2 January 2015

ESMA consultation – Future guidelines clarifying the definition of commodity derivatives as financial instruments under MiFID I

FIA Europe and ISDA welcome the opportunity to respond to the ESMA consultation on draft guidelines that aim to clarify the boundaries of the definition of financial instruments under MiFID I and to ensure that national regulators and market participants across the European Union (EU) apply MiFID I and EMIR consistently until MiFID II is fully implemented, *i.e.* January 2017.

We refer to our amendments to the proposed guidelines in the Annex.

Q1. Do you agree with ESMA's approach on specifying that C6 includes commodity derivative contracts that "must" be physically settled and contracts that "can" be physically settled?

- From our members' perspective, it goes without saying that a contract that ***"must"*** be physically settled ***"can"*** be physically settled.

- **Our members strongly believe that ESMA should not address the "must" be physically settled definition under MiFID I**.

  We do not believe it is appropriate for ESMA to address the ***"must be physically settled"*** definition under MiFID I, as this is not a concept present in the current Directive. The differentiation in the context of guidelines aiming to clarify the scope of MiFID I is likely to create confusion in the market, given the upcoming clarifications that will be made under MiFID II.

  In MIFID I, the text refers to contracts that **"can be physically settled"** to clarify which contracts are **in** scope, whereas the MiFID II text refers to contracts that **"must be physically settled"** to clarify that certain specified contracts are **out of** scope.

By following such an approach, ESMA may cause confusion within the market. For instance, physical contracts will have a provision for transfer of ownership or title embedded in the contract as primary obligation. Delivery is more a question of transfer of possession and should not be negated because of any adjustments in the actual delivery due to operational reasons or the breach of contractual obligations or in the case of operational netting. This view is being supported by ESMA's recognition in its Final Report on Technical Advice on MiFID II and MiFIR, dated 19 December 2014, page 406 number 2, that operational netting does not preclude a contract from being considered as must be physically settled.

We do agree that the terms of the contract at the point of its formation should not permit any voluntary form of cash settlement at the option of one party. However adjustments to the physical delivery obligation in the event of default or force majeure, for example, should not be considered as cash settlement in the sense of MiFID I.

- **Recommendation: Our members believe that a more consistent approach between the EU and the US regarding the scope of financial instruments should be considered**.

We highlight the following residual consequences from the approach taken under MIFID I in its interpretation of C6 and C7.

The EU approach is fundamentally very different to the approach adopted towards physical forward commodity contracts in the United States (US) (which are wholly exempted from financial services scope).

In the spirit of the new accord entered into between the EU Commission and CFTC to better accommodated regulatory recognition and "**substituted compliance**", we wonder how ESMA's approach would fit with the EU regulation and highlight that the growing proximity regarding the commonality between US and EU will be substantially impacted by the EU's approach to regulation of physical forward contracts. This will subsequently create a competitive imbalance between the US and the EU.

Q2. Do you consider there are any alternatives for or additions to the proposed examples of "physically settled" that ESMA should consider within the definition of C6? If you do, what are these?

We agree with ESMA's view on the examples provided. We believe that ***"physically settled"*** should incorporate a broad range of delivery methods, including (without limitation) documentary rights such as warrants, receipts or certificate of deposits which could be classified as title documents. By way of example, a warrant to obtain copper would not necessarily confer title to the copper in some jurisdictions.

Recommendation: In order to capture the broad range of delivery methods present in commodity markets, we recommend including paragraph (c) of the CESER 2005 advice (which is referred to in paragraph 37 of the ESMA consultation paper).

Recommendation: We would therefore request clarity in the definition of ***"physically settled"*** and the following changes to the guidelines (paragraph 41 of the ESMA consultation paper);

> ***"ESMA considers that definition C.6 of Annex 1 of MiFID applies in the following way:***
> ***[…]***
> ***b. "physically settled" incorporates a broad range of delivery methods and includes:***
> ***[…]***
> ***ii. delivery of a document giving rights of an ownership or possessory nature to the relevant goods or the relevant quantity of the goods concerned (such as a bill of lading or a warehouse warrant; ~~or~~***
> ***iii. the amendment, assignment or other form of alteration of the records of rights of ownership or rights to receive possession (or of entitlements to documents giving or evidencing such rights) in a storage facility, repository, central registry or other dematerialised system recording entitlement to establish a change in beneficial ownership of a physical commodity; or***
> ***iv. another method […]"***

