Consultation paper
31 March 2017

FINANCIAL MARKETS AUTHORITY
TE MANA TATAI HOKOHOKO - NEW ZEALAND

Short duration derivatives

About this consultation paper

Short duration derivatives (such as FX CFDs and binary options) are very high risk, even for experienced investors. This risk is exacerbated when they are offered by unlicensed providers.

We are concerned about the potential harm these products pose for NZ investors. As a result, we've reviewed how we regulate these products and decided that businesses selling these products should be licensed. This decision is based on our view that the Financial Markets Conduct Act 2013 (FMC Act) requires businesses selling these products to have a licence.

We want to ensure ordinary spot FX contracts involving actual delivery of the different currencies (deliverable spot FX) are not unintentionally captured by this change.

This consultation seeks your views on whether we should confirm that deliverable spot FX contracts are not derivatives for the purposes of the FMC Act, through a proposed class designation under section 562(1)(c) of that Act.

This consultation is for anyone who might be affected by the proposed class designation, including businesses offering derivatives, investors and legal advisers. It includes a draft declaration (appendix 1) for technical experts' review and comment.

Submissions close on Friday 28 April 2017. Please use the feedback form for your submission.

About this consultation:

This consultation is for: interested parties including offerors, investors and legal advisers

It aims to: gain feedback on the impact of a class designation for short duration derivatives

Document history

This version was issued in April 2017 and is based on legislation and regulations as at the date of issue.

FMA document reference code 3279979

Short duration derivatives

Issue

1. Until recently, our interpretation of the definition of "derivative" in section 8 of the FMC Act (the definition) was that any derivative transaction settled within three working days (foreign exchange agreements) or one working day (any other case) was not regulated. Therefore a derivative issuer licence was not required for that activity. Due to concerns about the potential harm these products pose for investors, we reviewed our position and decided that businesses selling these products should in fact be licensed. This decision is based on our view that the law requires businesses selling these products to have a licence.
2. We are concerned that deliverable spot FX contracts might be caught by the definition of derivative. We don't believe that ordinary deliverable spot FX contracts were intended to be regulated as derivatives. This consultation paper seeks feedback on whether we should use our designation power to declare that spot FX contracts physically settled by delivery of an amount of currency within three working days are not derivatives for the purposes of the FMC Act.

Background

3. Over the last 18 months, the volume of complaints about online FX and other short duration trading services (such as binary options) has remained at about 40 per cent of total complaints we've received.
4. We have also observed the emergence of online trading platforms, often based in overseas jurisdictions, targeting New Zealand investors with offers of short-duration derivative products.
5. As a result of these developing risks, we reviewed the definition of "derivative" in the FMC Act, specifically looking at whether providers of these products must be licensed as derivatives issuers.
6. The first paragraph of the definition (section 8(4)(a)) sets out three conditions an agreement must satisfy to qualify as a derivative under the Act. One condition is that the time at which the consideration for that agreement is to be provided is not less than the prescribed "future time". The prescribed "future time" for a "foreign exchange agreement" is three working days. In any other case it's one working day[1]. The second paragraph of the definition (section 8(4)(b)) then lists transactions that are recurrently entered into in the financial markets in New Zealand or overseas, and commonly referred to in those markets as:
    a. a futures contract or forward
    b. an option (other than an option to acquire by way of issue an equity security, a debt security or a managed investment product
    c. a swap agreement

[1] Regulation 13 of the Financial Markets Conduct Regulations 2014. The term "foreign exchange agreement" is not defined.

d. a contract for difference, margin contract, or rolling spot contract

e. a cap, collar, floor or spread.

7. Transactions not intended to be regulated as derivatives are excluded from this definition.

8. Our previous position was that foreign exchange related derivatives settling within three days and other derivatives settling within one day were not caught by the definition, so were not "derivatives" for the purposes of the FMC Act. This was because they settled within the prescribed future time. However we understand that these derivatives were intended to be regulated[2]. As a result of our recent review, we have changed our position to confirm that any product listed in the second paragraph of the definition is a derivative, regardless of whether or not it settles within the prescribed future time.

