

Reply to CESR's draft technical advice on defining Commodity Derivatives in MiFID

This paper is a reply to the arguments and position set out by CESR in its draft technical paper related to the List of Financial Instruments (recital 4 and Annex 1 section C). In many ways, the writers of this memo have a different opinion and wish to contribute accordingly to further debate.

GASELYS is a joint venture between Gaz de France and Société Générale, involved in trading and marketing derivatives transactions mainly in gas and electricity markets, as well as in oil markets.

It is a financially regulated entity involved in proprietary trading, and also offers large corporations a range of products and services for managing their financial risks inherent to the energy sector.

GASELYS is very happy to be able to comment on the draft technical advice of the Committee of European Securities Regulators ("CESR") on the list of financial instruments in section C of the Annex to the directive on Markets in Financial Instruments ("MiFID").

1. INTRODUCTION

The MiFID addresses the definition of commodities and commodity derivatives threefold: in the Annex 1 C (list of financial instruments), in the recital 4, and in the definition of a "financial instrument", in article 4.1.2. It is this article which delegates to the Commission the duty to precise under which conditions commodity derivatives which are neither cash settled nor negotiated via a regulated market, are to be considered as financial instruments, because they are not for "commercial purposes".

These level 2 measures will be adopted on the basis of CESR's advice. The second mandate will therefore have a significant impact on the range of instruments falling within the scope of the Directive.

Appropriately, CESR sets out a list of questions that need answering. We would like to comment on the following topics:

(a) What is a "commodity"?**(b) How do we answer to instruments "not being for commercial purpose"? Are there purpose activity using a derivative contract as opposed to financial or investment activities?**

While this is not explicitly part of the mandate, an understanding of this aspect is important to the question. Theoretically, according to the wording of Annex I section C(7), there could be non-financial instruments not being for commercial purposes or financial instruments being for commercial purposes. It is therefore important to clarify the notion of purpose as opposed to characteristics in order to provide CESR with a comprehensive view on the industry.

(c) When is a derivative contract relating to a "commodity" within the scope of the Directive, bearing in mind the wording of recital (4) to the Directive?**2. IMPLICATIONS OF MIFID TO RELATED SUBJECTS**

Debates around the definition of commodity derivatives in MiFID are increasingly focusing on the difference, even sometimes depicted as an opposition, between financial and commercial activities. The concern that Gaselys wishes to raise is that such a crystallisation is not a good way to reach the common goal of a level-playing field and promote active markets around Europe:

- Markets are liquid and efficient if different parties trade and provide their respective expertise or view on the markets without impediments. Banks and traders provide liquidity and match interests between producers and consumers. In this respect, it is important to enable financial institutions to benefit from a full EU passport.
- Increasingly, energy markets around Europe structure themselves in a way that attract banks and traders as well as physical participants to trade easily and develop price transparency and liquidity. Hubs are increasingly providing services to smooth operations and transfer of energy through :
 - notional transfer of ownership (instead of physically off-taking the commodity),
 - firm allocations of quantities (to protect market participants from having to deal with unexpected variations in quantities that happen in transportation) and,
 - cash settlement of mismatched quantities (differences between amounts on the sell and buy side).

The definition of commodity derivatives has a broader impact than the sole subject of MiFID. Firstly, it is relating to netting issues as in many member states close-out netting is considered valid – irrespective to local insolvency laws – only when considering financial instruments. Secondly, financial regulation would apply to undertakings which would trade financial instruments on a professional basis. A relatively narrow definition of

regulated activities and a large number of exemptions would probably lower or differ the weight of these changes (increased controls, capital charges, investment advice...).

3. PANEL OF OPINIONS SUBMITTED TO CESR CALL FOR EVIDENCE

A detailed analysis of the 10 written contributions to CESR's call for evidence was carried out as a preliminary work on this paper. As shown below, the variety of opinions in the industry make synthesis a difficult task.

