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

30 September 2014

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:

a. use this form and send your responses in Word format;

b. 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

c. 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 City of London Law Society ("**CLLS**") represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multijurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees.

This response to ESMA's Consultation Paper - Guidelines on the application of C6 and C7 of Annex I of MiFID (the "**CP**") has been prepared by the CLLS Regulatory Law Committee (the "**Committee**"). The Committee not only responds to consultations but also proactively raises concerns where it becomes aware of issues which it considers to be of importance in a regulatory context. The members of the Committee are listed in footnote 1 below.[1]

<u>Response to Question 1</u>

Although the Committee agrees that contracts that both C6 and C7 include derivative contracts that "must be physically settled", we disagree with ESMA's approach for three reasons:

a. It is unnecessary to specify that C6 includes contracts that "must" be physically settled;

b. In light of the usage of this concept in MiFID II, it would be confusing to refer to it in a different context at this point in time; and

c. Neither in relation to this concept nor other aspects of the proposed guidance should ESMA adopt any interpretation which could in practice prejudge the outcome of consultations and the resulting regulations under MiFID II.

Must/can be physically settled
On the assumption that the "must" is being interpreted such that contracts which "can" be physically settled necessarily (as a matter of English language) include those contracts that "must" be physically settled, the Committee agrees that the C6 category includes contracts which "can" and "must" be physically settled.

However, given the changes which MiFID II makes to C6, the Committee does not believe that it is necessary or desirable to define the term "must" (or the concept "must be physically settled") in the proposed Guidelines. On the contrary, since the concept of "can be physically settled" is used in MiFID I as one of the criteria for contracts to be within MIFID I's scope whereas the concept of "must be physically settled" is used in the opposite way in MiFID II (as a criterion for wholesale energy products which are out of scope), the concept of "must be physically settled" should not be defined in these Guidelines. To do so would be both confusing and risk prejudging the outcome of the MiFID II consultation. The concept should be defined only in the context of exclusions to C6 in MiFID II.

[1] Individuals and firms represented on The City of London Law Society Regulatory Law Committee members are as follows: Karen Anderson (Herbert Smith Freehills LLP) (Co-chair), Peter Richards-Carpenter (Berwin Leighton Paisner LLP) (Co-chair), David Berman (Macfarlanes LLP), Peter Bevan (Linklaters LLP), Margaret Chamberlain (Travers Smith LLP), Simon Crown (Clifford Chance LLP), Richard Everett (Travers Smith LLP), Robert Finney (Holman Fenwick Willan LLP), Angela Hayes (King & Spalding LLP), Jonathan Herbst (Norton Rose LLP), Mark Kalderon (Freshfields Bruckhaus Deringer LLP), Etay Katz (Allen & Overy LLP), Ben Kingsley (Slaughter and May), Tamasin Little (King & Wood Mallesons LLP), Simon Morris (CMS Cameron McKenna LLP), Rob Moulton (Ashurst LLP), James Perry (Ashurst LLP), Stuart Willey (White & Case LLP).

Force Majeure: how does this influence the assessment of contracts under MiFID I?
In the CP, ESMA notes that "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 clauses."

However, it is important that ESMA recognise that contracts which provide for physical delivery fall within the definition of contracts which "**can/must be physically settled**", even if they have a force majeure clause.

The reason behind this is that force majeure provisions are simply a contractual mechanism to be able to deal with certain unexpected and unavoidable situations which render physical delivery impossible. Force majeure is not a form of cash settlement even in those cases where the contract provides for a payment to be made in the event of a force majeure event; it is simply an agreement between the parties governing their relations as to how they will proceed in the event that performance of their contractual obligations to physically deliver a certain quantity of a commodity become impossible. This distinction is critical and ESMA should articulate a clear distinction between those contracts which provide for cash settlement, as opposed to physical contracts which include, inter alia, a force majeure clause.

The Committee would also caution against ESMA treating certain clauses providing for liquidated damages/penalties for a party not complying with its contractual obligations as evidence of "cash settlement" provided for in the contract. The implications of this could potentially cause a high level of disruption to the market. Financial regulators should not seek to erode the distinction between (on the one hand) normal commercial commodity contracts and the terms such contracts normally incorporate, and (on the other) financial contracts used for speculative and/or investment purposes.

Accordingly, the Committee believes that the same considerations as apply to force majeure would apply to those contracts which provide for a cash payment to be made in respect of one or more trades following an event of default or other termination event – and from ESMA's December 2014 Technical Advice to the Commission on MiFID II and MiFIR[2] we understand that ESMA accepts this, at least in relation to MiFID II. In other words, as is clear from our response to Question 3, we believe that force majeure and other bona fide inability to settle provisions, and default clauses providing that a party is entitled to financial compensation in the case of non- or defective performance of the contract are consistent with the concept of "must be physically settled" as described by ESMA in the Technical Advice[3], and therefore do not represent an option of one party to settle in cash which could bring a contract within C5.

Booking-out or closing-out of "circles"

Numerous standard forms of contract are used across the energy and commodities sector, and their terms vary enormously. Some contracts (often in oil and coal trading, for example) make provision for "book-outs" or close-out of "circles" in certain circumstances. Book-outs may occur where two parties have both long and short positions with each other, and circle outs where the seller ultimately becomes a buyer also, in a chain of contracts which thereby becomes a circle). In these circumstances, parties may agree to forego their rights and obligations in respect of physical delivery under the transactions concerned, and agree an amount to be paid which will be generally be different from the originally agreed price (or the net of those prices) – for example, taking into account market movements and the time which was remaining until delivery. These processes are clearly different from a right to cash settle because:

a. Book-outs and circle-outs typically occur for operational reasons, and only if the circumstances arise;

b. In any event, generally:

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[2] Final Report of ESMA's Technical Advice to the Commission on MiFID II and MiFIR, page 407, point 4.
[3] Technical Advice, page 407, points 4 and 7.

i. No one party has the right to settle a transaction in this way: each party must agree (see, for example, the extracts quoted below in respect of North Sea crude[4] and coal[5]), and
ii. Furthermore the parties need to negotiate the price at which it will happen; and

c. The original sale contracts themselves, at the time they are entered into, generally require physical delivery.

MiFID requires an instrument-by-instrument, contract-by-contract analysis. Although we cannot state that contracts allowing for this kind of close-out always satisfy the three criteria listed immediately above (nor that parties will never have separate understandings to enter into close-out arrangements), we would expect most trading agreements would comply at least with criteria (b)(i) and (c) and we submit that would be sufficient for any such contract not to be treated as C5.

