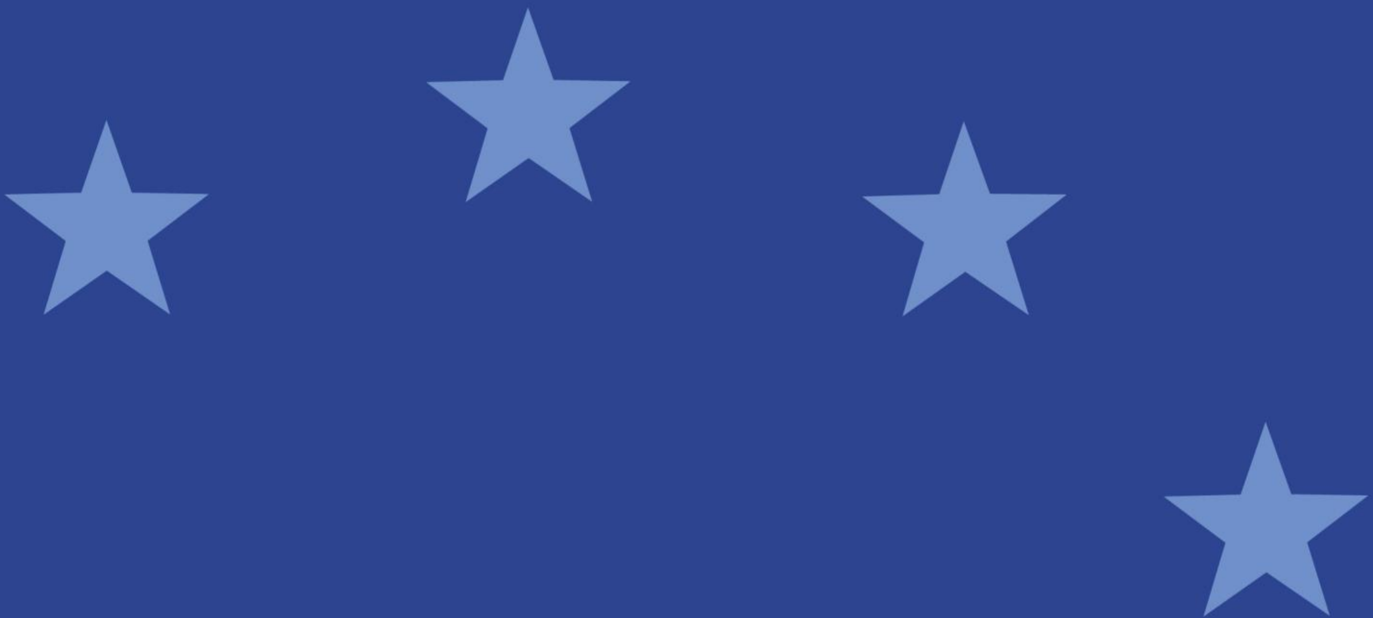
Consultation paper

Guidelines on the application of C6 and C7 of Annex I of MiFID



29 September 2014 | ESMA/2014/1189

European Securities and Markets Authority

Date: 29 September 2014
ESMA/2014/SMSC/1189

Responding to this consultation paper

ESMA invites comments on all matters set out in this consultation paper and, in particular, on the specific questions listed in Annex I. Comments are most helpful if they:

- indicate the number of the question to which the comment relates;
- respond to the question stated;
- contain a clear rationale, including on any related costs and benefits; and
- describe any alternatives ESMA should consider.

Comments should reach us by January 5th 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 and prominently indicate in your submission any part you do not wish to be publically 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'.

Who should read this paper?

This consultation paper should be read by investment firms (as defined in Article 4(1) (1) of MiFID), competent authorities, trade bodies, non-financial counterparties and consumer groups.