SUMMARY OF RESPONSES TO THE CALL FOR EVIDENCE

Topics used in criteria	CESR Document	Agree with CESR ?		
		Yes	No	?
Spot Transaction	Commercial	2	4	4
Intention to deliver	Commercial	5	3	2
Legal capacity to make/take delivery	Commercial	0	4	6
Explicit intention in contracts	Commercial	1	3	6
Any course of dealing between the parties	Commercial	1	3	6
Any history of behaviour in relation to equivalent transactions	Commercial	2	2	6
Producer, users and commercial merchants	Commercial	2	4	4
Contracts not made solely in reference to regularly published prices or standard lots or delivery dates	Commercial	0	7	3
Traded on a third country marketplace or trading facility	Financial	3	1	6
Expressed to be as traded on an organised market even though not traded on such	Financial	6	2	2
Performance is enforced by an organised market or clearing house	Financial	7	2	1
Arrangements for the payment of margin	Financial	7	2	1

Legend :

- *Yes : submitted paper agrees with the criterion mentioned*
- *No : submitted paper disagrees with the criterion*
- *? : submitted paper does not mention the criterion*

What this illustration points out is that many subjects or criteria used by CESR are challenged by written contributions, most of misunderstanding being on the choice of a maturity limit (spot transactions) or status of counterparty as undisputed dividing lines for transactions.

Moreover, the content of CESR's draft technical advice and the combination of criteria set out in text box 3 tend to change significantly the meaning of the definition set out in level One.

We therefore believe it to be necessary to further clarify several issues set out in CESR's technical document.

4. DEFINITION OF A COMMODITY

Although it is difficult to formulate a clear and unambiguous definition of commodities for the purposes of the Directive, the intention appears to be to include commodities whose trading shares several key characteristics, such as products:

- routinely bought and sold to transfer price and delivery risk between producers, consumers and specialist risk-management intermediaries;
- traded under standardised industry trading agreements with industry standard lot sizes, delivery calendars, etc; and
- of standardised quality or specifics, in order to make the commodity fungible and the delivery of one lot of the product easy.

We believe it is possible to form a broad consensus around the products that should fall within the intended scope of the Directive. For example, the following products are all traded on standardised terms in fungible lots for risk management purposes and can serve as an indicative list for the same purpose:

- Oil and refined products, Natural gas, Coal, Electricity;
- Metals;
- Agricultural products (wheat, soy beans, oats, cocoa etc);
- Timber and related pulp/paper products;
- Carbon allowances.

5. GENERAL COMMENT ON TESTS SET OUT IN ANNEX I SECTION C6: COMMERCIAL PURPOSE AND FINANCIAL CHARACTERISTICS

The MiFID sets out two different approaches to defining when commodity derivatives do belong to financial instruments, depending on whether the focus is on recital 4 or on the list of financial instruments in Annex 1 C.

- **Annex 1 section C7 mixes two tests, one based upon the purpose of a trade and the other being based upon the characteristics of the instrument that is looked upon.**

*“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 regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls”.*

- **Recital 4 focuses on the context of trading in these instruments are traded.**

“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”.

We believe it extremely difficult to focus only on the characteristics to define a transaction made for a commercial purpose, since this mostly refers to the nature of the business that uses the derivative instrument. A set of characteristics and a purpose cannot be at the same level and any intention to mix them could easily lead to contradictions.

Indeed, certain interpretation of this wording are currently mixing purpose and characteristics. This interpretation naturally leads therefore to a set of two independent tests:

- First level: is the derivative a commercial trade? This question is solely meaningful because many commodity derivatives are physically settled, thus could be used as additional sourcing of the underlying.
- Second level: if not, is it a financial derivative?

In fact, according to this interpretation of Annex I section C, there exists an intriguing possibility that : physically-settled derivative instruments might be financial and still be used for commercial purposes as well as for speculative purposes ; and more difficult an instrument might neither be a commercial trade nor a financial trade. **Such a loophole in a regulation is of course not satisfactory.**

Instead, it is far more logical to look at “purpose” as a category of activity rather than being attached to a trade. Table 1 shows, with a few concrete examples, it is almost impossible to distinguish trades solely by their characteristics, but it is far clearer to categorise the nature of the business they support.

TABLE1: DESCRIPTION OF ACTIVITIES USING COMMODITY DERIVATIVES WITH *PHYSICAL* DELIVERY

Activity-based		
	regulated activity	exemptions (art. 2) or regulated if professional and regular activity (art. 4)
	"Not being for commercial purpose"	"Being for Commercial purpose"
Product-based	"have the characteristics of other derivative financial instruments" dynamic hedging of a physical position, being either a storage, a plant, a field... arbitrage position on forward prices or physical positions arbitrage position on different underlyings speculative trading	market-based sourcing of the underlying commodity (e.g. : power in the UK power hub) static hedging of prices or physical positions (i.e.: trade held until maturity, little maturity mismatch with underlying position)
	do not "have the characteristics of other derivative financial instruments" Non banking activity (usually industrial of carried out via a SPV if inside a bank): operation on shipping a cargo...	physical delivery at a specified point for consumption, transformation of the commodity selling of a structural long physical position on a market (e.g.: mining, energy field)

A Commercial purpose activity relies, in our view, to different kinds of services or businesses, amongst them:

(a) *producing, sourcing, transforming, using the commodity;*

In this perspective, it is somewhat easy to define when trading in a commodity may be considered as being for a commercial purpose, i.e. the transactions would be for commercial purposes **if the person trading the commodity expects to have a net physical delivery requirement**.

