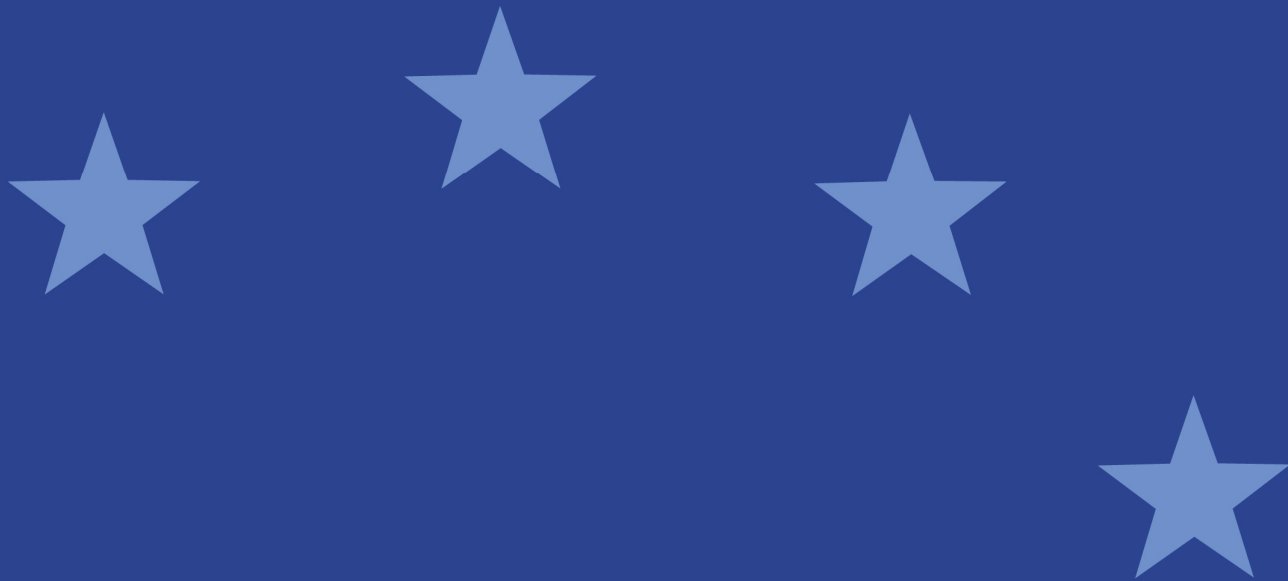


**Reply form for the
Consultation paper
Guidelines on the application of C6 and C7 of Annex I of MiFID**





European Securities and
Markets Authority

Date: 30 September 2014



Responding to this paper

The European Securities and Markets Authority (ESMA) invites responses to the specific questions listed in the Consultation paper - Guidelines on the application of C6 and C7 of Annex I of MiFID, published on the ESMA website ([here](#)).

Instructions

Please note that, in order to facilitate the analysis of the number of responses expected, you are requested to use this file to send your response to ESMA so as to allow us to process it properly. Therefore, please follow the instructions described below:

- i. use this form and send your responses in Word format;
- ii. do not remove the tags of type < ESMA_ MIFID_ C6_ C7_ QUESTION_ 1 > - i.e. the response to one question has to be framed by the 2 tags corresponding to the question; and
- iii. if you do not have a response to a question, do not delete it and leave the text “TYPE YOUR TEXT HERE” between the tags.

Responses are most helpful:

- i. if they respond to the question stated;
- ii. contain a clear rationale, including on any related costs and benefits; and
- iii. describe any alternatives that ESMA should consider

To help you navigate this document more easily, bookmarks are available in “Navigation Pane” for Word 2010 and in “Document Map” for Word 2007.

Responses must reach us by **05 January 2015**.

All contributions should be submitted online at www.esma.europa.eu under the heading ‘Your input/Consultations’.

Publication of responses

All contributions received will be published following the end of the consultation period, unless otherwise requested. **Please clearly indicate by ticking the appropriate checkbox in the website submission form if you do not wish your contribution to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure.** Note also that a confidential response may be requested from us in accordance with ESMA’s rules on access to documents. We may consult you if we receive such a request. Any decision we make is reviewable by ESMA’s Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading ‘Disclaimer’.



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?

<ESMA_MIFID_C6_C7_QUESTION_1>

The Asset Management Group (“AMG”)¹ of the Securities Industry and Financial Markets Association (“SIFMA”) welcomes this opportunity to respond to European Securities and Markets Authority (“ESMA”) regarding its Consultation Paper on guidance on the application of C6 and C7 of Annex I of MiFID (the “Consultation Paper”).

While the AMG agrees with ESMA’s assertion that there is no conflict in the overlap of definitions between commodity derivatives under C5 and commodity derivatives under C6 and C7, the AMG does not think it necessary or desirable to introduce and define the phrase “must be physically settled” in any guidance.

