

Clients & Friends Memo

New MiFID I Consultation Paper Creates Further Challenges for Commodity Market Participants

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On 29 September 2014, ESMA published a consultation paper (the Consultation Paper)¹ seeking industry feedback for guidelines relating to certain commodity derivatives, namely those falling under C6 and C7 of Annex I² of the Markets in Financial Instruments Directive (MiFID). One of the reasons for publication of the guidelines is to ensure consistent treatment of these contracts under the European Market Infrastructure Regulation (EMIR) which has been in force throughout the European Union (EU) since 12 August 2012. EMIR was implemented with the objective of increasing transparency and reducing risk in the European OTC derivatives markets. The obligations under EMIR include certain clearing, risk mitigation and reporting requirements for parties entering into OTC derivatives.

EMIR relies on MiFID, a directive, to define “derivative contracts”, of which C6 and C7 commodity derivative contracts form a subset. These terms have been interpreted differently in certain EU member states, leading to an inconsistent application across the EU. This potentially impacts a number of core EMIR provisions. While the proposals set out in the Consultation Paper are well-intentioned and target a specific and unexpected challenge that has arisen in EMIR implementation, the result may well be increased short-term confusion resulting from the continued inconsistent interpretation of the key terms, and significant further compliance challenges requiring navigation by market participants.

¹ ESMA/2014/1189, Consultation Paper, Guidelines on the application of C6 and C7 of Annex I of MiFID, (29 September 2014). http://www.esma.europa.eu/system/files/guidelines_on_mifid_1_c6_and_c7.pdf

² Annex I, Section C of MiFID provides the following definitions for points 6 and 7:

(6) Options, futures, swaps and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market and/or an MTF.

(7) Options futures, swaps, forwards and any other derivative contract relating to commodities that can be physically settled not otherwise mentioned in C(6) and 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.

C6: Forwards and the meaning of “can be physically settled”

ESMA proposes in the Consultation Paper that commodity forwards are captured under C6 because, provided they can be physically settled and are traded on a regulated market and/or a multilateral trading facility (“MTF”), “[t]he language of C6 includes explicitly ‘*any other derivative contract*’.”³ This interpretation is based upon a CESR/CEBS Consultation Paper from 2008, which states that “a significant portion of forwards are transacted on MTFs, which qualifies them as derivatives in the sense of MiFID.”⁴

- i. ESMA also relies on CESR guidance from 2005 to help clarify the definition of “physically settled”, which incorporates a broad range of delivery methods and includes:
- ii. Physical delivery of the relevant goods themselves;
- iii. Delivery of a document giving rights of an ownership nature to the goods concerned; or,
- iv. Another method of bringing about the transfer of rights of an ownership nature in relation to the relevant quantity of goods without physically delivering them that entitles the recipient to the relevant quantity of the goods.⁵

C7: Contracts with characteristics of other financial instruments

A C7 contract is a commodity derivative contract which does not fall under C6 and has “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.”⁶

This definition has already partly been clarified by Article 38 of the MiFID I Implementing Regulation 1287/2006/EC, which states that C7 contracts are commodity derivative contracts that can be physically settled which are not traded on a regulated market or an MTF and:

- i. is not a spot contract as defined under Article 38(2) of Regulation 1287/2006/EC;⁷
- ii. is not for the commercial purposes described under Article 38(4) of regulation 1287/2006/EC;⁸ and

³ Recital 34, *Discussion of forwards*, Consultation Paper, p. 9.

⁴ Fn 5, *Discussion of forwards*, Consultation Paper, p. 9. *Citations omitted*.

⁵ Recital 41(b), *Guidelines*, Consultation Paper, p. 14.

⁶ Annex I, Section C(7), MiFID I, OJ L 145, 30.4.2004, p. 42.

⁷ A spot contract for the purposes of [MiFID] means a contract for the sale of a commodity, asset or right, under the terms of which delivery is scheduled to be made within the longer of the following periods:

(a) two trading days; (b) the period generally accepted in the market for that commodity, asset or right as the standard delivery period. However, a contract is not a spot contract if, 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 period mentioned in the first subparagraph.

- 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.

