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Final ESMA Guidelines Clarifying Commodity Derivatives Definitions Under MiFID

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Financial Services and Regulation

Introduction

On May 6, 2015 the European Securities and Markets Authority ("ESMA") published their finalised guidelines (the "Guidelines") on the application of the definitions of commodity derivatives and their classification under Sections C6 and C7 of Annex I to the Markets in Financial Instruments Directive ("MiFID"). This follows ESMA's consultation paper published on September 29, 2014 which set out draft guidelines. ESMA's feedback to the consultation is set out in Annex 1 to the finalised Guidelines.

Purpose of the Guidelines

The implementation of MiFID in the various Member States has given rise to varying interpretations amongst national competent authorities ("NCAs") as to what should constitute a "financial instrument". The position is particularly acute in relation to physically settled commodity forwards. The variations in the ways in which financial instruments are classified as derivatives under MiFID across the European Union ("EU") has led to significant problems in the practical implementation of a number of provisions in the European Markets Infrastructure Regulation ("EMIR"), which refers to the MiFID definition of commodity derivatives. This led ESMA to raise the issue with the European Commission in February 2014. The European Commission asked ESMA to issue guidelines regarding the consistent classification of certain financial instruments as derivatives, thus allowing NCAs to take a consistent approach towards the implementation of EMIR, in the period before MiFID begins to apply.

The Guidelines

Section C6 of Annex I of MiFID covers "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". In the Guidelines, ESMA suggests that the definition of this provision has a broad application and will apply to all commodity derivative contracts, including forwards, provided that they can or must be physically settled; and they are traded on a regulated market and/or an MTF. ESMA defines "physically settled" to incorporate a broad range of delivery methods, which include physical delivery of the relevant commodities themselves; delivery of a document giving rights of an ownership nature to the relevant commodities or the relevant quantity of the commodities concerned (such as a bill of lading or a warehouse warrant); or another method of bringing about the transfer of rights of an ownership nature in relation to the relevant quantity of commodities, without physically delivering them (including notification, scheduling or nomination to the operator of an energy supply network) that entitles the recipient to the relevant quantity of the commodities.

Section C7 of Annex I of MiFID covers “options, futures, swaps, forwards and any other derivative contracts relating to commodities that can be physically settled not otherwise mentioned in C6 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”. In the Guidelines, ESMA sets out how it considers that this definition applies. ESMA believes that Section C7 forms a category “that is distinct from C6” and would apply to commodity derivative contracts that can be physically settled which are not traded on a regulated market or an MTF. This is provided that the commodity derivative contract is not a spot contract; is not for specified commercial purposes; and meets certain criteria set out in Article 38(1) of Regulation 1287/2006/EC. These are as follows.

The commodity derivative contract must meet one of three criteria: it is traded on a third country trading facility that performs a similar function to a regulated market or an MTF; it is expressly stated to be traded on, or is subject to the rules of, a regulated market, an MTF or such a third country trading facility; or it is expressly stated to be equivalent to a contract traded on a regulated market, MTF or such a third country trading facility. The commodity derivative contract must also meet the requirement that it must be cleared by a clearing house or other entity carrying out the same functions as a central counterparty, or there are arrangements for the payment or provision of margin in relation to the contract. In addition, the contract must be standardised so that, in particular, the price, the lot, the delivery date or other terms are determined principally by reference to regularly published prices, standard lots or standard delivery dates.

In relation to Section C7, ESMA repeats the definition of “physically settled“ that it set out for Section C6.

The finalised guidelines will apply from August 7, 2015 and will be superceded by the European Commission’s MiFID II delegated acts. ESMA has decided not to translate the Guidelines into other EU languages, due to the short time period in which they will apply.

NCAs are required to notify ESMA whether they are in compliance with - or intend to comply with - the Guidelines, giving reasons for any non-compliance. This must be done within two months of the date of publication by ESMA. If an NCA does not respond by the deadline, it will be considered to be non-compliant.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our Financial Services and Regulation practice group:

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