This definition would have to be drawn sufficiently wide not to include storage of the commodity (e.g. gas storage or metals warehousing). However, the key driver would be that the market participant did not routinely deliver or take delivery of the commodity under the contracts to manage directly the risks associated with underlying production and consumption requirements.

Moreover, it is easily understandable that a user of a commodity would take/make real physical delivery of the product, and not just take/make delivery of a notional product (either title of ownership or notification).

(b) *And/or entering into related basic balancing strategies implying a nearly perfect match in terms of maturity and/or underlying.*

In this case, it is difficult to draw an absolute line between hedging an underlying (physical position) and becoming an active and regular trader of the associated commodity in its own right, particularly since many significant physical players will also regularly offer risk management services to other companies.

Unless an undertaking is actually using a derivative instrument on a professional basis or to provide risk management services to third parties, it would still be able to use financial instruments without being regulated (many companies' treasury departments make use of interest rate derivatives without being financially regulated).

As a matter of fact, prudential obligations do not derive from qualifying a contract as financial instrument but rather from the concept of regulated entity itself. In the case of MiFID, own account dealing has a narrow meaning (compared to other legislation) and encloses a vast number of exemptions.

Therefore, we advocate for a clarification of purpose as opposed to a characteristic. A purpose lies at an activity level, it is the context within which a trade is used. For us, this should be dealt with through articles 2 and 5 which define what kind of business should be requiring a licence and which should be exempted. Incidentally, many of the business exempted in article 2 could be classified in our table1, whether or not they use derivatives with financial characteristics or not.

Let us now comment on other key criteria.

6. ANALYSIS OF CESR'S COMMERCIAL PURPOSE CRITERIA

A number of items are discussed in CESR technical paper and we felt useful to review them all and comment on the findings set out in CESR's report.

a) Criteria One: Exclusion of Spot transactions from the scope of the Directive

CESR proposes a first set of criteria:

A contract not falling within Annex I, paragraph C(6), is to be regarded as made for commercial purposes and as not having the characteristics of another derivative financial instrument, if under the terms of the contract –

(a) delivery is to be made within the lesser of:

(i) two business days; and

(ii) the period generally accepted in the relevant market as the standard delivery period, unless it can be shown that there existed an understanding that (notwithstanding the express terms of the contract) delivery would not be made within that period; or

(b) the contract is with or by the operator of an energy transmission grid or pipeline network, and is either to ensure security of energy supplies or is necessary to keep in balance the supplies and uses of energy at a given time.

Comments / Reaction:

As some of the respondents mentioned, the 'spot' contract test (under which a transaction is deemed to be made for a commercial purpose) is whether, under the terms of the contract, delivery is to be made within a stated period of time – commonly seven days. This first set of criteria is very difficult to prove conclusive and even useful.

Firstly, applying such a distinction between trades carried out on the same trading facility would have many drawbacks, especially on **credit risk**. In fact, spot trades and other trades would be dealt separately, the former being on a master agreement and the latter on another one. This two-tier regime would imply that: 1/ netting exposure would be split along the same lines thus making management of credit risk less efficient; and 2/ more complexity to manage trades and thus create operational risk in back office procedures.

Secondly, the subjective criterion (ii) used as a way to differentiate maturity between markets tends to create a lot of **uncertainty and complexity**, especially when cross-commodity products are developing (spread such as spark spread or dark spread are widespread in spite of very different specifics in terms of delivery constraints).

Whilst such a test has considerable merits, such as being relatively simple to apply, given the wide array of market conventions in the various European commodity derivatives markets, we would recommend that such a simplistic measure is **inappropriate**.

Nevertheless, should spot transactions be excluded from MiFID scope because they are, for a vast majority, typical instruments of a non-financial balancing activity, clear and

objective criteria to define excluded spot transactions would certainly be **the shortest maturity available on an organised market (often day-ahead contracts or below)**.

b) Criteria Two: Exclusion from the scope of the Directive of derivatives when intention to make/take delivery is legally possible (related question 2.9)

CESR proposes a second set of criteria to qualify a transaction as being entered into for commercial purpose:

A contract not falling within Annex I, paragraph C(6), is to be regarded as not made for commercial purposes and having the characteristics of another derivative financial instrument if the parties do not have both the legal capacity, and any necessary permits or licences, to make or take delivery of the commodity to which the contract relates.