<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 respect of the term "physically settled", the City of London Law Society Regulatory Law Committee ("**Committee**") is very concerned that:

a. ESMA should not define it too narrowly;

b. The Guidelines should allow for developments in market practice in physical markets;

c. The Guidelines should in effect recognise that the market practices in all commodities in all parts of the world cannot be known by the regulators (or by respondents to this Consultation Paper ("**CP**"); and therefore

d. Any attempt by ESMA at an exhaustive definition or exhaustive list of examples would be misconceived and inevitably conflict with the three preceding points.

The Committee generally believes that it is critically important that the term "physical settlement" for the purposes of determining what is a MiFID I financial instrument should not be defined too narrowly. Any

[4] Clause 20(a) of Agreement for the sale of Brent Blend Crude Oil on 25 Day Terms Part 2 General Conditions Shell U.K. Limited July 1990 (as amended) provides: " If after the date on which this Agreement is entered into it is found that the transaction which is the subject of this Agreement forms part of a series of transactions which can be shown by any party to any of such transactions to form a continuous circle of such transactions ("the circlet'), the parties hereto hereby express willingness to consider entering into any book-out agreement (as defined in Clause 20(b) below) that may reasonably be proposed by any party to any of the transactions in the circle provided always that each party involved in the circle has given or gives a similar undertaking, it being always understood that each party hereto- retains all rights to decline to enter any such book-out agreement in its sole and unfettered discretion and without any obligation to give any reasons therefor."

[5] The SCoTA® Version 8 General Terms and Conditions published by globalCOAL ® provides at Clause 12: " 12.11 Unless otherwise agreed, if it is found that any Shipment forms part of a series of shipments in any given Delivery Period or Arrival Period (as applicable) which can be shown by any party to form a continuous circle of such shipments (a “Circle”), the Parties hereby express willingness to consider entering into a Close-Out Agreement provided always that each party in the Circle has given or gives a similar undertaking, it being always understood that each Party hereto retains all rights to decline to enter into a Close-Out Agreement in its sole discretion and without any obligation to give any reasons for its action..." and at clause 5: "5.1 Subject to any agreement between the Parties to the contrary, the Parties may mutually agree to settle their obligations in respect of part or all of the Quantity in a given Delivery Period or Arrival Period (as applicable) by financial means provided both Parties agree to do so and enter into a Financial Settlement Agreement in the form of Appendix 2 by no later than forty-five (45) days unless otherwise agreed prior to the commencement of the Delivery Period or Arrival Period (as applicable)."

definition of "physically settled" must be capable of reflecting practice in the physical market place which frequently evolves and can vary from commodity to commodity, and even between different markets in similar commodities. We note that similar concerns were raised in some of the responses to ESMA's consultation on MiFID II over the summer of 2014.

Any attempt to provide an exhaustive definition or exhaustively list examples of what constitutes "physical settlement" would be misconceived because:

a. It is certain that any exhaustive list of delivery or transfer mechanisms that constitute "physical settlement" would inadvertently omit genuine examples of physical delivery of the underlying commodity;

b. It is important that any list of "physically settled" contracts be flexible enough to keep up with and reflect market practice, without in effect constraining market development, particularly in non-financial, physical markets.

Therefore, guidance on the meaning of "physically settled" should allow for new commodities and new ways of doing business – for example, new storage, transfer, delivery and registration/record-keeping mechanisms that improve commercial efficiency. ESMA's guidance should be flexible enough to accommodate these developments, through an approach that conveys the essence of physical settlement but which does not pretend to be exhaustive. Any approach which constrained moves to more efficient trading and settlement methods in the real economy would be most unfortunate.

The inadequacy of the definition proposed by ESMA testifies to the difficulty of covering all possibilities. However, the solution is not simply to improve the proposed description of "physical settlement" in the Guidelines, but to clarify that it is not intended to be exhaustive or to exclude from the scope of "physically settled" other methods of settlement whether or not similar to those described.

In this context, we would emphasise five points:-

a. The risks to the "real" world of international commerce of ESMA getting this wrong;

b. The desirability and demand for legal certainty, so far as that is possible;

c. The wide range of commercial terms in energy and other commodity markets, which militates in favour of a nuanced approach;

d. The need for a broader range of delivery/settlement methods to be referenced in the Guidelines; and

e. The way ownership is addressed in the proposed Guidelines seems to confuse that concept with possession.

Risk to international trade in goods

In referring to the need to accommodate market practice, the Committee is not pleading against further regulation of financial markets; we are not suggesting a restriction of MiFID I's impact on dealings in securities or financial derivatives. Rather, we are concerned about an inadvertent and unwanted capture of significant parts of the "real" world of the commercial trade in physical goods. A wrong move at this point would be exacerbated:

a. By MiFID II, as a result of the use by truly physical markets of OTF-like execution mechanisms, which would risk bringing those trades within the scope of MiFID II;

b. By the approach to defining "commercial purpose" for C7 in Article 38 of Regulation 1287/2006/EC (or any revised versions of Article 38 made in light of MiFID II);

c. By the arguably very broad definition of "commodity" in the MiFID Implementing Regulation (Commission Regulation 1287/2006/EC), which arguably includes processed or even manufactured goods if they are fungible[6]; and

d. By the somewhat circular definitions of regulated market and MTF (and OTF in MiFID II): the C6 definition in respect of financial instruments contains the criterion of "traded on a regulated market and/or an MTF" and the definitions of those venues contains the criterion of bringing together "multiple third-party buying and selling interests in financial instruments". It might be argued that the nature of a traded instrument might trigger the need for authorisation of the venue where it is traded, even if the contract resulting from the trade is truly physical.

Legal certainty

There is a desire for legal certainty for contract counterparties. However, this is a question of balance. The Committee agrees that it should be possible to determine with reasonable certainty the Annex I, Section C categorisation of a particular financial instrument, and therefore (in the context of this CP) what constitutes a contract /delivery method that is "physically settled". On the other hand, it is more important not to capture truly physical markets and impose financial regulation on the commercial trade in goods.

These points militate in favour of guidance that provides a broad but non-exhaustive description of what constitutes "physically settled".

An insufficiently broad definition could have the perverse result of redefining the boundaries of what constitutes a physical trade in such a way that certain commodity derivatives that did not fall within the examples of "physically settled" might also not be capable of being treated as "settled in cash". This would leave a regulatory gap, and the risk of this would be greater unless it were clear that:

a. The description and examples in the guidance were not comprehensive or exhaustive; and

b. Other settlement methods could qualify as physical settlement even if they were quite different in nature. (Later in our response to this question) we give examples of physical settlement which might be considered different in kind to those which are listed in the CP.

