
- The lever effect/multiplier (*e.g.* 1 to 100/1,000);
- The settlement takes place by determining the difference in money, with no intention of physical delivery (the settlement is achieved as a *cash settlement)*;
- The contracts ending at the end of the day automatically reopen the next day (like a *CFD*).

It appears that financial products such as spot currency pairs and/or *rolling spot Forex* which are traded on the Forex market are similar to derivatives in terms of economic function, characteristics and risks incurred by investors. Thus, we can assert that only the designation of these contracts (*rolling spot Forex*) refers to the spot market and that, by default, they give the Forex services providers the possibility of classifying them as foreign currency operations.

An analysis of the recital above **as a whole** shows that the factor leading to the inclusion of products such as *currency pairs* and *rolling spot Forex* traded on the Forex markets into the category of derivatives or into the category of foreign exchange transactions is given by the destination of the amounts transferred by the client into the settlement account of the Forex services provider, namely:

1. of paying the equivalent of the purchased foreign currency quantity relevant to the two opposite operations;
2. of securing the good performance of the obligations devolving on the client as a result of carrying out the relevant opposite operations; of covering the possible negative differences occurring as a result of carrying out the two opposite operations in the event that the price evolves to the detriment of the position open on the client's behalf

In the first case, we are talking about two foreign exchange transactions carried out shortly after one another, whereas in the second case we are in the presence of a derivative transaction.

In consideration of the arguments put forward, we believe that products such as currency pairs and *rolling spot Forex* traded on Forex markets should be included into the category of foreign currency derivatives.

Further to be noted is that although some transactions on the spot market are settled within a longer lapse of time because of the activities required for settling the transactions with certain assets, they need not be automatically considered as derivative transactions. **Obtaining an economic function, as well as effects and risks similar to a derivative incurred by an investor are consequent to the change of destination of the amounts transferred from the client into the agent's settlement account, the other aspects being merely effects of this.**

This principle of identification of a derivative (even if its designation includes the term "spot") can also be applied to other products having an underlying asset other than foreign currencies (*e.g.* commodities, securities)

B. Forex services providers

According to the European legislation on markets in financial instruments (MiFID), the professional provision/conduct of financial investment services and activities in connection with financial instruments can only be performed by authorized agents (investment firms and lending institutions). Thus, if products such as *currency pairs* and *rolling spot Forex* traded on Forex markets were classified as derivatives, then they could be offered only to investors through authorized agents. In this situation, Forex services providers (as authorized agents) must observe all the obligations imposed by the MiFID in terms of investor protection.

If products such as *currency pairs* and *rolling spot Forex* traded on Forex markets were classified as foreign exchange transactions, then they could be offered to clients by entities other than authorized agents according to the provisions of the MiFID. Thus, these entities are not held to observe the legal provisions on investor protection imposed by the MiFID.

C. The trading venues for currency pairs/rolling spot Forex transactions

The "trading venue" for *currency pairs* and *rolling spot Forex* transactions can be described as external to the regulated markets[3] (RMs) or the multilateral trading facilities[4] (MTFs). These transactions conducted outside the RMs/MTFs are known as *OTC – "over the counter" transactions* and range from ad-hoc bilateral transactions to permanent electronic systems, as follows:

a. market maker[5] (liquidity provider) located outside an RM/MTF – also known as independent operator – *systematic internaliser (SI*[6]); in this situation the Forex services provider acts as an SI, but is not authorized as such according to the provisions of the MiFID,

b. electronic network for trading by order crossing outside the market (Broker Crossing Systems/Dealer Crossing Networks/Electronic Broking Service – BCS/DCN/EBS),

c. platform for trading derivatives outside the market, developed in-house by the Forex services provider, or licensed and purchased from another Forex services provider.