Comments / Reaction:

This wording does not fit with the practice of commodity derivatives markets in Europe. Since the bulk part of derivatives are traded on “hubs” and therefore physically settled, each market participants is required by the network operator to have all legal means and necessary authorisations to actually ship and deliver energy as part of a licensing process to trade on the “hub” facility. In this respect, every participant will be having the legal capacity to match the above mentioned criteria regardless of its actual willingness to use the commodity for a commercial use or as part of its industrial process. This applies to producers or consumers of commodity as well as traders.

But, at the same time, energy operators and energy regulators tend to improve market structure on OTC hubs so as to make them as efficient a trading facility as possible and encourage banks and traders to trade. Most markets operate under a system of title transfer of energy and cash-out imbalance settlement rules.

As an example, on energy markets, physical delivery takes place automatically through an integrated network/grid. This means that there might be discrepancies between notional quantities and actual deliveries. On hubs, where market structure is sophisticated, there are mechanisms governing settlement that manage imbalances: differences between deliveries and notional quantities are metered by the grid operator and settled at a given price by the grid operator. Market participants therefore have to close any open positions before delivery or would be forced to cash-out any remaining imbalances, in a sort of “buy-in” procedure. This market structure, where delivery is notional and regulated by an operator, makes trading on hubs very similar to trading on a financial market place. **The rationale behind the intention to deliver is therefore less relevant on hubs if the purpose is to pinpoint trades carried out with a commercial intent (i.e: a willingness to provide the commodity to an actual user or producer of it).**

It still bears meaning for inflows to or outflows from facilities where participants use transportation capacity and **obviously exhibit a net physical position**. Indeed, when

Transco measure the volume of energy delivered, it does so by metering energy entering or exiting the hub facility.

Therefore, it should be appropriate to limit this criterion to trades **outside hubs** (hubs providing titles of transfer services instead of physical movement of energy). We would advise CESR or the EC to focus this criterion to trades with physical delivery on facilities where the ***person trading the commodity expects to have a net physical delivery requirement¹***.

c) Criteria Three: exclusion from the scope of the Directive of trades carried out by some types of counterparties and / or with respect to the usual course of their dealings with regard to delivery

CESR proposes to exclude transactions related to business or activities aimed at the use of the energy (basically for the production or consumption):

The following are indications that a contract (outside Annex I, paragraph C(6), and outside (1)) is made for commercial purposes, and does not have the characteristics of an other derivative financial instrument

(a) one or more of the parties is a producer of the commodity or uses it in his business;

(b) the seller delivers or intends to deliver the property or the purchaser takes or intends to take delivery of it, determined as at the moment of formation of the contract, where the following are indicators of the intention –

(i) the terms of the contract as set out explicitly between the parties;

(ii) any other terms of the contract, whether implicitly agreed between the parties or implied by law or custom or practice in the relevant market;

(iii) any course of dealings between the parties;

(iv) any history of behaviour in relation to equivalent transactions with other parties;

Comments / Reaction:

Is the business of a counterparty on a wholesale market a criterion to exclude the trade on a derivative from any kind of financial supervision?

It is true that the physical settlement of commodity derivatives often raise questions so as to know whether a forward / future trade is a sale or purchase of the specified

¹ Usually, this physical requirement entails a physical off-take on a point located on the border of the hub. If not balanced, a market counterparty will usually be paying a cash amount from the transport operator whose role is to balance positions at a penalty price (as in a regular "cash-out procedure")

commodity with deferred delivery or a financial derivative. All of this discussion comes from this plain difficulty.

Everybody would probably agree with the following statement: a Commercial purpose activity relies, in our view, to specific services or businesses, amongst them: producing, sourcing, transforming, using the commodity. In this perspective, it is somewhat easy to define when trading in a commodity may be considered as being for a commercial purpose, i.e. the transactions would be for commercial purposes ***if the person trading the commodity expects to have a net physical delivery requirement***.

This definition would have to be drawn sufficiently wide not to include storage of the commodity (e.g. gas storage or metals warehousing).

Moreover, it is easily understandable that a user of a commodity would take/make **real** physical delivery of the product, and not just take/make delivery of a notional product (either title of ownership or notification).

Is mixing business orientations or purpose (such as criteria (a) or (b)) with characteristics of a trade per se is of any help for our discussion?