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Acronyms

Commission	European Commission
CCP	Central Counterparty
EMIR	European Market Infrastructures Regulation – Regulation (EU) 648/2012 of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories – also referred to as "the Regulation".
ESMA	European Securities and Markets Authority
ESMA Regulation	Regulation (EU) No. 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC
NCA	National Competent Authority
MiFID	Directive 2004/39/EC
MiFID L2	Regulation (EC) No 1287/2006 Implementing MiFID
MiFID II	Directive 2014/65/EU amending Directive 2004/39/EC
MIFIR	Regulation (EU) No 600/2014
MS	Member States
RTS on OTC derivatives	Regulation (EU) No 149/2013 of 19 December 2012
RTS on CCPs	Regulation (EU) No 153/2013 of 19 December 2012
TR	Trade Repository

I. Overview

Reasons for publication

1. The different approaches to the interpretation of MiFID I across Member States mean that there is no commonly-adopted application of the definition of derivative or derivative contract in the EU for some asset classes. Whilst this issue has in the past been noted as a concern since the implementation of MiFID, the practical consequences have come to the forefront with the implementation of Regulation (EU) No 648/2012 (EMIR).

2. As indicated in the European Securities and Markets Authority's (ESMA) letter to the Commission of 14 February 2014, there are significant problems in the implementation of EMIR caused by the non-harmonised classification of financial instruments as derivatives.

3. In response to the letter of 14 February 2014 from ESMA, the European Commission on 26 February 2014 invited ESMA to consider issuing guidelines in accordance with Article 16 of Regulation (EU) 1095/2010 on the application of the definitions of C6 and C7 of Annex 1 of MiFID.

4. ESMA considers it essential to ensure, amongst other things, a consistent application of EMIR in the EU and is therefore considering the adoption of guidelines to ensure the consistent classification of certain financial instruments as derivatives. This will allow a common approach by NCAs in the implementation of EMIR from the date these guidelines start applying and until MIFID II and the relevant implementing regulation will start applying.

5. ESMA has prepared this Consultation Paper (CP) in order to consult interested parties for the purpose of producing these guidelines. Respondents are encouraged to provide the relevant information to support their arguments or proposals.

Contents

6. Section II explains the background to the proposed guidelines in more detail.

7. Section III sets out the rationale for the draft guidelines on the application of definitions C6 and C7 of Annex 1 of MiFID

8. Annex I lists all the questions set out in the consultation paper;

9. Annex II sets out the cost-benefit analysis;

10. Annex III contains the full text of the draft guidelines.

Next steps

11. ESMA will consider the responses it receives to this consultation paper following the consultation and expects thereafter to publish a final report, and final guidelines.

12. These guidelines are based solely on the current MiFID requirements. The potential impact of MiFID II and future implementing measures falls outside of the scope of this exercise.

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II. Background

13. The different approaches to the interpretation of MiFID I across Member States mean that there is no commonly-adopted application of the definition of derivative or derivative contract in the EU for some asset classes. Whilst this issue has been noted as a concern since the implementation of MiFID, the practical consequences have come to the forefront with the implementation of Regulation (EU) No 648/2012 (EMIR).

14. According to Article 2(5) of EMIR 'derivative' or 'derivative contract' means a financial instrument as set out in points (4) to (10) of Section C of Annex I to MIFID as further specified by Articles 38 and 39 of Regulation (EC) No 1287/2006.

15. The obligations resulting from Title II of EMIR and the related Commission Delegated Regulations (EU) No 148/2013 and 149/2013 (RTS on OTC derivatives) apply to derivatives or OTC derivative contracts. In addition, certain requirements for CCPs, as specified in Commission Delegated Regulation (EU) No 153/2013 (RTS on CCPs) only apply to OTC derivative contracts.

16. As stated in Recital 12 of EMIR, uniform rules are required in EMIR for derivative contracts set out in points (4) to (10) of Section C of Annex I to MiFID.

17. The implementation of MiFID in the different Member States gave rise, for certain types of instruments or contracts, to different interpretations among competent authorities on what should constitute a financial instrument. This is the case in particular for physically settled commodity forwards. These different interpretations may lead to an inconsistent application of MiFID, EMIR and potentially other directives and regulations that rely on MiFID definitions of financial instruments.

18. A Regulation (such as EMIR) that is directly applicable in all the Member States cannot be applied differently. This is contrary to the spirit and objectives of the Regulation.