The order crossing trading systems, regardless of whether they appear as an in-house system developed by a financial entity or as a network of several financial entities, achieve a continuous flow of orders and are equipped with engines to match those

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[3] article 4 par. 1 section 21 of the Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU - *"regulated market" means a multilateral system, operated and/or administrated by a market operator who reunites or facilitates the reuniting, within the system and in accordance with its non-discretionary rules, multiple interests of third parties in selling and buying financial instruments, in a way entailing the conclusion of contracts with financial instruments accepted for trading by virtue of its rules and/or systems, and who is authorized and regularly operates in accordance with Title III of this Directive;*

[4] article 4 par. 1 section 22 of the Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU - *"multilateral trading facility" (MTF) means a multilateral system operated by an investment firm or by a market operator who reunites, within the system and in accordance with its non-discretionary rules, multiple interests of third parties in selling and buying financial instruments, in a way entailing the conclusion of contracts in accordance with Title II of this Directive;*

[5] article 4 par. 1 section 7 of the Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU - *"market maker" means a person who is permanently available on the financial markets to trade on their own by selling and buying financial instruments by engaging their own capital, at prices established by itself;*

[6] article 4 par. 1 section 20 of the Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU - *"independent operator" means an investment company carrying out transactions on its own in an organized fashion, frequently, systematically and substantially, executing the orders of its clients outside of a regulated market, of a MTF or of a OTF, without administrating a multilateral system;*

orders (the clients' orders placed between them or the clients' orders placed with the Forex services provider's own orders aimed at closing deals).

OTC transactions compete with authorized trading venues according to the provisions of the MiFID, providing multilateral trading services without having the obligation of observing regulations on pre- and post-trading transparency. Due to the lack of transparency, they are also known as "dark pools" or *dark venues*.

In general, Forex services providers acting as a market maker outside the market to build a bid and quotations, "clone" the quotations of another liquidity provider located outside the market (authorized or not as an independent operator) provided that the cloned quotations are outside the spread used by the relevant liquidity provider. The reasons for that some Forex services providers build their quotations in this manner are: i) on the Forex market, agents make their income from quotation differences, not from the fees applied to the deals closed on behalf of the clients, ii) thus they ensure that the open positions can be closed at any time by using the quotations offered by the liquidity provider whose quotations they "cloned".

The entities managing these "dark trading venues" are in a privileged position compared to their clients in terms of order execution, as they can execute orders in a discretionary fashion when merging only client orders, and also benefit from the informational asymmetry and lack of transparency when merging client orders with their own.

In the near future, the proposed amendment to the MiFID will regulate a new trading venue, *i.e.* the organized trading facilities[7] (OTFs). Thus, after introducing this new trading venue, the category of OTC will continue to include transactions closed occasionally, ad-hoc and irregularly by eligible counterparties outside the RMs, the MTFs and the OTFs (or at least this is the objective pursued by the implementation of the new MiFID provisions).

The OTF administrators will not be able to close any deals engaging their own capital (by merging/matching client orders to their own) as is the case of an IS. Also, no OTF shall be able to be connected to another OTF in a way allowing the interaction of orders with several OTFs. In other words, the OTF administrators will no longer be able to build trading networks by crossing orders outside the regulated markets/MTFs such as BCS/DCN/EBS.

[7] article 4 par. 1 section 23 of the Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU - *"organized trading facility" (OTF) means a multilateral system that is not a regulated market or a MTF and within which multiple interests of third parties in selling and buying securities, structured financial products, emission certificates and derivatives can interact in a way entailing the conclusion of contracts in accordance with Title II of this Directive;*

As regards CFD and forward Forex transactions, they fall under the provisions of the MiFID and EMIR, and authorized agents must implicitly observe all the obligations relevant to derivative transactions.

D. Set-off and settlement of currency pairs/rolling spot Forex transactions

The set-off and settlement of OTC transactions relevant to the Forex market must take into account the specificity of the financial services provided by the Forex services provider, as an independent operator - “systematic internaliser” – or as an administrator of a trading system by crossing orders outside the market.

- **a.** An independent operator is that entity who, in an organized fashion, frequently and systematically, carries out transactions on its own behalf, executing the clients’ orders outside of an RM/MTF in a bilateral system. A bilateral system allows or facilitates the reuniting of the various interests in selling and purchasing financial instruments, and where the agents operating the system execute the clients’ orders through their own account.

Considering the characteristics of transactions carried out through an internal operator, we can assert that they are of “back to back” type *(permanent offering of quotations, both for sale and for purchase)* by engaging own capital *(both the sale and the purchase are made by matching the client’s order to the agent’s order)*, and that transactions are set-off and settled on a gross basis, through the accounts held by the relevant agent.

The Forex services providers build quotation systems for sales and purchases by “cloning” the quotations offered by another independent operator/market maker and thus ensure that their own quotations are outside the spread used as reference. At the end of the trading day, the Forex services provider closes the positions still open by opening new positions, equal and opposite, on the platform administrated by the independent operator/market maker whose quotations he “cloned”.