As ESMA acknowledges in the Consultation Paper, MiFID does not currently refer to contracts that “must be physically settled”, referring instead to contracts that “must be settled in cash” (C5), contracts that “may be settled in cash at the option of one of the parties” (C5) and contracts that “can be physically settled” (C6 and C7). Given that, as a matter of ordinary understanding, contracts that “can be physically settled” necessarily include contracts that “must be physically settled”, these phrases, between them, already address all possible means of settling a commodities contract and are understood by participants in both financial and commercial markets as doing so. ESMA implicitly acknowledges as much in its assertion that there is no conflict in the overlap between C5, C6 and C7. Introducing the “must be physically settled” concept would therefore add little, if anything, in terms of additional clarity or certainty.

Indeed, introducing the “must be physically settled” concept might in fact be counterproductive as it risks creating confusion, given that MiFID II uses the same phrase but for different purposes. It also risks introducing a possible implication that under MiFID today any contract not fitting the “new” test of “must be physically settled” is, by definition, a derivative. This is a potentially confusing implication, which might also have the inadvertent effect of broadening the scope of commercial transactions drawn into the scope of “derivatives” regulation (see also our comments in response to question 3 below).

<ESMA_MIFID_C6_C7_QUESTION_1>

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?

<ESMA_MIFID_C6_C7_QUESTION_2>

In general, the AMG believes that any guidance issued by ESMA should take account of the fact that the interpretation of C6 and C7 of Annex I of MiFID impacts not just financial markets but also commercial (i.e. physical, non-financial) markets. The guidance should also consider the scope of other legislative regimes that refer to or rely on MiFID definitions, and any such guidance should be drafted so as to mini-

¹ The AMG’s members represent U.S. asset management firms whose combined assets under management exceed \$30 trillion. The clients of AMG member firms include, among others, registered investment companies, endowments, state and local government pension funds, private sector Employee Retirement Income Security Act of 1974 pension funds and private funds such as hedge funds and private equity funds.

mise potential unintended consequences in those areas. The impact upon the interpretation of other categories of MiFID financial instruments should also be taken into account.

MiFID seeks to regulate markets in financial instruments, including derivatives, and it therefore (rightly) covers within its scope certain types of commodity derivatives. There are, however, significant commercial markets based on the production, sale and purchase of commodities² that are clearly distinct from the types of financial markets that MiFID, together with other related legislation, seeks to regulate. There is therefore a tension inherent in regulating the boundaries between financial and commercial markets in this area – regulation must be sufficiently broad as to promote and support efficient, safe and robust financial markets, while not placing unnecessary or inappropriate burdens on participants in commercial markets that do not present the same sorts of risks that may be presented by the financial markets.

Given the size and importance of the commercial markets, guidance intended to clarify the scope of existing financial regulation should not risk broadening the scope more than was originally intended in order to address particular concerns related specifically to financial markets. It should also be sufficiently clear to avoid the unintended consequence of bringing within the scope of financial markets regulation activity in commercial markets where such intervention is not justified or necessarily required by the text of MiFID.

A key concern with respect to any attempt to define or describe physical settlement is the potential impact on commercial (i.e. physical, non-financial) markets. Such markets accommodate a range of practices that are understood and accepted in such markets as constituting physical settlement, which must be properly taken into account in any attempt to define or describe physical settlement in order to avoid unintentionally or inappropriately bringing within the scope of financial regulation contracts that are properly characterised as forming part of the commercial, rather than financial, markets.

The AMG is therefore of the view that any attempt to define or describe physical settlement should be guided by the following principles:

- it should reflect and allow for, rather than contradict or disrupt, current practices in the commercial (i.e. physical, non-financial) markets;
- it should allow for the future development and evolution of settlement practices in such markets.

To that end, the AMG is of the view that:

- any attempt to define or describe physical settlement should allow for a broad interpretation rather than require a narrow interpretation; and
- any list of examples should be illustrative rather than an exhaustive.

In terms of specific content of any guidance that ESMA might provide, the AMG encourages ESMA to acknowledge the role of “settlement netting” without changing the character of physical settlement. By “settlement netting”, we refer to practices under which gross contractual physical delivery obligations under multiple contracts in a given commodity on the same date remain distinct and are satisfied in full but the parties agree operationally to net opposing deliveries so as to deliver a single amount of a particular commodity on any day in one direction or the other.

² These sales and purchases are often not immediate, but are a sale and purchase at a future date agreed between the parties.

Such practices are common in commercial markets and generally reflect efficient operational practices rather than an indication that the markets in question are “financial” in nature. Any guidance that did not allow for such practices to fall within the scope of physical settlement without changing its character – whether by providing an exhaustive list of examples that did not include these practices, or by otherwise taking too narrow an interpretation – would potentially jeopardise the settled and understood operation of these markets.