19. Against this background and in line with Article 29 of the ESMA Regulation, ESMA considers it should promote consistent application of directly applicable provisions throughout the Union. For this reason, a clarification for certain financial instruments for which different interpretations among Member States have been identified is needed.

Identification of the problems caused by the different classification of derivatives

20. Under EMIR the reporting obligation to trade repositories applies to all derivative contracts. This obligation is directly applicable across the Union. Different classifications of what constitutes a financial instrument may lead to the reporting of certain transactions in one Member State and not in others. This would lead to a non-uniform and inconsistent application of EMIR within the Union and it would create an un-level playing field, which is contrary to the spirit of a Regulation.

21. Under EMIR the clearing obligation applies to OTC derivative contracts. The power to determine the classes of derivatives subject to the clearing obligation has been given to ESMA to ensure, amongst other things, one single uniform and consistent application of this obligation across the Union. If competent authorities adopt different classifications of what constitutes an OTC derivative contract, the clearing obligation would not apply in a uniform manner across the Union, contravening the objectives of EMIR.

22. Under EMIR and the RTS on OTC derivatives, the calculation of the clearing threshold by non-financial counterparties is made on the basis of positions in OTC derivative contracts. Directly applicable obligations on non-financial counterparties are derived from the calculation of the clearing threshold. Different classifications of what constitutes an OTC derivative contract would determine the inclusion of certain instruments in the calculation of the clearing threshold for non-financial counterparties established in some Member States and the exclusion of those for non-financial counterparties established in other Member States. This would result in a non-uniform application of EMIR across the Union and the creation of an un-level playing field amongst non-financial counterparties, which is contrary to objectives of EMIR.

23. Under EMIR and the RTS on OTC derivatives, obligations for risk mitigation techniques apply for OTC derivative contracts not cleared by a CCP. These obligations are directly applicable in the Union and should therefore apply in a uniform and consistent manner. Different classifications of what constitutes an OTC derivative contract by different Member States would lead to an inconsistent application of EMIR across the Union, which is contrary to the Regulation.

24. Under the RTS on CCPs, higher margin requirements apply to OTC derivative contracts than to other financial instruments. If Member States apply different classifications of what constitutes an OTC derivative contract, a CCP established in one Member State may face higher margin requirements than a CCP established in a different Member State. Therefore, different classifications of what constitutes an OTC derivative contract would lead to an un-level playing field among CCPs operating in the Union.

Approach

25. On 14 February 2014[1], ESMA wrote to Michel Barnier, the Commissioner for Internal Market and Services at the Commission, to highlight its concern that an inconsistent application of the definitions of FX and physically settled commodity forwards could have a significant detrimental effect on the consistent application of EMIR and therefore considered that it was essential that references to the MiFID definitions in the context of EMIR are clarified.

26. On 26 February 2014, the Commission responded to ESMA and, in relation to physically settled commodity forwards, proposed that ESMA consider issuing guidelines.

Extract from the Commission's request to ESMA[2]:

27. *"With regard to the definition of commodity forwards that can be physically settled, …this issue was discussed during the MiFID II negotiations. The European Parliament and the Council agreed to empower the Commission to further specify in a delegated act the derivative contracts referred to in point (6) of Section C of Annex I to MiFID II that must be physically settled, taking into account specific wording included in recital 8b[3] of MiFID II. Against this background, it would be inappropriate for the Commission to prejudge the imminent work on the delegated acts for MiFID II by developing level 2 proposals under the current MiFID, the preamble of which does not contain specific recitals to frame the definition.*

[1] http://www.esma.europa.eu/news/ESMA-asks-Commission-clarify-derivative-definition-under-MiFID-EMIR?t=326&o=home
[2] http://www.esma.europa.eu/system/files/ares2014513399_ec_response_on_classification_of_financial_instruments.pdf
[3] Now recital 10 of MiFID II

28. *I would therefore like to invite ESMA, as part of its preparation for its advice to the Commission under MiFID II, for which you will receive a mandate before the summer, to also assess the status of physically settled commodity forwards. In addition, and in order to ensure the common, uniform and consistent application of MiFID, ESMA could also consider issuing guidelines in accordance with Article 16 of Regulation (EU) 1095/2010."*

MiFID II

As expressed in the Commission's letter quoted above, the Commission is empowered to further specify in a delegated act the derivative contracts referred to in points (6) and (7) of Section C of Annex I to MiFID II that must be physically settled. The Commission has asked ESMA for advice in relation to preparing elements of the delegated acts and ESMA has consulted on the draft advice it proposes to provide to the Commission in its consultation paper[4]. However, given MiFID II will not enter into force until the start of 2017, ESMA and the Commission considers it is necessary to provide clarity on the application of these definitions more immediately.