Outcome

9. As a result of our revised view, people making regulated offers[3] of products listed in the second paragraph of the definition will need to get a derivatives issuer licence and comply with the relevant FMC Act obligations. This includes short duration derivatives such as contracts for difference and options. Providers who already have a licence will need to review their existing PDS and business practices to ensure they comply with FMC Act obligations for these products. Providers will also need to consider whether they need to register on the Financial Service Providers Register, or amend their registration.

10. We understand providers may need time to get a licence or update their processes, so we will provide a grace period. We expect all currently unlicensed providers to apply for a licence by 1 August 2017. All providers must hold a licence and be fully compliant by 1 December 2017.

If you need to get a licence, please contact us and we will help to you understand the requirements.

Please also let us know if you think you will be unable to become fully compliant by 1 December 2017.

Unintended consequences

11. We would like to ensure our new interpretation of the definition does not unintentionally capture contracts outside the legislation's policy intention. In particular, we understand from initial targeted consultation on this issue that deliverable spot FX contracts (a physical exchange of currency) with a delayed settlement can be processed as a "forward" in New Zealand markets. This means they may be captured by the second paragraph of the definition. We would like to know whether you agree with this interpretation.

[2] "Financial Markets Conduct Regulations: Discussion Paper" (December 2012) page 124 (http://www.mbie.govt.nz/info-services/business/business-law/financial-markets-conduct-act/regulations/financial-market-conduct-regulations-discussion-paper-december-2012/documents-images-library/Financial%20Markets%20Conduct%20Regulations%202013%20Discussion%20Paper.pdf)

[3] The offer will usually be a regulated offer unless an exclusion applies, for example because it is only made to wholesale investors.

12. The purpose of section 8(4)(a)(ii) of the FMC Act was to exclude ordinary deliverable spot contracts settled within the prescribed future time[4] from the definition. This will not work if they are forwards and therefore fall within the second paragraph of the definition. Deliverable spot FX contracts have not previously been considered derivatives for the purposes of the FMC Act. This means some issuers would need to make significant changes to their current practices (eg disclosure and training of staff) if they were included.

13. Clause 21 of Schedule 1 to the FMC Act contains an exclusion for prescribed currency forwards issued by a registered bank or a subsidiary of a registered bank. This is a currency forward for which settlement is at a time no later than 12 months and 3 working days after the time when it is entered into. This will mean banks are not subject to Part 3 disclosure requirements in the FMC Act for offers of these products. However, these products will still be "financial products" for the purposes of the FMC Act, so banks will still have to comply with the relevant obligations under the Financial Advisers Act 2008 (FA Act).

14. The FMC Act adopted the definition of derivative from the Corporations Act 2001 (*Australia*) (Corporations Act). The same problem does not arise under the Corporations Act, as it doesn't have an equivalent to the second paragraph of the definition. The Corporations Act also has a specific definition of "foreign exchange contract" which is limited to genuine sales or exchanges of foreign currency. These contracts are not treated as derivatives, provided they settle within three business days.

15. We are therefore considering whether we should exercise our designation power to declare that if foreign exchange forward contracts settle by delivery of an amount of the relevant currency within three working days (ie a deliverable spot FX contract) they are not financial products for the purposes of the FMC Act.

Questions

1. Do you think spot FX contracts that settle by delivery of an amount of the relevant currency within three working days are captured by the definition of "derivative"? Please provide your reasons.
2. Do you think we need to use our designation powers to declare that spot FX contracts that settle by delivery of an amount of the relevant currency within three working days are not financial products?
3. What impact do you believe this class designation might have on investors? We are particularly interested in any negative consequences that might occur as a result of the proposed designation. Do you think that investors expect deliverable spot FX contracts to be regulated as financial products?
4. What advantages, disadvantages or risks do you see in us using our power to designate that deliverable spot FX contracts are not financial products?

Other short duration derivatives

16. We have considered the meaning of the words "commonly referred to" in the definition. In our view, all agreements commonly referred to as falling within the transaction types referred to in the second paragraph of the definition are derivatives, even if called other names. However, we would like to know if there is a good

[4] "Financial Markets Conduct Regulations: Discussion Paper" (December 2012) page 124 (http://www.mbie.govt.nz/info-services/business/business-law/financial-markets-conduct-act/regulations/financial-market-conduct-regulations-discussion-paper-december-2012/documents-images-library/Financial%20Markets%20Conduct%20Regulations%202013%20Discussion%20Paper.pdf)

reason to specifically designate any short duration agreements as derivatives for the purposes of the FMC Act, such as spread bets.