The AMG also notes the impact that any definition or description of physical settlement in the context of commodity derivatives may have on non-commodity markets. For example, any guidance on the meaning of physical settlement in the physical commodity context could potentially impact the way that FX market participants interpret the scope of the regulation as it applies to FX instruments. As FX represents a vital marketplace for asset managers to manage currency risk for the investment portfolios that they oversee, it is essential that the scope of the definition of “derivative” or “derivative contract” is defined appropriately under applicable European Union (“EU”) legislation. That being so, the need to ensure: (1) that any attempt to define or describe physical settlement should allow for a broad interpretation rather than require a narrow interpretation, and (2) that any list of examples should be illustrative rather than an exhaustive, becomes more pronounced.

<ESMA_MIFID_C6_C7_QUESTION_2>

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.

<ESMA_MIFID_C6_C7_QUESTION_3>

While the AMG agrees with ESMA’s assertion that there is no conflict in the overlap of definitions between commodity derivatives under C5 and commodity derivatives under C6 and C7, it does not agree with ESMA’s discussion as to whether C6 captures forward contracts.

ESMA’s draft guidance states that “C6 has a broad application, applying to all commodity derivative contracts, including forwards, providing: (i) they can be physically settled; and (ii) they are traded on a regulated market and/or an MTF”. The AMG notes that this formulation seems to suggest that commodity forwards that can be physically settled are, necessarily, derivative contracts, and that this is why it is appropriate to include them within the scope of C6 (provided that they can be physically settled and they are traded on a regulated market and / or an MTF)”. We do not believe this is correct, and believe that the wording of MiFID, which does not reference forwards, was intentional and supports our view. A commodity forward might, in certain cases, constitute an “other derivative” but that should only be in circumstances where it meets the criteria for an “other derivative” as contemplated within MiFID, i.e. (as referenced in C7) it is not for commercial purposes and has the characteristics of other derivative financial instruments.

As noted in response to Q1, paragraphs C5 to C7, between them, already address all possible means of settlement and are understood by participants in both financial and commercial markets as doing so – there are therefore no gaps that need to be addressed.



The AMG has previously written to the United Kingdom’s Financial Conduct Authority (FCA) regarding “to-be-announced” mortgage-backed securities transactions and, in this context, discussed more generally the characterisation of transactions with long physical settlement periods which are not considered to be derivative contracts.³ To the extent that it would be helpful to ESMA, the AMG would be happy to discuss its views in that regard.

<ESMA_MIFID_C6_C7_QUESTION_3>

Q4: What further comments do you have on ESMA’s proposed guidance on the application of C6?

<ESMA_MIFID_C6_C7_QUESTION_4>

The AMG supports consistent application of the definition of “derivative” or “derivative contract” in the EU. The AMG believes, however, that there remain a number of important legal and practical issues that arise in relation to ESMA’s proposed approach as addressed in our responses to the questions set forth herein.

The AMG believes that within the boundaries of the MiFID text, ESMA should seek to minimise, as far as possible, regulatory divergence between the EU’s regulation of commodity and commodity derivatives markets and the regulation of such markets in other jurisdictions. In particular, in relation to physically-settled commodity forward transactions, we would urge ESMA to consider the scope of comparable regulatory exclusions in the US. To the extent that the EU’s regulation of commodity and commodity derivatives markets is materially broader than the equivalent regimes in other jurisdictions, there is the potential for international inconsistency between important markets that operate on a global basis, setting back attempts by regulators to improve regulatory convergence across borders.

Further, any mismatch in the scope of regulation between the EU’s regime and the regime of another jurisdiction would lead to increased compliance and administrative burdens, and associated systems build, for market participants. Depending on the scale of these burdens, market participants might find the cost associated with doing business in the EU prohibitive, placing the EU at a competitive disadvantage in these markets.

Additionally, we note that the introduction of Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories (the European Market Infrastructure Regulation or “EMIR”) has demonstrated the (often unintended) consequences that can arise where one legislative regime refers to, is based on, or leverages concepts or definitions used in another. It is clear that any guidance issued relating to the scope of MiFID as it relates to derivatives will have a direct impact on the application of EMIR. Such guidance can also be expected to have an impact on other regimes that rely or build on MiFID derivative definitions (for example, the Market Abuse Regulation). Any guidance issued by ESMA must therefore take into account the potential impact on such other regimes, again to minimise the potential for unintended consequences in such areas.

<ESMA_MIFID_C6_C7_QUESTION_4>

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

<ESMA_MIFID_C6_C7_QUESTION_5>

³ See AMG letter to FCA, “Request for comments on the treatment of mortgage-backed securities (“MBS”) traded on the To-Be-Announced market (“TBA trades”)” 2 May 2014, available at <http://www.sifma.org/issues/item.aspx?id=8589949002>.



The AMG makes the same comments as it makes in response to Q2 with respect to attempts to define or describe physical settlement for these purposes. The AMG also makes the same further comments with respect to C7 as it does in response to Q4 with respect to C6.

<ESMA_MIFID_C6_C7_QUESTION_5>