[4] http://www.esma.europa.eu/system/files/2014-549_-_consultation_paper_mifid_ii_-_mifir.pdf Consultation 2014/549 from 22 May 2014 to 1 August 2014.

III. Application of point (6) of Section C of Annex I

29. Annex 1, Section C of MiFID provides the following definitions for points (6) and (7) ('C6' and 'C7'):

30. *(6) Options, futures, swaps and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market and/or an MTF.*

31. *(7) Options, futures, swaps, forwards and any other derivative contract 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.*

32. The interpretation of definitions C6 and C7 in relation to physically settled forwards is not convergent across the Union. In particular, there is not a common understanding of whether forwards are included within the definition of C6 and what is meant by "physically settled" for both C6 and C7.

Discussion of forwards

33. C7 explicitly applies to "futures" and "forwards" whereas C6 omits reference to forwards. Consequently there are divergent views with regard to whether forwards that can be physically settled and are traded on a regulated market or an MTF fall within MiFID's scope. Furthermore, the word 'forward' is not a defined term under MiFID.

34. ESMA is of the view that forwards are included within the definition of C6 for the following reason. The language of C6 includes explicitly "*any other derivative contract"* as well as referring specifically to options, futures and swaps. A forward[5], that is a type of derivative contract, could thus be captured.

35. Consequently, ESMA considers that the definition given in C6 has a broad application and includes all commodity derivatives, including those which might be called "forwards", providing they "*can be physically settled"* and *"they are traded on a regulated market and/or an MTF"*.

Discussion of "physically settled" for the purpose of C6

36. C6 (as does C7) applies to instruments which can be "physically settled". However, "physically settled" is not a defined term under MiFID. Further, C5 refers to instruments that "*must be settled in cash or may be settled in cash at the option of one of the parties*" whereas C6 and C7 refer to instruments that "*can be physically*" settled. Consequently, determining what is meant by "can", "may" and "must" be physically settled is necessary for the identification of the contracts that fall within these definitions of derivatives.

37. ESMA has taken into consideration, and agrees with in this respect, the CESR advice issued in 2005[6] which clarified what is meant by physically settled. Specifically, "physically settled" can incorporate a broad range of delivery methodologies including:

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[5] ESMA notes that the CESR/CEBS consultation paper on the MiFID commodities review (CESR/08-370) defines forward transactions in its glossary as "*a contract that includes an obligation of at least one of the counterparties that has a due date which is later than for spot contracts in the sense of Article 38(2)(a) of the [MiFID Implementing Regulation]*", futures as "being standardised forward transactions that are traded on an exchange", and later makes the statement that "*a significant portion of forwards are transacted through MTFs, which qualifies them as derivatives in the sense of MiFID*" (paragraph 32).

[6] http://www.esma.europa.eu/system/files/05_290b.pdf

a. physical delivery of the relevant goods themselves;

b. delivery of a document giving rights of an ownership nature to the relevant goods or the relevant quantity of the goods concerned (such as a bill of lading or a warehouse warrant);

c. the amendment, assignment or other form of alteration of the records of rights of ownership in a central registry or other dematerialised system recording entitlement to establish a change in beneficial ownership of a physical commodity; or

d. 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 (including notification, scheduling or nomination to the operator of an energy supply network) that entitles the recipient to the relevant quantity of the goods.

Trading of instruments are traded on a regulated market or an MTF

38. C6 applies when a transaction in the specified instruments takes place on a regulated market or an MTF. The definition of MTF that is set out in Article 4 of MIFID requires that orders for financial instruments that are submitted to the multilateral system must be executed on a non-discretionary basis.