Questions

5. Do we need to use our designation powers to declare that a specific type of agreement of a short duration is a derivative? Please provide your reasons and describe any products that you think should be included.

Designation

17. Section 562(1)(c) of the FMC Act enables us to declare that a security that would otherwise be a financial product of a particular kind is not a financial product. We are seeking your views on whether we should declare that spot FX contracts that settle by delivery of an amount of the relevant currency within three working days are not derivatives for the purposes of the FMC Act. We would like to use the same definition of "foreign exchange contract" that is used in the Corporations Act.

18. The Corporations Act definition is as follows:

    "**foreign exchange contract** " means a contract:

    a. to buy or sell currency (whether Australian or not); or

    b. to exchange one currency (whether Australian or not) for another (whether Australian or not).

19. We will exclude rolling spot contracts from this designation, as those contracts are specifically listed in the second paragraph of the definition and are intended to be regulated as financial products under the FMC Act.

Questions

6. Do you think the definition of "foreign exchange contract" used in the Corporations Act is an appropriate definition? Please let us know if this definition does not pick up all the circumstances in which a deliverable spot FX contract may be used.

7. Should we include any other types of spot contracts within this designation? If you think that we should, please provide an example of a non-FX spot contract that should be included within this designation.

8. Do you think we should use our power to grant an exemption from relevant provisions of the FMC Act or FA Act rather than a designation? If so, which provisions should we exempt (or rather, not exempt) market participants from?

9. Do you think the class designation should be provided to all market participants or be targeted in favour of non-registered banks (with an exemption from the FA Act provided to registered banks)?

Consequences of designation

20. The effect of the proposed designation will be that spot FX contracts that settle by delivery of an amount of the relevant currency within three working days will not be derivatives for the purposes of the FMC Act, so not subject to FMC Act obligations for derivatives. In particular, no disclosure will need to be made to investors under Part 3 of the FMC Act. We think this simply reflects the intention of the authors of the FMC Act (that deliverable spot contracts were not to be regulated) and is understood by providers in the market to be the current position.

Timing

21. We intend to give market participants a grace period to ensure they can comply with their obligations under the FMC Act. As a result, we do not intend to change our interpretation of the definition of "derivative" and make a designation until the grace period has expired (ie 1 December 2017). Subject to our decision on the designations, from 2 December 2017 any business making a regulated offer of derivatives (as described in the second paragraph of the definition in the FMC Act) without a derivative issuer license would be subject to action by the FMA. We encourage people who think they may need a licence to contact us as soon as possible.

Appendix 1

We will declare each 'spot FX contract' that would otherwise be a derivative is not a financial product for the purposes of the FMC Act and the Financial Conduct Regulations 2014, where the term spot FX contract is defined as follows:

spot FX contract means an agreement to:

(a) buy or sell currency (whether New Zealand currency or not); or

(b) to exchange one currency for another (whether New Zealand currency or not) for another (whether New Zealand currency or not),

that involves the delivery of the relevant amount of currency within three working days, and excludes a rolling spot contract.

Feedback: Short duration derivatives

Please submit this feedback form electronically in both PDF and MS Word formats and email it to us at consultation@fma.govt.nz with '**Feedback: Short duration derivatives'** and your entity name in the subject line. Thank you. **Submissions close on Friday, 28 April 2017.**

Date: Number of pages:

Name of submitter:

Company or entity:

Organisation type:

Contact name (if different): Contact email and Phone:

Paragraph or Question Number:	Comment	Recommendation
You don't need to quote from the consultation document if you use question numbers. You may attach extra pages – please label each page with your name and organization. You don't need to give an answer to every question if you don't want to.		
Q1		
Q2		
Q3		
Q4		
Q5		
Q6		
Q7		
Q8		
Q9		

Feedback summary – *if you wish to highlight anything in particular*

Please note: Feedback received is subject to the Official Information Act 1982. We may make submissions available on our website, compile a summary of submissions, or draw attention to individual submissions in internal or external reports. If you want us to withhold any commercially sensitive or proprietary information in your submission, please clearly state this and note the specific section. We will consider your request in line with our obligations under the Official Information Act.

Thank you for your feedback – we appreciate your time and input.

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