Accordingly, we suggest that ESMA's guidance adopt a two-pronged approach to the definition of "physical settlement" to include:

a. A description with examples of settlement methods that would certainly be regarded as physical settlement – as broad a range as possible should be included; and

b. A non-exhaustive list of factors that are considered relevant to determining whether any particular settlement method is to be regarded as physical settlement.

Accommodating the variability of commercial terms

This approach would be comparable to the UK's approach to determining, in the definition of "futures", whether a particular contract for the sale of a commodity is to be regarded as made for investment purposes (in which case it is treated as a "futures" contract) or for commercial purposes (in which case, unless it is otherwise within the scope of MiFID I, it generally would not be treated as a "futures" contract).[7] The relevant legislation sets out criteria which are conclusive, and criteria which are indicative.

[6] And there is a risk that if a sufficiently narrow range of goods is considered, then fungibility is more likely to exist – for example, even among a range of branded goods such as wine, whisky, foodstuffs (ingredients or consumable), microprocessors.
[7] The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, Article 84 ("Futures"), as amended.

We understand that legislation in certain non-EU jurisdictions such as the US may also identify indicative criteria to distinguish unregulated forward contracts from regulated derivatives.

This enables a more nuanced approach to be taken, particularly in relation to situations where delivery is expressly provided for in a contract but may not actually occur due to changing supply and demand factors, which may be outside the control of the commercial parties. For example, contracts may contain embedded optionality as to volume, and this may include provision for compensation payments (e.g. in the form of liquidated damages) where an agreed volume is not taken/delivered. It may be necessary to consider such arrangements in context rather than provide an absolute criterion: for example, nature of the parties, intention of the parties, likely basis for exercise/non-exercise of the option to increase/decrease volume (e.g. factors predominantly beyond the control of the parties such as physical factors (weather or unscheduled outages, for example), insolvency or other failure of logistics, or regulatory factors such as energy reserve or capacity requirements).

As mentioned earlier, it is important to accommodate evolution in the market. For example, in the physical market for North Sea oil, the deadline for nominating cargo and delivery details has been extended at least twice in the last 15 years, from 15 to 21 and now 25 days.

Additional delivery/settlement methods

The Committee believes the proposed Guidelines as to the meaning of "physically settled" should address a wider range of delivery mechanisms, such as:

a. Book entry; and

b. Off-setting/net scheduling.

Both are common if not standard in certain physical commodities markets, but the issues may arise more generally where goods are held by third parties (i.e. not by the person whom one would normally regard as beneficial owner or entitled to claim possession).

Book entry

In certain commodities markets, the use of book entry as a transfer mechanism is common or prevalent. This is the case in the London bullion market, for example, and we understand it is also common if not normal in the sale and purchase of natural uranium.

There are two main types of bullion account, unallocated and allocated accounts. Most bullion transactions in the London market are entered into and settled on an unallocated account basis.

The customer holding an unallocated account does not own specific bars of metal, but has a general entitlement to an amount of metal. A purchase or deposit of bullion by the customer is settled by crediting the account, and a sale by debiting the account. Withdrawing customers do not generally receive back the same bars they originally deposited. Customers' balances are backed by the stock of bullion held by the bank or other dealer, of which the customer is an unsecured creditor for the relevant amount of gold. When a client requires an amount of the actual metal, the equivalent metal content is debited from the unallocated account and specific bullion will be allocated and made available for collection.

Allocated accounts are for customers who wish to own specific bars, which the bank/dealer holds on their behalf. We understand that holdings for each customer are typically identified by weight list of bars, showing the unique bar number, gross weight, the assay or fineness of each bar and its fine weight.

Settlement of precious metals transactions usually takes place by effecting "paper transfers" between the respective accounts of seller and buyer, debiting one account and crediting another. This avoids the issues associated with the physical movement of bullion.

We understand that uranium is typically transferred between the seller's and buyer's accounts in the records of the owner/operator of the processing facility where the uranium is located. Uranium is usually subject to continuous rather than batch processing, which means that uranium is not held in lots, and particular uranium cannot be identified as belonging to a particular person. Ownership is represented by a book entry in the processor's inventory records, but the applicable law might not necessarily regard this as ownership, and may regard the processor as both owning and having possession of the metal.

Off-setting/net scheduling

As in relation to MiFID II, we believe that ESMA needs to recognise expressly the off-setting or netting of delivery obligations and of payment obligations that occurs in various physical markets, for sound operational and/or risk management reasons (for example, as noted above in relation to coal).

In the gas and power markets, a form of netting is commonly required by the operational rules of the transmission system operator and or the rules of other entities involved in system balancing and settlement administration rather than a right to offset transactions, and various industry standard agreements used in the physical markets make equivalent or consequential provision for counterparties to net the volumes deliverable between them for any particular delivery period, so that only a net amount is notified or nominated into the system. ESMA's recent Technical Advice seems to recognise this [but could be clearer].[8]

Of course, payment netting is also common as a credit and operational risk management measure and should not affect the status of a contract as "physically settled", though it would be helpful if the Guidelines clarified this.

Ownership/possession

The focus on ownership in ESMA's draft Guidelines seems confused because delivery as a hallmark of physical settlement is more about the transfer of possession than of ownership. These two concepts, possession and ownership, are distinguished not only in the English legal system but also, we understand, in many other, if not most, legal systems. Thus, in a contract for the sale of commodities or other goods:

a. Title or ownership frequently transfers in advance of delivery, often at the same time as risk – often transfer occurs simply by virtue of the terms of the contract (supported by the applicable law) or because the law itself specifies when ownership transfers under a contract for the sale of goods;

b. Delivery is about transferring actual possession, or the right to possession or ability to obtain actual possession (often referred to as constructive possession).[9]

c. Nevertheless (many but by no means all) standard terms and commodity sale contracts provide that title will pass at the point of delivery.

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[8] See the Final Report of ESMA's Technical Advice to the Commission on MiFID II and MiFIR, at pages 406, 407, points 2 and 3. In fact, the Technical Advice seems to recognise the operational netting required by TSOs but not the net scheduling, etc. under EFET, GTMA and other agreements for gas and power trading.

