

June 26th, 2012

Amendments tabled on MiFID – Physically settled commodity derivatives

- The debate around the definition of physically settled commodity derivatives that should or should not be covered by MiFID is triggered by the Commission's proposed addition of OTFs to the Annex 1 Section C point 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, ~~OTF and/or~~ or an MTF"**.
- Both financial and commodity firms are concerned by this addition because:
 - o The OTF category being subject to controversial debates (notably for the purpose of equities) within the parliament as well as the Council working group, there is uncertainty as to whether some existing trading hubs used by commodity producers and end-users to manage risks in their underlying business would be captured irrespectively of the purpose and the fundamental characteristics of the contract;
 - o The debate is not of the same nature as in the context of the MiFID I with the addition of MTFs because both MTFs and Regulated Markets are exchanges based on non-discretionary trading rules and full market transparency, the result of which being that only harmonised products with liquid secondary markets are traded on these platforms;
- MEPs O. Schmidt, W. Langen and A. Pallone have sought to address the issue by adding reference to other criteria in order to distinguish whether:
 - o contracts are entered into for commercial purposes or for financial purposes;
 - o the parties intend to physically settle the contract or to cash settle it;
 - o the contract has the characteristics of other financial derivatives or not.
- ISDA members agree that:
 - o Defining the contracts by reference to the trading venue brings uncertainties and potential extension of the scope to commercial contracts;
 - o Defining the contracts with regard to their characteristics, whatever the trading venue, would be more appropriate;
 - o The existing Annex 1 section C point 7 of the directive is considered by market participants and by regulators clear enough, thanks to level 2 measures (articles 38 and 39 of the MiFID implementing regulation) when it targets *"Options, futures, swaps, forwards and any other derivative contracts 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 regards to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls"*.
- ISDA's position is therefore that:
 - o Physically settled contracts should be covered by MiFID if they exhibit the characteristics of other financial instruments;
 - o The reference to the OTF category is problematic as long as it is a criteria for defining the scope of the instruments but could be kept if it is clear that it is not a criteria; as a result, either it should be deleted or it should be made clear that it is not a determinative factor as to whether a contract is a financial instrument.

- ISDA's proposed amendment would be:

Either Section C point 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, ~~OTF and/or~~ an MTF *which have the characteristics of other derivative financial instruments and except where:*

- *they are entered into for commercial purposes; and*
- *the contract shall be physically settled."*

| Amdt | Provision | Tabled by | Content | Suggested ISDA position |
|------|---------------------------|-----------|--|-------------------------|
| 354 | Recital 88 a (new) | Langen | <p>Exclusion of physically settled commodity derivatives from the scope of financial instruments as long as <i>‘the transaction does not have the characteristics of other derivative financial instruments’</i>.</p> <p>ISDA would prefer a wording that clarifies the criteria for establishing that the contract is not for commercial purposes. See above.</p> | Neutral |
| 1305 | Annex 1 Section C point 6 | Langen | <p>Exclusion of physically settled derivatives when <i>“entered into for commercial purposes and do not display any characteristics of other derivative financial instruments”</i>.</p> <p>ISDA would support the amendment provided that it clarifies criterias for establishing that the contracts are for commercial purpose or not. See above.</p> | Neutral |
| 1306 | Annex 1 Section C point 6 | Pallone | <p>Same as 1305 (with the addition of ‘and’ which makes it easier to read and understand).</p> <p>Same ISDA comment as for 1305.</p> | Neutral |
| 1307 | Annex 1 Section C point 6 | Schmidt | <p>Application of MiFID to “options, futures, swaps and any other derivative contract relating to commodities <i>that are not intended to be physically settled</i> provided that they are traded on a regulated market, OTF or and MTF”.</p> <p>Same ISDA comment as for 1305 and 1306.</p> | Neutral |

| Amdt | Provision | Tabled by | Content | Suggested ISDA position |
|------|---|-----------|--|-------------------------|
| 1308 | Annex 1 Section C point 6 | Goulard | <p>Deletes reference to OTF in the definition of physically settled derivatives.</p> <p>ISDA supports this amendment as long as the OTF category is a criterion for defining the scope of contracts covered by the directive but would strongly support a new definition of the scope based on other criteria (see comments to amendments 1305).</p> | Support |
| 1310 | Annex 1 Section C point 7 | Schmidt | <p>Same as 1307 for the purpose of point 7: application of MiFID to centrally cleared or settled contracts or to contracts subject to regular margin calls provided that <i>they are not intended to be physically settled</i>.</p> <p>Same ISDA comment as for 1305.</p> | Neutral |
| 1314 | Annex 1 Section C point 11 a (new) | Langen | <p>Addition of a specific exclusion from the list of financial instruments of <i>“forward contracts relating to commodities that are concluded over-the-counter and which are physically settled”</i>.</p> <p>ISDA considers that the addition of a new point in section C does not help interpreting points 6 and 7 but brings uncertainty as to whether or not contracts that should be caught under point 6 or point 7 are excluded under point 11 ...</p> <p>ISDA would prefer that section C point 6 is defined as stated in comment to amendment 1305.</p> | Neutral |