39. ESMA is of the opinion that it is the responsibility of all investment firms, including those that operate an MTF, to make themselves aware of the boundary of their activities that require authorisation under MIFID and those activities that do not.

Discussion of relationship between C5, C6 and C7

40. ESMA's view is that there is no conflict in the overlap of definitions between commodity derivatives under C5 which "*may be settled in cash at the option of one of the parties*[7]" and commodity derivatives under C6 and C7 which *"can be physically settled"*. ESMA considers that the boundary between the definitions is determined by the following:

    a. Contracts which **must be settled in cash** fall under C5.

    b. Contracts which **may be settled in cash *at the option of one of the parties*** fall under C5. This means that a C5 contract may be physically settled if the party with the option to settle in cash does not exercise this option.

    c. Contracts which **must be physically settled**[8] fall initially under either C6 or C7, depending upon the place of execution and, in the case of C7, whether they are for commercial purposes which is discussed further at (46) below.

    d. Contracts that **can be physically settled** in all cases fall initially under C6 or C7, depending on the place of execution, except for where there is an option, available to one of the parties, to cash settle in which case the contract will fall under C5.

Guidelines

41. ESMA considers that definition C6 of Annex 1 of MiFID applies in the following way:

    a. C6 has a broad application, applying to all commodity derivative contracts, including forwards, providing that:

        i. they must or can be physically settled; and

        ii. they are traded on a regulated market or an MTF.

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[7] Also note this phrase is used under Article 38.3(a) of implementing regulation 1287/2006/EC in relation to definition C10.

[8] In this regard, however, ESMA notes 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* provisions that would prevent physical delivery.

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 relevant goods or the relevant quantity of the goods concerned (such as a bill of lading or a warehouse warrant); or

   iii. 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 (including notification, scheduling or nomination to the operator of an energy supply network) that entitles the recipient to the relevant quantity of the goods.

Questions

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?**

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?**

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.**

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

IV. Application of point (7) of Section C of Annex I

Overview

42. Physically settled commodity derivatives which do not fall within the definition of C6 may be financial instruments that fall within the definition of C7. ESMA considers that the definitions of C6 and C7 form two distinct categories as C7 applies to commodity derivatives "*that can be physically settled not otherwise mentioned in C.6*" i.e. they are not traded on a regulated market or an MTF.

Discussion of "physically settled" for the purpose of C7

43. ESMA refers to its definition of "*can be physically settled*" set out under C6 above and proposes the same definition for use in C7.

Characteristics of other derivative financial instruments

44. The other characteristics of commodity derivatives under C7 - *"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"* - are further defined under Article 38 of the MiFID I implementing regulation 1287/2006/EC, the relevant sections of which are displayed below.

Article 38, Regulation (EC) No 1287/2006
Characteristics of other derivative financial instruments

1. For the purposes of Section C(7) of Annex I to Directive 2004/39/EC, a contract which is not a spot contract within the meaning of paragraph 2 of this Article and which is not covered by paragraph 4 shall be considered as having the characteristics of other derivative financial instruments and not being for commercial purposes if it satisfies the following conditions:

(a) it meets one of the following sets of criteria:

(i) it is traded on a third country trading facility that performs a similar function to a regulated market or an MTF;

(ii) it is expressly stated to be traded on, or is subject to the rules of, a regulated market, an MTF or such a third country trading facility;

(iii) it is expressly stated to be equivalent to a contract traded on a regulated market, MTF or such a third country trading facility;

(b) it is cleared by a clearing house or other entity carrying out the same functions as a central counterparty, or there are arrangements for the payment or provision of margin in relation to the contract;

(c) it is standardised so that, in particular, the price, the lot, the delivery date or other terms are determined principally by reference to regularly published prices, standard lots or standard delivery dates.

2. A spot contract for the purposes of paragraph 1 means a contract for the sale of a commodity, asset or right, under the terms of which delivery is scheduled to be made within the longer of the following periods:

(a) two trading days;

(b) the period generally accepted in the market for that commodity, asset or right as the standard delivery period.