[9] For example: (a) under English law ownership of specific or ascertained goods transfers to the buyer at the time the parties intend it to do so, and the Sale of Goods Act 1979 sets out factors and rules to determine that intention. Of course many contracts state expressly when ownership is to transfer. "Delivery" is defined (except in relation to co-owned goods) as "voluntary transfer of possession from one person to another"; (b) we understand the French Code Civil, also distinguishes clearly the concepts of ownership and possession, for example article 1583 (concerning the transfer of ownership) versus article 1604 (defining delivery as transfer of control and possession).

Because ownership and possession can be separated, and for good reasons, the law may make provision to protect innocent parties such as buyers of goods who are unaware that the "seller" is not the owner. Nevertheless there are numerous situations where a person's right or ability to obtain possession itself is indirect: it may represent a property right (i.e. a right in the property itself which is recognised by law) or merely a right against a person to demand transfer of possession (more in the nature of a contractual right). The difference can be crucial if the person who has actual possession or other property right in the goods becomes insolvent. That does not mean that the concept of delivery should focus only on mechanisms which constitute transfer of property rights in goods that are recognised by law, because frequently the mechanisms that the relevant legal system formally recognises are impracticable in today's commercial world.

The legal nature of the documents typically used has changed and continues to change. For example, we understand that the formally recognised documents of title are rarely used in some jurisdictions[10], because of the conditions and formalities required. In some jurisdictions, the law may provide no negotiable instrument incorporating legal title to goods except (perhaps) a bill of lading in respect of goods shipped by sea.[11] Informal storage receipts, such as warehouse receipts, are frequently used but these may not be title documents, and delivering them may not transfer title or the right to possession. Of course, even the use of warehouses means that possession is in a sense indirect, so that transfer of the right to have goods loaded out of the warehouse may not necessarily be recognised by the law as a transfer of possession nor as a transfer of ownership.

Furthermore, the movement of warehouse receipts and other documents across borders and immobilisation in depository systems complicate the interpretation, introducing complex private international law and conflicts of laws issues. For example, even if a warrant is a document of title in the jurisdiction of the issuing warehouse operator, the transfer of that warrant once it is located in another jurisdiction may be treated differently than it would have been if it had remained in the issuing jurisdiction; that treatment may differ further depending on the nature of the warrant (e.g. bearer, endorsable, or registered), whether it is electronic, and whether the warrant is immobilised in a depository such that transfer of entitlement to the warrant, from one account to another, may have a different legal effect than transfer of the warrant itself or transfer of the goods.

Note that many physical trades are settled using warrants in depositories managed by or on behalf of exchanges. That does not mean that the trades or the transfers themselves are financial rather than physical. For example, to physically deliver metal traded on the LME, the seller will give the buyer an LME warrant and we understand LME warrants are widely used in the physical metals business.

Commodity sale contracts will generally provide for a transfer of title to the underlying commodity, and the Committee accepts ESMA's apparent view that a transfer of ownership is a key characteristic of a physical sale contract. However, as explained above, since physical delivery represents a transfer of possession, not necessarily of ownership, ownership may transfer on physical delivery (or delivery of some document) or at some other time provided in the contract or by law.

In light of the above, the Committee recommends that:

a. If ESMA decides that transfer of ownership is the critical characteristic of physical settlement, then the Guidelines should:
    i. Ensure that beneficial and indirect forms of ownership are covered; and
    ii. Expressly include transfer of ownership by the terms of the contract or by operation of law.

    See below for our recommended amendments to the proposed Guidelines as regards the term "physically settled".

[10] Including some EU member states (such as, we understand, France, Italy and Spain).
[11] We understand that this may be the position in Belgium since 1 December 2014 in respect of any new warehouse receipts or warrants.

b. If ESMA decides that transfer of possession is also relevant then the Guidelines should make additional provision to cover the different ways in which actual or constructive possession may be transferred; and

c. If ESMA decides that possession rather than ownership is the defining characteristic of physical settlement, then the Guidelines would need more substantial amendment.

In any case, the Guidelines should be sufficiently broad to recognise that different legal systems provide different ways to effect transfers, and documents referred to in similar terms (such as "warehouse warrant") may have a different legal status and effect in different jurisdictions.

On the basis that ESMA determines that transfer of ownership is the key characteristic, we recommend the following changes to ESMA's proposed Guidelines as regards the term "physically settled":

> ‘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 nature to the <u>relevant</u> goods concerned <u>or the relevant quantity of goods concerned (such as a bill of lading or, in certain jurisdictions, a warehouse warrant)</u>;
> iii. <u>the amendment, assignment or other form of alteration of the records of rights of an ownership nature (or of entitlements to documents giving or evidencing such rights) in a central registry or other system (in dematerialised or other form) which records entitlements to establish a change in beneficial ownership of a physical commodity; or</u>
> 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<u>, including transfer of such rights by the terms of the contract or by operation of law</u>.’

Please note two additional points concerning these suggested changes:-

(1) We acknowledge the inclusion in our suggested changes of a substantial section of the changes proposed by ISDA and FIA Europe in their joint response to this Consultation Paper, but have used a slightly different form of words in (iii); and

(2) The changes to (ii) merely address the discrepancy between ESMA’s proposed Guidelines as to the interpretation of “physically settled”, as set out on pages 11 and 14 of the Consultation Paper, and the equivalent text set out in paragraphs 21 and 22 of Annex III: Draft Guidelines.

<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>
The City of London Law Society Regulatory Law Committee ("**Committee**") generally agrees with the statement of ESMA as to the relationship between C5, C6 and C7, as set out in paragraph 40 of the Consultation Paper ("**CP**"), but subject to several clarifications and qualifications. These are as follows:

a. Sub-paragraphs a-d of paragraph 40 each refers to contracts generically without recognising that the types of contracts listed in each of C5-C7 is different:
   i. For example, forwards are mentioned only in C7;
   ii. Potential conflict between C6 and C7: as our responses to Questions 4 and 5 indicate, ESMA's approach of interpreting C6 as including forwards creates a conflict with C7.

b. Some statements by ESMA suggest that it takes a very expansive view of the range of contracts covered by MiFID I and potentially falling within C5, C6 or C7. We would emphasise that each of these categories comprises only derivatives, so that most contracts for the supply of commodities and other commodity related contracts (including the types of contract which typically include "take or pay" clauses) are out of scope.

c. It is important that "settled in cash" should not be interpreted as applying too widely so as to capture contracts which have provided for situations where physical performance might not take place for commercial or operational or other reasons. Some of these situations are addressed in ESMA's recent Technical Advice to the Commission on MiFID II and MiFIR.[12]

C5, C6 and C7 are limited to derivatives

The universe of contracts to which the criteria in C5 to C7 must be tested is not all contracts in respect of commodities and does not include all contracts for the sale of goods, but only "derivative contracts relating to commodities" which are financial instruments.