Complexity comes from the fact that sophisticated participants of derivatives markets use physically-settled products to hedge or manage both physical (having to balance energy requirements with production over time) and price risks (being subject to a loss in case the commodity price moves).

It is only if an undertaking is actually using derivative instruments on a professional basis (i.e. with a high turnover) or providing risk management services to third parties that it would be regulated. Otherwise, any undertaking would be able to use financial instruments – subject to our static hedging practice caveat – without being financial regulated. An undertaking would certainly not be qualified a professional trader or investment firm if it is entering into static hedging strategies implying a nearly perfect match in terms of maturity and/or underlying.

The question of which businesses need to be regulated are dealt with in articles 2 and 4 of the Directive: producers or distributors of commodities are not qualified as investment firms.

As far as characteristics are concerned, a trade even physically settled should be plainly defined commercial or financial with objective criteria limited to the trade itself or to the facility on which it is traded. Trades carried out on energy hubs or other likewise wholesale markets (exhibiting high turnover compared to actual net delivery) should be deemed financial.

After all, the pre-eminent aim is to catch within MiFID commodity derivatives and/or businesses which give rise to regulatory issues comparable to traditional financial instruments, such as investment advice, risk management requirements, financial markets security...

7. PROPOSED SET OF COMMERCIAL AND FINANCIAL CRITERIA

We would recommend a newly designed set of criteria that meet the following objectives:

- Two simple and objective sets of test to limit uncertainty
- No difference of weight between criteria proposed
- A fair translation of physical requirements into the choice of a dividing line between commercial and financial transactions
- A view consistent with EC's orientation to foster market efficiency and EU passport as well as accounting norms (IAS)
- Links with related subjects such as CAD requirements

a) First, we would recommend clarifying the purpose test as being an activity-based test to be dealt with in art. 2 and 5

We strongly advocate CESR to review this purpose item as being part of activity or exemptions and clearly state that this has no practical meaning in the characteristics testing for the qualification of a transaction.

It should rather say that in some cases, commodity derivatives being physically settled could be used in commercial activities such as sourcing or distribution. In these cases, using derivatives would not be seen as own account dealing on a professional basis and would not requalify the nature of the business as being that of an investment firm (see recital 7, 11 and art.4). Sourcing, producing and distributing commodity should therefore not be included in the scope of the Directive, contrary to specialised subsidiaries whose aim is to internalise commodities flows, trade intensely around them and optimise assets.

CESR should also bear in mind that status of investment firm also bears positive implications for non-professional customers willing to hedge their crops or their output with derivatives, be they financially or physically settled: better prevention of conflicts of interest, conduct of business rules, price transparency and best execution are all beneficial to customers and non professional counterparties.

b) Second, we would recommend simplified tests to characterise transactions:

- 1) A contract not falling within Annex I, paragraph C(6), is to be regarded as having the characteristics of another derivative financial instrument when:
 - a) Governed by industry-wide standard master agreements issued by professional associations²
 - b) Traded on "hubs" or marketplaces³ with the following characteristics:

² Today's list would include ISDA (most notably with their gas and power annex), EFET, GTMAs. How often such a criterion is updated is clearly a point for further discussion.

- i) the physical delivery is managed through title of transfer services co-ordinated by an appropriately⁴ authorised operator,
 - ii) participants are requested to have no net physical requirement over time,
 - iii) price publicity is arranged by third parties
- 2) A contract not falling within Annex I, paragraph C(6), is to be regarded as made for commercial purpose when:
 - a) It is not governed by industry-wide standard master agreements issued by professional associations
 - b) The trade is expected, under the terms of the contract and rules of settlement require participants to have a net physical requirement over time,
 - c) Transportation capacity is needed,
 - d) Price publicity is not arranged by third parties,
 - e) Transaction refer to non-standard delivery dates

c) For the dealing of related issues

Related issues of significant impact on the industry are expected, the main one being the capital charge regulation under discussion. It is expected to be applicable for undertakings that need a license under MiFID consideration.

It is therefore important not to rush in to treat these new issues and try to fit them in an appropriate framework. We would propose that both MiFID and CADI Directive be linked on the subject of commodity derivatives via the inclusion of a recital in CADI Directive demanding a review of capital charges in view of specifics of commodity markets and consistently with the review of exemptions listed in MiFID article 2.

³ Marketplaces that meet these requirement would fall into the category of energy hubs for example in Europe and comprise NBP Hub, Zeebrugge Hub, TTF, Italian PSV, French PEG hubs...

⁴ Who is qualified to authorise local operators (e.g.: government, law, industry bodies...) and how often such a criterion is updated is clearly a point for further clarification.