A full analysis of C7 contracts are beyond the scope of this paper; however, C7 contracts are generally analogous to exchange-traded contracts.

Analysis

Clarifying the definitions of commodity forwards that “can be physically settled” is important for the consistent application of MiFID and EMIR.

However, a perceived area of concern is that ESMA may be applying the criteria for C6 and C7 commodity derivatives in a vacuum, as “the potential impact of MiFID II and future implementing measures falls outside the scope” of its paper. In practice, the Consultation Paper referenced here directly contradicts a separate consultation paper written to clarify the new MiFID II/MiFIR by taking similar definitions and giving them a different application. For example, the MiFID I Consultation Paper finds that no instrument can be accurately described as “must be physically settled” because “all instruments appear to contain force majeure provisions that would prevent physical delivery.”⁹ On the other hand, the MiFID II/MiFIR consultation paper states that “ESMA considers that the existence of force majeure provisions should not prevent a contract from being characterised as ‘must be physically settled’ . . . the same applies to any other *bona fide* inability to perform the contract on a physical settlement basis.”¹⁰ This creates incongruent boundaries between C6 and C7 commodity derivatives and means that different definitions would need to be used between the date that final guidelines are published by ESMA and 3 January 2017, when MiFID II comes into force.

ESMA includes forward contracts traded on a regulated market or an MTF as classified under the C6 definition and therefore subject to EMIR rules. However, most commodities are bought and sold and supplied to consumers through forward contracts. To compare this interpretation to another jurisdiction, under long-standing precedent, the US Commodity Futures Trading Commission’s (CFTC) regulations have explicitly excluded forward contracts from regulation as futures and, more recently, from the definition of “swap” and “security-based swap.” The CFTC has explained this exclusion by noting that because “[t]he primary purpose of a forward contract is to transfer ownership of the commodity and not to transfer solely its price risk . . . [t]he underlying postulate of the [forward contract] exclusion is that the [Commodity Exchange Act’s] regulatory scheme for futures trading simply should not apply to private commercial

⁸ A contract shall be considered to be for commercial purposes . . . 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.

⁹ Fn 8, MiFID I Consultation Paper.

¹⁰ Recital 15, Section 7, MiFID II Consultation Paper.

merchandising transactions which create enforceable obligations to deliver but in which delivery is deferred for reasons of commercial convenience or necessity.”¹¹

As a practical matter, ESMA’s proposed definition would subject large numbers of commodity physical forwards to a financial services regulatory regime and bring the EU’s commodities regulations into conflict with analogous regimes in the US and, potentially, other jurisdictions. This divergence will also create disparities and confusion in the global commodity market. ESMA should instead defer to the MiFID II interpretation, which will reduce complexity and increase the prospect of industry compliance.

Given that the regulatory regime for financial services in Europe is already complex and costly, the requirement to comply with interim guidelines engenders what is arguably an unnecessary burden for firms. Moreover, as ESMA guidelines are less stringent than regulatory technical standards, there must remain a concern that the guidelines may not be applied consistently by EU member states. This is particularly relevant given the short period of time that the prospective guidelines will be effective, and the fact that many regulators already may have entrenched views on how such contracts should be interpreted or have taken their own steps and/or issued their own guidelines to ensure smooth application of EMIR rules in their jurisdiction. Commodity market participants operating in multiple EU member states may find themselves having to comply with intransigent, overlapping, regulatory regimes, creating the real potential for further disruption of the operation of orderly markets.

Instead, the rationale behind the MiFID II definitions should also be applied to the MiFID guidelines so that they are complimentary instead of contradictory. This will allow market participants a smoother transition into a uniform application of EMIR.

Next steps and implementation

ESMA will accept comments on the Consultation Paper until 5 January 2015, and will then publish final guidelines. The jury is out as to how effective the guidelines will be, particularly in the context of the looming shadow of MiFID II and the entrenched views of many regulators on how MiFID rules should be applied within their jurisdiction. Market participants should seriously consider commenting on this Consultation Paper either directly or via industry groups, given its potential impact in the EU energy and commodities markets.

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¹¹ 77 Fed. Reg. 48228 (Aug. 13, 2012). *Citations omitted.*

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