We would reiterate that MiFID I concerns financial instruments and there is a huge danger if ESMA overreaches the scope of MiFID I to seek to apply the directive to non-financial contracts which are commercial contracts for the sale of goods, based on narrow criteria in C5, C6 or C7 which supplement the basic scope of each of those definitions, that basic scope being namely derivatives that are financial instruments.

This is clear from the words of the directive itself, but is reinforced by aspects of the EU's energy policy and recent legislation. For example, the European Commission itself recognised recently in its Communication entitled 'Progress towards completing the Internal Energy Market': "*As our energy systems need to become more flexible with the integration of variable wind and solar power, it is important to develop short term markets which allow buyers and sellers to adjust their gas and power purchases on a continuous, real-time basis during the day, buying at short notice or selling unforeseen surpluses.*"[13]

It is clearly not envisaged that such markets will be subject to financial regulation as well as energy regulation and therefore important that ESMA's view of the C5-C7 conditions does not result in it capturing such physical markets. Although this statement relates to the energy market, and indicates that these markets should develop in a framework of energy regulation, an equivalent realistic approach is appropriate and necessary in relation to other physical commodities markets which are non- financial in character.

Both MiFID II and the new Market Abuse Regulation 596/2014 ("**MAR**") emphasise this in their respective approaches to interpreting "financial instruments" and "spot" commodity contracts/markets:

a. Recital (4) to MiFID II states, "it is appropriate to include in the list of financial instruments certain commodity derivatives and others which are constituted and traded in such a manner as to give rise to regulatory issues comparable to traditional financial instruments.

b. In the definitions set out in Article 3(1)(15) and (16) of MAR, the legislators acknowledge that physically-settled forward contracts and forward markets for commodities are not part of the financial markets:

[12] See the Final Report of ESMA's Technical Advice to the Commission on MiFID II and MiFIR, at pages 406, 407, points 2 and 3.
[13] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions. Progress towards completing the Internal Energy Market'. COM(2014) 634 final.

i. "spot commodity contract" which is defined as "*a contract for the supply of a commodity traded on a spot market which is promptly delivered when the transaction is settled, **and a contract for the supply of a commodity that is not a financial instrument, including a physically settled forward contract***" (emphasis added); and

ii. "spot market", which means "*a commodity market in which commodities are sold for cash and promptly delivered when the transaction is settled, **and other non-financial markets, such as forward markets for commodities***" (emphasis added).

These are as discussed further below in response to Question 4.

Accordingly, a theme running through our responses to the CP is a concern that ESMA's approach seems to ignore the context of MiFID legislation, such as the points just mentioned, and seeks to "cast the net" much too widely in interpreting the types of contract that should be considered as potentially falling within C5-C7. ESMA should be similarly concerned that its Guidelines might represent potential over-reach beyond the world of derivatives and financial instruments into the "real economy" sale and purchase of goods, with potential economic damage, as it is about "gaps".

"Take or pay" contracts/provisions

The last sentence of Question 3 seems to be an example of ESMA extending to its interpretation of C5 the misconceived approach of ignoring the derivatives element when interpreting C5 through C7.

As with its approach to interpreting C6 and C7, ESMA's reference to "take or pay" contract indicates a risk that financial regulation will be inadvertently applied to a wide range of commercial contracts for the sale of goods which incorporate terms that have become common over many years. A clear intent by legislators would have been required in order to bring such contracts within the scope of MiFID I. It would be unrealistic and inappropriate to expect forms of commodity offtake contracts to be adjusted or curtailed to avoid treatment as C5 derivatives.

A non-spot commodities sale contract would not be within C5 merely because the buyer could exercise its rights under a "take-or-pay" provision, for several reasons:

a. A commodity-sale contract with a take or pay provision will generally not exhibit the characteristics of a derivative.

b. C5 does not apply to forward contracts unless they are derivatives:
   i. In MiFID I C5 refers to "forward rate agreement" which is a different type of derivative, similar to a swap.
   ii. In any event, even if "forwards" were mentioned, as they are in MIFID II, (1) it is clear from the terms of C5 that only derivatives are being referred to, and (2) only instruments of the nature of a financial instrument are covered, not every non-standard, individually-negotiated contracts for the supply of a commodity under which a cash payment happens to be required in circumstances that can be determined by one party. (See further our response to Question 4 regarding the application of C6 to forwards, much of which much of which is relevant to the interpretation of C5.)

c. The payment made by a buyer under a "take or pay" provision should not generally be regarded as "settled in cash" in the way derivative instruments might be settled in cash within the meaning of that term in C5:
   i. Generally it is not a settlement of differences or linked to a valuation of parties' respective commitments but, for example, the full contract price for the commodity.
   ii. Typically though not necessarily these provisions arise in long-term supply contracts which provide for multiple deliveries (and payments therefor) in the context where the seller has made substantial investment (e.g. a mine) – in some cases the buyer, too, has invested (e.g. a regasification facility for LNG).

iii. The buyer may have the right to reclaim at a later date (probably subject to a time limit) quantities of the commodity for which it has paid but not received.
iv. The payment may not be in respect of a specific scheduled delivery of a quantity of the commodity concerned: take-or-pay obligations are usually determined on a calendar or contract year basis, so that the payment is for the annual shortfall in the quantity taken versus quantity committed for the relevant year (as adjusted in accordance with the contract to reflect events during (such as any force majeure or other event which would have affected deliveries).

Both the economics underlying take or pay provisions and the legal terms of such provisions tend to be complex and practices have evolved over many years to reflect the requirements of different legal systems (e.g. in terms of contract and competition law) and of government authorities that may control natural resources. ESMA should be careful not to use the blunt instrument of the criteria on which it can give Guidelines to cut across such provisions.

Cash settlement and interpretation of C5

There are often very good reasons why a commodity sale transaction which was intended to be physically delivered does not in practice result in the agreed quantity being delivered. It is important not to characterise these as "settled in cash" merely because a cash payment is made by one party or there is some other adjustment between the parties. We are pleased that ESMA formally recognised this last month in its Technical Advice to the Commission on MiFID II and MiFIR.[14] Although the terms of MiFID II are slightly different, and in particularly the context of the Technical Advice on C6 is the new "must be physically settled" exception, we think some of the points would be helpful in MiFID I Guidelines.