Q3. Do you agree with ESMA's discussion of the relationship between definitions C5, C6 and C7 and that there is no conflict between these definitions? If you do not, please provide reasons to support your response. In particular, ESMA is interested in views regarding whether the proposed boundaries would result in "gaps" into which some instruments would fall and not be covered by any of the definitions of financial instrument. ESMA also seeks views on whether there are any adverse consequences from the fact that some instruments could fall into different definitions depending upon the inherent characteristics of the contract e.g. those with "take or pay" clauses that may be either cash or physically settled.

We do not see any conflict, apart from the need for a clear and concise definition of **"physically settled."**
We do not understand the statement made in Section 40 (c) of the ESMA consultation paper in footnote 8; which states:

> ***"In this regard, however, ESMA notes it has not been able to identify any instrument which can be accurately described as "must be physically settled", as all instruments appear to contain force majeure provisions that would prevent physical delivery."***

We believe that default and force majeure do **not** constitute cash settlement. ESMA has recognised this in its Final Report on Technical Advice on MiFID II and MiFIR, dated 19 December 2014, page 407 number 7. None of these events change the fundamental nature of the legal obligations between the parties to physically deliver and accept the relevant commodity and should not prevent the contract from being described as "can be physically settled". Due to the nature of physical commodity markets (i.e. exposure to force majeure events is unavoidable and consequences of

which need to be reflected in the relevant contract) and other contingencies (such as insolvency or breach leading to failure to deliver or accept), it is impossible for contracts which contemplate physical settlement not to provide for the consequences of these events which prevent physical delivery and which will either result in one party paying damages to the other or in certain cases (e.g. force majeure) that neither party is required to pay damages due to the no-fault nature of the event. These types of events should not detract from classification of a contract as "can be physically settled".

Q4. What further comments do you have on ESMA's proposed guidance on application of C6?

Spot contracts

We consider the definition of "**spot"** of key importance.

Given that market practices vary from one commodity to another, we recognise that the reference in Article 38(2)(b) to a **"period generally accepted in the market for that commodity",** when this period is beyond 2 trading days, can potentially lead to different applications across different products within the commodities markets. We would emphasise that there are differences in markets and their usual delivery periods, not in the interpretations of different regulators across the EU. Our members have not experienced situations of conflicts across the EU Member States and do not see any need for further regulation in this area.

Nevertheless, we note that Art. 38(2) provides a definition for spot contracts only in relation to MiFID I Annex I C.7, whereas the market generally applies the same definition also to C.6.

Recommendation: It would be beneficial if ESMA could confirm in its guidance that Art. 38(2) should also apply to C.6 when determining whether a contract is a spot contract.

Physical forwards

Whether physically settled forwards traded on MTFs should fall under C.6 is still very debatable from some of our members' point of view.

The wording of C.6, in MiFID II as well as MiFID I, does not explicitly refer to forwards. Some of our members argue that whilst it could be said that under MiFID I the lack of explicit inclusion of "forwards" in the level 1 text of C.6 has been an oversight of the regulator and this was mitigated by including forwards under "other derivative contracts", the level 1 text of MiFID II perpetuates this alleged "flaw", keeping the wording regarding "forwards" unchanged, i.e. not listed in the examples under C.6, but in C.5 and C.7. Some of our members believe that this supports the view that the exclusion of "forwards" from the listed examples in C.6 was done with the intention to have commodity forwards assessed under the requirements of C.5 and C.7 instead of C.6. This is supported further through recital (8) of MiFID II, to only include such commodity derivatives (i.e. extending the scope) that "give rise to regulatory issues comparable to traditional financial

instruments", which clearly shows the intention to limit the application of MiFID II and apply a requirement of "characteristics of a derivatives" which is a criterion provided for under C7, not C6.

