



Your ref: CESR/04-562

Committee of European Securities Regulators
11-13 Avenue de Friedland
75008 Paris
France

January 19, 2005

Dear Sirs,

Directive on Markets in Financial Instruments - Advice on 2nd Set of Mandates

The Weather Risk Management Association (WRMA) welcomes this opportunity to comment on CESR's draft technical advice on possible implementing measures under the Directive on Markets in Financial Instruments (MiFID) in relation to the second set of mandates, with particular reference to the treatment of weather derivatives under the definition of financial instruments.

Founded in 1999 by the leading companies in the weather risk management industry, WRMA is an international trade organization dedicated to promoting the industry both to those within it and to end-users. The industry began in 1997, offering companies the opportunity to control their financial exposure to weather conditions. As a part of its mission, WRMA advocates the standardization of contracts and other documentation used for transactions, and sponsors forums and conferences around the world for members to meet and discuss a range of topics such as international markets, data collection issues, and tax and legal matters. The association also develops and promotes policy and the expansion of the industry, as well as commissioning surveys of the industry. More information about WRMA and the weather risk management industry is available at <http://www.wrma.org/>.

In summary, we welcome the proposals to treat cash settled weather derivatives as financial instruments. However, we are concerned about other aspects of CESR's proposals as outlined below.

Definition of climatic variables

WRMA agrees with CESR that there is no need for its advice to provide a definition of climatic variables for the purposes of paragraph C(10) of Annex I MiFID. This term is readily understood, without further elaboration, as covering weather derivative contracts linked to variables such as temperature, precipitation or wind.

Treatment of cash settled weather derivatives as financial instruments

WRMA welcomes CESR's proposals regarding the treatment of weather derivatives under paragraph C(10) of Annex I MiFID. In particular, WRMA agrees with the proposed advice in Box 6 of CESR's October 2004 consultation paper that a derivative relating to a specified other

underlying (such as weather) should be regarded as having the characteristics of other derivative financial instruments if it is settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event). WRMA believes that this is appropriate given that cash settled commodity derivatives are treated as financial instruments under paragraph C(5) of Annex I MiFID.

In a wide variety of industries, from property management to natural gas retailing, weather creates volatility in expenses and revenues. Businesses can protect themselves against these volatilities by entering into weather derivatives contracts whose payout is linked to climatic variables.

Treating these instruments as financial instruments within the scope of the directive will have a number of benefits:

- Those firms that are licensed as investment firms in one EU state will have the benefit of the passport in order to conduct their business across the EU free from additional local licensing requirements. There have been concerns that existing authorisation requirements in some member states are creating barriers to cross-border business in weather derivatives and, thus, restricting the development of these risk management activities.
- Making clear that weather derivatives are financial instruments like other derivative contracts should help make clear that weather derivatives contracts benefit, in the same way as other derivative contracts, from member state laws which protect close-out netting agreements from the adverse impact of insolvency laws and which protect the enforceability of derivative contracts from national rules regulating gaming contracts. Again, enhanced legal certainty should assist the development of these risk management activities.

Definition of derivative contract

On a related issue, we do not agree with CESR's analysis of when a contract is a derivative contract, in particular in so far as CESR proposes to adopt an inappropriately narrow interpretation that would exclude contracts that have a fixed cash payout (sometimes called digital options in derivative markets). While it would currently be unusual for a weather derivative contract to provide a fixed cash payout triggered by fluctuations in a particular climatic variable through a specified barrier point, this is possible. We see no reason why such a contract should not be treated as a financial instrument in the same way as other derivative contracts.

Contingent forward contracts

In some cases, contracts linked to climatic variables are not cash settled. For example, a power generating company may enter into a contract with a counterparty under which the counterparty agrees that, if certain climatic thresholds are triggered, it will supply a specified quantity of oil or coal at a pre-agreed price. This protects the generator against the risk that particular climatic conditions, such as a cold snap, may drive up the cost and/or reduce the availability of oil or coal supplies.

WRMA considers that this type of contract will fall within paragraph C(7) of Annex I MiFID. The question of whether the contract is a financial instrument will depend on whether it is not for a commercial purpose and the contract otherwise has the characteristics of other derivative financial instruments within the meaning of that paragraph.

As regards the criteria set out in CESR's proposed advice, WRMA considers that CESR should clearly separate the question of whether the contract is for a commercial purpose from the question of whether the contract objectively has the characteristics of other derivative financial instruments. As regards the first question, WRMA considers that there is no simple test of when a party has a commercial purpose in entering into the contract, although the intention to make or take delivery is clearly an important factor. However, a party to a contract should only have to have regard to his own intentions (and status or business) when making these determinations. A contracting party should not be required to investigate the intentions (or status or business) of its counterparty when determining whether it requires authorisation as an investment firm.

Regulatory regime applicable to weather derivatives business

However, if weather derivatives are to be treated as financial instruments, it is essential that the regulatory regime applicable to investment firms trading in these instruments is proportionate and not unduly burdensome. Regulation should not act as an unnecessary barrier to business between professional counterparties. In this regard, we welcome CESR's proposal to set the thresholds for treatment as an eligible counterparty under article 24(3) at the same level as those in Annex II, allowing professional clients to elect to be treated as counterparties where this is appropriate. Similarly, we believe that, where the conduct of business rules apply CESR should not impose unnecessary rules under article 19 on business with professional clients. In general, the high-level requirements of the directive should be sufficient for this kind of business.

Definition of investment advice

We also consider that CESR's advice should not seek to expand the definition of investment advice.

The definition should be limited to recommendations of specific financial instruments. We would be concerned if the definition encompassed generic recommendations or recommendations of services as opposed to transactions.

Similarly, we consider that CESR's proposals do not adequately distinguish between marketing and advice. For example, in wholesale markets, it is common for one counterparty to seek to persuade another to enter into a particular transaction by presenting information, term sheets, etc. setting out details of and information about the transaction structure that will take into account the likely requirements of the recipient. However, it would be unusual for the recipient of marketing material of this kind to regard this material as investment advice simply because it is held out as based on a consideration of the personal circumstances of the recipient. In our view, the definition of advice should be limited by a further requirement, namely that, as a result of the actions of the putative adviser, it is reasonable for the recipient to rely on the information or opinion as indicating that the transaction is suitable for the recipient.

We are concerned that an overly broad definition of advice will make it harder for corporates participating in these markets to rely on exemptions from regulation such as article 2(1)(d) and 2(1)(k) which are (in the latter case in part) limited to those that deal for own account and would not apply if exchanges of marketing or transaction related information were regarded as investment advice. Similarly, for investment firms it would be inappropriate if the suitability obligations of article 19(4) were triggered by this sort of activity.

We hope that the above is of assistance. If you have any questions or comments, please contact Valerie Cooper at +1 202 289 3800 (wrma@kellencompany.com) or Claude Brown at +44 20 7006 1000 (claude.brown@cliffordchance.com).

Yours faithfully,

A handwritten signature in black ink, reading "VB Cooper". The letters are cursive and fluid, with the first name "VB" being more compact and the last name "Cooper" written in a standard cursive style.

Valerie Cooper, CAE

Executive Director