We would recommend that the proposed MiFID I Guidelines include both some specific points based on the conclusions in the Technical Advice and follow some of the general points that can be inferred from the Technical Advice. Specific points we would highlight in this context are:

a. Types of contracts which ESMA characterises as "must be physically settled" (or as not being precluded from being considered as "must be physically settled") could be stated in the MiFID I Guidelines as outside the scope of C5;

b. Operational netting in power and gas markets shall not be considered as offsetting of obligations under a contract against obligations from other contracts and does not preclude a contract from being considered as must be physically settled and accordingly do not mean a contract should be characterised as settled in cash;

c. Likewise, the existence of provisions of the following kind do not prevent a contract from being characterised as “must be physically settled”:
   i. Force majeure or bona fide inability to settle provisions
   ii. Default clauses providing that a party is entitled to financial compensation in the case of non- or defective performance of the contract.

General points include:

a. Practices such as operational netting should not be the sole determinant for the application of financial regulation;

b. Events happening post trade generally do not change the characterisation of the contract if they are not at the discretion of the parties to the contract (because MiFID I criteria focus on the derivative trade/contract and its execution venue or terms);

[14] See the Final Report of ESMA's Technical Advice to the Commission on MiFID II and MiFIR, at pages 406, 407, points 2 and 3.

c. Recognition that:
   i. Matters such as operational netting is handled in different ways in different Member States of the Union;
   ii. There is merit in defining terms at a high level rather than by a list of concrete cases in order (1) not to create legal uncertainty, and (2) to respect differences in national civil or case laws.

On the other hand, we think that it would not be appropriate to include in the Guidelines reference to the possible requirement mentioned in the Technical Advice that buyer and seller should have proportionate arrangements in place to make or receive delivery of the underlying commodity.[15] Even if such a requirement were appropriate in the context of the wholesale energy product exception from MiFID II (and ESMA did not formalise the point as technical advice to the Commission), it is not relevant in determining what is or is not within C5 or C6 of MiFID I.

The Committee understands that in some markets parties frequently agree a trade that provides for physical settlement (and which does not provide for cash settlement), only to agree at a later date to cash settle the transaction. This does not mean that the original contract which provides for physical settlement should fall within the C5 category. The physical commercial needs of commodity traders changes over time, often over short periods of time: this is in the nature of physical business. It is not a reason to extend the boundaries of activities which are the subject of financial regulation. (On the contrary, physical commodity markets are often separately regulated, either under EU law (e.g. REMIT and the Third Energy Liberalisation Package for gas and power) or by Member States' domestic laws.)

Accordingly we believe that there is neither a legal reason nor a policy reason to treat contracts subject to C5 merely because there is a possibility that the parties will subsequently agree to cash settlement, so long as neither party has the right on its own to require cash settlement. This possibility to cash settle is raised in the Technical Advice[16] but not addressed – ESMA simple refers to this MiFID I Guidelines CP. The Committee considers that for the purpose of MiFID I the possibility is not one where a derivative "may be settled in cash at the option of one of the parties" and accordingly does not bring a contract within C5. This applies even if the parties frequently agree to cash settlement in practice, so long as there is no agreement or understanding to do so – some anti-evasion language may be appropriate. ESMA should make these points clear.

<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>
Although it is indicated in ESMA's Consultation Paper ("**CP**") that the proposed Guidelines are relevant only in the context of MiFID I, the City of London Law Society Regulatory Law Committee ("**Committee**") thinks that ESMA's Guidelines could have an impact on the interpretation of MiFID II provisions, specifically C6 and C7. Accordingly, while we consider that ESMA should not be adopting MiFID I Guidelines on the basis that they will apply to MiFID II, or based on its MiFID II consultations, there is bound to be some impact. That is why we emphasise the importance of taking into account the consequences of applying the same interpretations under MiFID II - particularly, as mentioned above, given the capture in C6 and C7 of contracts traded on an OTF or equivalent third country facility. This could capture significant physical trade (in raw materials, processed and manufactured goods) that happens to be broked in ways that fall within the OTF concept but that has little or absolutely no connection with the world of finance and exchange-traded commodities.

[15] See the Final Report of ESMA's Technical Advice to the Commission on MiFID II and MiFIR, at page 406, point 1(i).
[16] Paragraph 7.1(40) of the Final Report of ESMA's Technical Advice to the Commission on MiFID II and MIFIR refers to the "possibility by mutual consent to cash settle".

Treatment of Forwards

The Committee considers that it would be wrong to treat forwards as generally included within C6 if they are physically settled and are traded on a regulated market and/or an MTF. In this respect paragraphs 34 and 35 of the CP are wrong. There are numerous reasons for our position on this, both from a legal and a policy perspective.

a. The danger of adopting an interpretation which prejudges MiFID II Level 2 regulations and is unworkable under MiFID II;

b. MiFID I and more recent Level 1 legislation (i.e. MiFID II and MAR, as noted in our response to Question 2 above) imply that forwards are not generally covered by C6, and arguably not at all;

c. As explained in response to Question 3, we consider that only derivatives are potentially captured by C5-C7, and forwards are not necessarily derivatives – most non-spot commodity supply contracts are not derivatives; and

d. The risk of inadvertently bringing into the scope of financial regulation a large amount of business in goods that cannot be regarded financial or derivatives but is part of the "real economy".

These arguments are explained further in the rest of this response to Question 4.

Consistently with Commission's statement in its letter to ESMA (as quoted in paragraph 27 of the CP should not adopt any guidelines that would pre-judge the interpretation of MiFID II, particularly given the significant change made to C6 in MiFID II, namely the extension to OTF's.

While some futures may be regarded as forwards, and are within C6 if traded on a regulated market/MTF, it is wrong to characterize other physically-settled forwards as within C6. except possibly those which can be characterized as "other derivatives contracts", in which case criteria used in C7 (including Article 38 of the implementing directive) should apply.

If exchange-traded physically-settled commodity futures are a type of forward contract, that does not imply that all forwards traded on an exchange are futures, nor that a modern trading-platform should be considered as an exchange for these purposes. The more one extends the notion of regulated venue to platforms which bring participants together to trade, the more risk there is of capturing business in the trading of goods which, quite legitimately, is not subject to financial regulation. This risk is exacerbated by:

a. The breadth of the definition of "commodity" to include all goods, including for example manufactured goods; and

b. A degree of circularity in the definitions of "MTF" (and under MiFID II, "OTF") when applied to C6.