- **b.** A platform for order crossing trading outside the market is a multilateral system or mechanism that currently is not a trading venue regulated by the MiFID, within which multiple interests in the sale and purchase of financial assets of third parties may interact in a way entailing the conclusion of transactions.

The platform for order crossing trading outside the market does not meet any of the requirements of a set-off/settlement. Therefore, if the administrator is a financial institution, it will take over the settlement function, and else will resort to such an institution.

In terms of the financial institution’s role in set-off/settlement activities, it updates on a daily basis the level of collateral deposited by the transacting parties into the margin accounts, it conducts the margin call activity, and facilitates transfers from debit accounts into credit accounts. All these activities will be conducted by the financial institution without interposing by means of novation between the two transacting parties and without guaranteeing the good performance of the obligations devolving on the relevant parties. For this reason, the OTC transactions relevant to the Forex market, carried out through order crossing systems outside the market are exposed both to the settlement risk and to the counterparty's credit risk.

The implementation of the new MiFID will allow conducting of the OTC transactions relevant to the Forex market through an OTF as well. The OTF is a trading venue organized and administrated by an agent who is the only participant in that particular venue, so that, in terms of organization, it is similar to that of a trading system by order crossing outside the market. Thus, by introducing this trading venue, the new MiFID aims at moving some of the OTC transactions to regulated and transparent venues.

c.In the case of an electronic network, the Forex services providers generally apply the ISDA (International Swaps and Derivatives Association) rules that regulate the interaction of the counterparties of the OTC transactions. *These rules include all the aspects regarding bank account instructions, set-off and settlement instructions, collateral accounts, cancellation protocols and novation procedures*.

E. Investor protection

In terms of investor protection, another important aspect of including spot transactions on currency pairs and/or rolling spot Forex into the category of derivatives is the possibility of setting-off their claims by another investor set-off Fund.

The role of the investor set-off Fund is to settle the claims of investors originating from the incapacity of an agent/investment administration company to return money and/or financial instruments owed or belonging to investors, which are held and/or administrated on their behalf for the purpose of providing financial investment services.

In case of products belonging to the category of derivatives according to the MiFID that are traded on the *Forex markets*, investors in these Forex instruments will be able to benefit from set-off claimed from the investor set-off Fund up to the threshold established by the applicable legislation.

3. Conclusions

By changing the destination of the amounts deposited by clients into the Forex services provider's settlement account, as well as of the amounts deposited for covering the equivalent of purchased foreign currencies, into amounts aimed at covering any price difference, the financial products such as *currency pairs* and *rolling spot Forex* acquire characteristics similar to those of derivatives. Moreover, these financial products become similar to CFD derivatives in terms of economic function and risks incurred by the investors.

The recognition of these financial products as derivatives will entail a series of microstructure changes of the market they are traded on. Thus, they will be handled only by those Forex services providers who hold the quality of authorized agents according to the provisions of the MiFID. As a result, investors in these financial products will enjoy both the protection provided by the MiFID for retail investors and the protection ensured by the investor set-off funds.

Further, even if these financial products continue to be traded OTC, the EMIR provisions will be applicable and agents will have to report transactions with such products to the trade depository, thus allowing for a better assessment by the supervisory authorities of any potential systemic risk entailed by these transactions.

The recognition of these products of the *Forex market (currency pairs and rolling spot Forex*) as derivatives would determine a series of transformations of the microstructure of the market they are traded on, changes that would contribute to a better protection of investors and to improved monitoring and prevention by the supervisory authorities of the potential financial risks induced by such transactions on the financial market.

Also, through the recognition of these *Forex market* products as derivatives, investors will benefit from the protection of the Financial Supervision Authority concerning prevention, identification and penalization of any fraudulent practices.

To be noted is that although some transactions on the spot market are settled within a longer lapse of time because of the activities required in view of settling the transactions with certain assets, they need not be automatically considered as derivative transactions. **Obtaining an economic function, as well as effects and risks similar to a derivative incurred by an investor are consequent to the change of destination of the amounts transferred from the client into the agent's settlement account, the other aspects being merely effects of this.**

This principle of identification of a derivative (even if its designation includes the term "spot") can also be applied to other products having an underlying asset other than foreign currencies (*e.g.* commodities, securities)

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