Some of our members consider that the inclusion of physical forward commodity contracts under C.6 of MIFID I will create an arbitrary and artificial divide between physical forward contracts which are traded on a regulated market/MTF, and those traded by means other than a regulated market or MTF. This would result in physical forward contracts traded on a regulated market/MTF to be automatically construed as commodity derivatives, notwithstanding that the contracts terms, intentions and the course of dealings between parties identify it as a physical contract. In the normal course of events, all physical forward contracts would be treated in the same way as physical "spot" contracts which are not regulated as a financial services product but pursuant to physical market regulation (REMIT and physical supervisory authorities of member states). Including forwards in C.6 creates an artificial divide between financial and physical commodity markets, insofar as physical forward contracts, which would otherwise fall to be regulated pursuant to physical market regulation, would fall into financial services regulations simply because of the platform on which they are traded.

Some of our members consider that this view is supported further by the Market Abuse Regulation, adopted in 2014, which in its definition of spot commodity contracts in Article 3(15) of MAR, explicitly includes physically settled forwards.

Q5. Do you have any comments on ESMA's proposed guidance on the specification of C7?

There are two views on the "commercial purpose" test within our membership.

The first view held by some of our members considers that the specification of **"commercial purpose"** as currently in paragraph 4 of Article 38 of Regulation (EC) 1287/2006 is working well.

The second view held by some of our other members is that the current specification is too narrow. The use of commercial purpose needs to be relevant to the market participant. A commercial purpose test would be useful if used in the right context. The language in the Level 1 text and later interpretative advice uses the phrase **"commercial purpose"** on an inconsistent basis. Some of our members would recommend ESMA to clarify its use and purpose in giving the market implementation guidelines. The below suggestion of only applying it to power and gas operators is insufficient to cover the breadth of the physical commodity market.

> ***"Article 38 (4) of 1287/2006/EC defines a specific type of commodity derivative contract as being for commercial purpose "if it is entered into with or by an operator or administrator of an energy transmission grid, energy balancing mechanism or pipeline network, and it is necessary to keep in balance the supplies and uses of energy at a given time". In such cases, the commodity derivative is not financial instrument under MiFID I."***

Other than contracts entered into for the purpose of balancing the supplies and uses of energy, it should also include contracts entered into for the purpose of meeting regulatory requirements, such as Compulsory Stock Obligations (CSOs) and the Renewable Transport Fuel Obligation (RTFO)

Recommendation: We therefore propose that ESMA should clarify that:
"A contract shall be considered to be for commercial purposes for the purposes of Section C(7) of Annex I to Directive 2014/65/EU and as specified in Article 38 of Regulation 1287/2006/EC, and as not having the characteristics of other derivative financial instruments for the purposes of Sections C(7) and (10) of that Annex, if it is entered into:

1. *With or by an operator or administrator of an energy transmission grid, energy balancing mechanism or pipeline network, and it is necessary to keep in balance the supplies and uses of energy at a given time; or*
2. *For the purpose of meeting regulatory requirements to purchase, sell, hold or deliver a commodity."*

Although it is indicated in ESMA's document that the proposed guidance is only relevant in the MiFID I context, we think that ESMA's guidelines should have an impact on the way the MiFID II provisions should be interpreted under Annex I section C.6 and C.7.

FIA Europe

FIA Europe, formerly the Futures and Options Association (FOA), represents some 175 firms involved in the exchange-traded and centrally-cleared derivatives markets – including banks, brokers, commodity firms, exchanges, CCPS, vendors, law firms and consultants. FIA Europe works with its members to maintain constructive dialogue with government and regulatory authorities and deliver high standards of industry practice. In 2013, FIA Europe formed an affiliation with FIA under a new structure – FIA Global. Under this arrangement, FIA, FIA Europe and FIA Asia have strengthened their influence on cross-border issues, substantially increasing the coordination and information flow between regions and providing a powerful global voice to express the views of their members. The organisations preserve their ability to deal with legislative, regulatory and market issues in their respective time-zones and continue to operate with their own leadership and staff, separate boards of directors and distinct memberships.

ISDA

Since its founding in 1985, the International Swaps and Derivatives Association has worked to make over-the-counter (OTC) derivatives markets safe and efficient.

ISDA's pioneering work in developing the ISDA Master Agreement and a wide range of related documentation materials, and in ensuring the enforceability of their netting and collateral provisions, has helped to significantly reduce credit and legal risk. The Association has been a leader in promoting sound risk management practices and processes, and engages constructively with policymakers and legislators around the world to advance the understanding and treatment of derivatives as a risk management tool.