Accordingly, ESMA needs to acknowledge that the reference to "derivatives" in C6 and C7 narrows the scope of those categories, and ESMA should not apply execution venue and delivery period as sole and conclusive criteria. Otherwise there is a risk of capturing much of the real commercial economy or limiting the ability of the non-financial sector to develop new mechanisms to trade goods for physical delivery. That risk is exacerbated if ESMA's MiFID I Guidelines are too expansive and subsequently similar interpretations are applied under MiFID II – the introduction of OTFs on a misunderstood and expansive interpretation of C6 could have disastrous consequences in the domestic and international trade of goods.

As the CP notes (in paragraph 33), whereas, C7 of the list of financial instruments in MiFID I expressly lists "forwards" among the types of contracts covered, C6 does not refer to "forwards". Hitherto, it was argued by some that this was a drafting oversight and that C6 was intended to cover forward contracts. MiFID II and MAR contradict that:

a. Neither the Commission's MiFID II proposal nor the final adopted text of MiFID II sought to "correct" or change C6 in this respect;

b. Recital (8) of MiFID II states that " it is appropriate to include in the list of financial instruments commodity derivatives and others which are constituted and traded in such a manner as to give rise to regulatory issues comparable to traditional financial instruments": from this it is clear that the scope of the legislation is limited and it cannot be applied mechanistically to all non-spot contracts executed on a regulated venue. A more sophisticated or nuanced approach is required, for example by applying criteria to determine whether the contracts concerned have the characteristics of derivatives. This means that either:
   i. Criteria equivalent to those applied to C7 by Article 38(1) of the MiFID Implementing Regulation should be applied to "other derivative contracts" under C6; or
   ii. Forwards should be considered entirely outsides the scope of C6, and whether they are financial instruments should be assessed under C7 – in this case, if they were traded on a regulated market/MTF they would fall within Article 38(1)(a)(ii), and would have "the characteristics of other derivative financial instruments" if they also satisfied the criteria in Article 38(1)(b) and (c).

c. The Market Abuse Regulation 596/2014 ("**MAR**"), which was considered by the EU's legislative authorities at the same time as MiFID II and adopted only three months earlier, distinguishes "physically settled forward contracts" from "financial instruments" under MiFID II. The definitions in Article 3 of MAR rely on the MiFID II and MiFIR definitions respectively of "financial instrument" and "commodity", but in Article 3(1)(15) and 3(16) provide:

   "(15) 'spot commodity contract' means a contract for the supply of a commodity traded on a spot market which is promptly delivered when the transaction is settled, and <u>a contract for the supply of a commodity that is not a financial instrument, including a physically settled forward contract</u>;
   (16) 'spot market' means a commodity market in which commodities are sold for cash and promptly delivered when the transaction is settled, and <u>other non-financial markets, such as forward markets for commodities</u>;"

(We have underlined part of the text to emphasise the express provision that:
a. a physically settled forward commodity contract is not a financial instrument if it meets the specified criteria specified in (15) and (16); and
b. forward markets for commodities are not financial markets.)

ESMA should not ignore these strong interpretative indicators (in addition to recognising that the scope of C6 (and C5 and C7) is limited to derivatives).

The Committee submits that this drafting of C6 and C7 of MiFID I reflected a deliberate difference to give effect to a policy position. It is not merely a technical, linguistic difference that should be disregarded. In particular, the difference is critical to the efficient functioning of commercial non-financial business of trading goods domestically, cross-border within the EU and internationally, especially once MiFID II is in force and C6 applies to OTF-executed contracts. If not, there is a risk that a broad interpretation of what constitutes a "physically settled contract" will in turn categorise a number of commercial contracts as financial instruments under C6, purely on the basis of the venue of where they are traded. This problem will be accentuated under MiFID II with the introduction of OTFs.

The difference can be explained as follows. MiFID I provided that commodity derivatives traded on a regulated market (RM) or MTF should be financial instruments. Physically settled forward contracts in commodities *may be* but *are not necessarily* derivatives – across the commercial world they typically would not be derivatives, whereas futures and swaps for example would generally be regarded as derivatives. The Committee would highlight the comment made previously by the Cross-Border Physical Commodities Coalition that "*The primary effect of a commodity physical forward is to transfer ownership of the underlying commodity and not just to transfer the price risk of the underlying commodity. As a* *result, physical forward contracts contain complicated terms relating to the mechanics of delivery that would not be found in a commodity derivative transaction.*"[17]

Because forwards that can be physically settled are not necessarily derivatives, reference to them was omitted from C6. This leaves no loophole because such forwards as display derivative characteristics would be within either:

a. The C6 reference to "any other derivative contract relating to commodities"; or

b. C7 if the other C7 criteria (including the criteria elaborated in Article 38 of the MiFID Implementing Regulation[18]) were satisfied.

This becomes all the more important under MiFID II because the extension of C6 to OTF executed trades potentially captures a huge range of trades in physical goods that are intermediated by physical brokers and various discretionary market mechanisms in domestic and international trade, merely because a longer than standard delivery period is agreed. One effect could be to inhibit the development of more efficient, market-based mechanisms for physical supply markets.

Even under MiFID I, C6 would be problematic if it captured all non-spot contracts executed on an MTF: where truly physical markets for fungible goods are involved (e.g. various B2B auction mechanisms (for auto parts, for example, and perhaps even e-Bay for certain products), commercial contracts with no derivatives characteristics other than a longer-than-"standard" delivery date could be captured where executed on a non-discretionary multi-lateral platform.

As noted above, MAR implicitly acknowledges that "forwards" are not automatically covered by C6, given its definitions of "spot commodity contract" and "spot market" as quoted above.

For the buying and selling of physical goods in the commercial world, there must be some characteristics that distinguish between (1) a derivative contract and (2) a contract for future delivery of goods that happens to be executed through an intermediary who brings together multiple buying and selling interests. C7 substantially achieves this by supplementing the use of a multilateral market mechanism with not just one other characteristic but a combination of characteristics – clearing/margining, absence of commercial purpose[19] and a particular form of standardisation. Generally, these and physical delivery are among the characteristics that distinguish derivatives from other contracts in the underlying.

However, it may be helpful to provide guidance on criteria which would be relevant in identifying contracts are likely to be "derivatives",

a. Bearing in mind the MiFID II recital (8) and the MAR definitions quoted above;[20]

b. Acknowledging that physically settled forwards are not necessarily derivatives;

c. Confirming that the terms of Article 38(2) and (3) are relevant to determining whether forwards are derivatives.