Today, ISDA has over 800 member institutions from 64 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers.

ISDA's work in three key areas – reducing counterparty credit risk, increasing transparency, and improving the industry's operational infrastructure – show the strong commitment of the Association toward its primary goals; to build robust, stable financial markets and a strong financial regulatory framework

Guidelines on the application of C6 and C7 of Annex 1 of MiFID

FIA Europe and ISDA suggested amendments

Application of C6 of Annex 1 of MiFID

21. ESMA considers that definition C6 of Annex 1 of MiFID I applies in the following way:

a. C6 has a broad application, applying to all commodity derivative contracts, but excluding forwards, providing that:

i. they can be physically settled; and

ii. they are traded on a regulated market and/or an MTF.

b. *"Physically settled"* incorporates a broad range of delivery methods and includes:

i. physical delivery of the relevant goods themselves;

ii. delivery of a document giving rights of an ownership **or possessory** nature to the goods concerned; ~~or,~~

iii. **the amendment, assignment or other form of alteration of the records of rights of ownership or rights to receive possession (or of entitlements to documents giving or evidencing such rights) in a storage facility, repository, central registry or other dematerialised system recording entitlement to establish a change in beneficial ownership of a physical commodity; or,**

iv. another method of bringing about the transfer of rights of an ownership nature **or of possession** in relation to the relevant quantity of goods without physically delivering them that entitles the recipient to the relevant quantity of the goods.

c. **Art. 38(2) of Regulation 1287/2006/EC shall apply to the determination of a spot contract in relation to C6 of Annex 1 of MiFID I**.

Application of C7 of Annex 1 of MiFID I

22. ESMA considers that definition C7 of Annex 1 applies in the following way:

a. C7 forms a category that is distinct from C6 and applies to commodity derivative contracts that can be physically settled which are not traded on a regulated market or an MTF providing that the commodity derivative contract:

i. is not a spot contract as defined under Article 38(2) of Regulation 1287/2006/EC;

ii. is not for the commercial purposes described under Article 38(4) of Regulation 1287/2006/EC; and

iii. meets one of the three criteria under Article 38(1)(a) and also the separate criteria under Article 38(1)(b) and 38(1)(c) of 1287/2006/EC.

b. "*Physically settled*" incorporates a broad range of delivery methods and includes:

i. physical delivery of the relevant goods themselves;

ii. delivery of a document giving rights of an ownership **or possessory** nature to the goods concerned; ~~or,~~

iii. **the amendment, assignment or other form of alteration of the records of rights of ownership or rights to receive possession (or of entitlements to documents giving or evidencing such rights) in a storage facility, repository, central registry or other dematerialised system recording entitlement to establish a change in beneficial ownership of a physical commodity; or,**

iv. another method of bringing about the transfer of rights of an ownership nature **or of possession** in relation to the relevant quantity of goods without physically delivering them that entitles the recipient to the relevant quantity of the goods.

23. Physically settled commodity derivatives which do not fall within the definition of C6, i.e. are not traded on a Regulated Market or an MTF, may fall within the definition of C7 and the definitions of C6 and C7 form two distinct categories as C7 applies to commodity derivatives "*that can be physically settled not otherwise mentioned in C6.*

24. The other characteristics of commodity derivatives under C7 - "*not being for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls*" - are further defined under Article 38 of the MiFID I implementing regulation 1287/2006/EC.

24bis. A contract shall be considered to be for commercial purposes for the purposes of Section C(7) of Annex I to Directive 2014/65/EU and as specified in Article 38 of Regulation 1287/2006/EC, and as not having the characteristics of other derivative financial instruments for the purposes of Sections C(7) and (10) of that Annex, if it is entered into:

1. With or by an operator or administrator of an energy transmission grid, energy balancing mechanism or pipeline network, and it is necessary to keep in balance the supplies and uses of energy at a given time; or
2. For the purpose of meeting regulatory requirements to purchase, sell, hold or deliver a commodity.

25. ESMA notes that the conditions defined in Article 38 of Regulation 1287/2006/EC, whilst set out separately below, are to be applied cumulatively.