It must be recalled that an important reason for the current consultation is uncertainty in the application of EMIR. Treatment of a wide range of truly physical contracts as MiFID derivative financial instruments would not merely trigger EMIR obligations:

[17] Cross-Border Physical Commodities Coalition, Reply form for the ESMA MiFID II/MiFIR Consultation Paper (22 May), page 44.
[18] 1287/2006/EC.
[19] Arguably this is not a separate criterion but addressed fully by Article 38 – see further below.
[20] In this regard we disagree with ESMA's conclusion, as reflected in its recent Technical Advice, not to recommend amendment of the definition of "spot contracts" take MAR into account: see point 4 on page 416 of the Technical Advice.

a. It could have a major effect on the status of physical market participants as non-financial counterparties below the clearing threshold

i. i.e. it might push many above that threshold for the purposes of the EMIR clearing obligation and certain other obligations such as collateralisation;

ii. indeed, those other obligations could have severe implications: for example, large physical-trading parties pushed above the clearing threshold would be required to collateralise physical contracts between themselves which had been mis-characterised as derivatives under MiFID, thereby increasing costs and burdens enormously.

b. Such treatment would not merely trigger EMIR obligations. Under MiFID II (with the existing MiFID I Article 2(1)(k) deleted) it would result in many buyers and sellers of physical commodities having to become authorised – we suspect also that the quantitative criteria for the ancillary activities exemption on which ESMA is currently consulting (Consultation Paper ESMA/2014/1570 of December 2014) do not adequately take into account the inclusion of so many physical contracts as derivatives.

Note that, whereas a market can become a regulated market if it is authorised as such, the circularity of definitions means that a market can become an MTF by default, merely by trading forward commodity contracts in the manner described in the MTF definition. Although an MTF operator requires authorisation, arguably the absence of authorisation does not mean the operated market is not an MTF. This reinforces the importance of distinguishing forward contracts by reference to criteria additional to the market mechanism itself. Likewise with OTFs under MiFID II: ESMA should be careful that a situation cannot arise whereby certain physical forward contracts are considered to be C6 financial instruments because they are traded on an OTF, while in turn, the venue on which they are traded is an OTF simply because it is a multilateral system on which parties are able to trade such physical forward contracts.

To the extent possible within the constraints of the legislation, ESMA should also consider how are forwards treated in other G20 jurisdictions. ESMA seems to acknowledge this in its recent Technical Advice to the Commission on MiFID II and MiFIR – Final Report: "ESMA also appreciates the desirability of an alignment with legal rules and guidance in the US and Canada on how to treat physical transactions" (paragraph 20 of section 7.1). We believe there may be scope to provide further assurance on the treatment of certain physical forwards as being outside the scope of C5-C7, particularly in light of the extensive analysis and conclusions in respect of the meaning of "swap" in the CFTC/SEC Adopting Release for joint final rules and interpretations on various product definitions.[21]

Other characteristics of "other derivative contacts relating to commodities" in C6

There is no reason to distinguish the phrase "other derivative contract[s] relating to commodities" as used in C6 from C7, except that forwards that are derivative instruments may be regarded as outside the phrase in C7 because they are specifically referred to in C7 . Therefore, in determining what are "other derivatives contracts" falling within C6, the proposed Guidelines should expressly refer to the characteristics applied in respect of C7 by Article 38 of the MiFID Implementing Regulation, except for Article 38(1)(a) since the venue characteristic is already included within C6 itself. Accordingly:

a. The clearing/margining and standardisation criteria in Article 38(1) (b) and (c) respectively should be applied; and

b. The contract should not be a spot contract and, in distinguishing spot contracts from derivatives, the definition of "spot contract" applied should be the definition for C7 purposes in Article 38(2) but with guidance that takes MAR Article 3(1)(15) and (16) into account.

<ESMA_MIFID_C6_C7_QUESTION_4>

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[21] See: http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-18003a.pdf

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

<ESMA_MIFID_C6_C7_QUESTION_5>
The City of London Law Society Regulatory Law Committee ("**Committee**") welcomes ESMA's view that the conditions defined in Article 38(1) of Regulation 1287/2006/EC are cumulative, as explained in paragraph 45 of the Consultation paper ("**CP**") and 22.a.iii of the draft Guidelines. This provides helpful clarification in line with what we believe to be the general understanding and interpretation. However, the further reference in paragraph 25 of the Guidelines is unnecessary, and is incorrect in two respects, namely in the way it refers to Article 38 (rather than referring to Article 38(1), and making it clear (as does paragraph 22.a.iii of the draft Guidelines) that only one of the criteria in (1)(a) need be satisfied) and in referring to text "below" (which seems to be a typographical error given that there is no text below). Paragraph 25 could be deleted entirely.

We consider that the points we have made above in relation to the draft Guidelines on the meaning of "physically settled" in C6 should apply equally to C7 – and the draft Guidelines themselves propose similar text for this aspect of C6 and C7.

In addition, in relation to the interpretation of forward contracts in C7, it would be relevant for ESMA to consider many of the points we have made above in relation to C6 (and C5), in particular:

a. That forwards be treated as covered by C7 and not C6;

b. The legislators' intention as expressed in recital (8) of MiFID II, to limit the scope of C6 and C7 (and the definition of financial instruments generally) to commodity derivatives which "give rise to regulatory issues comparable to traditional financial instruments";

c. The interpretation of forward contracts set out in the Market Abuse Regulation 596/2014; and

d. That a contract must be a derivative to be within C7.

However, we do not consider it necessary for Guidelines in respect of MiFID I to address these points expressly.

Although it is indicated in ESMA's document that the proposed guidance is relevant only in the MiFID I context, we think that ESMA's Guidelines are likely to affect the way the MiFID II provisions are interpreted. Although we consider that ESMA should not adopt MiFID I Guidelines on the basis that they will apply to MiFID II, or based on its MiFID II consultations, ESMA should take into account the consequences of applying the same interpretations under MiFID II - particularly, as mentioned above, given the capture in C6 and C7 of contracts traded on an OTF or equivalent third country facility. Hence we have emphasised in our responses the adverse effects of over-reaching MiFID I's limits and intent by inadvertently capturing significant physical trade (in raw materials, processed and manufactured goods) that happens to involve non-spot sales or to be brokered in ways that fall within the OTF concept but that has little or absolutely no connection with the world of finance and exchange-traded commodities.

<ESMA_MIFID_C6_C7_QUESTION_5>