However, a contract is not a spot contract if, irrespective of its explicit terms, there is an understanding between the parties to the contract that delivery of the underlying is to be postponed and not to be performed within the period mentioned in the first subparagraph.

[...]

4. A contract shall be considered to be for commercial purposes for the purposes of Section C(7) of Annex I to Directive 2004/39/EC, and as not having the characteristics of other derivative financial instruments for the purposes of Sections C(7) and (10) of that Annex, if it is entered into with or by an operator or administrator of an energy transmission grid, energy balancing mechanism or pipeline network, and it is necessary to keep in balance the supplies and uses of energy at a given time.

45. In summary a contract qualifies as a financial instrument under this provision if the conditions in Article 38(1) are fulfilled on a cumulative basis and the contract is neither a spot contract as defined in Article 38(2) nor for commercial purposes as defined in Article 38(4).

"not being for commercial purposes"

46. Article 38(4) of 1287/2006/EC defines a specific type of commodity derivative contract as being for commercial purposes *"if it is entered into with or by an operator or administrator of an energy transmission grid, energy balancing mechanism or pipeline network, and it is necessary to keep in balance the supplies and uses of energy at a given time."* In such cases, the commodity derivative is not a financial instrument under MiFID I.

"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"

47. A contract which is not a spot contract, as defined under article 38(2) of 1287/2006/EC and is not covered by article 38(4) as being for commercial purposes, will be classed as a financial instrument under C7 if it meets one of the three criteria under Article 38(1)(a) in addition to the criteria under Articles 38(1)(b) and 38(1)(c) of 1287/2006/EC, as follows:

    a. *it meets one of the following sets of criteria:*

        i. *it is traded on a third country trading facility that performs a similar function to a regulated market or an MTF;*

        ii. *it is expressly stated to be traded on, or is subject to the rules of, a regulated market, an MTF or such a third country trading facility;*

        iii. *it is expressly stated to be equivalent to a contract traded on a regulated market, MTF or such a third country trading facility;*

b. *it is cleared by a clearing house or other entity carrying out the same functions as a central counterparty, or there are arrangements for the payment or provision of margin in relation to the contract;*

c. *it is standardised so that, in particular, the price, the lot, the delivery date or other terms are determined principally by reference to regularly published prices, standard lots or standard delivery dates.*

48. Article 38(1)(a)(ii) and (iii) require the commodity contract to have an express statement to be traded on a Regulated Market, MTF or similar third country trading facility or to be equivalent to such traded instrument respectively, not merely to be traded on such a trading venue or to be equivalent to a contract traded on such a trading venue.

49. An instrument which does not have these characteristics does not fall within C7. If the instrument does possess these characteristics, it will be deemed to not be for commercial purposes, as stated under Article 38(1) and therefore fall within C7.

Guidelines

1. ESMA considers that definition C7 of Annex 1 applies in the following way:

    a. C7 forms a category that is distinct from C6 and applies to commodity derivative contracts that can be physically settled which are not traded on a regulated market or an MTF providing that the commodity derivative contract:

        i. is not a spot contract as defined under Article 38(2) of Regulation 1287/2006/EC;

        ii. is not for the commercial purposes described under Article 38(4) of Regulation 1287/2006/EC; and

        iii. meets one of the three criteria under Article 38(1)(a) and also the separate criteria under Article 38(1)(b) and 38(1)(c) of 1287/2006/EC.

    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 relevant goods or the relevant quantity of the goods concerned (such as a bill of lading or a warehouse warrant); or

        iii. 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 (including notification, scheduling or nomination to the operator of an energy supply network) that entitles the recipient to the relevant quantity of the goods.

Questions

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

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Annex I: List of questions

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?**

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?**

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.**

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

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

Annex II: Cost-benefit analysis

I. Introduction

1. Article 16 of the ESMA Regulation[9] requires ESMA, where appropriate, to analyse the potential costs and benefits relating to proposed guidelines. It also states that cost-benefit analyses must be proportionate in relation to the scope, nature and impact of the proposed guidelines.

2. The objective of performing a cost-benefit analysis is to assess the costs and benefits of the various policy or technical options which were analysed during the process of drafting the guidelines.

3. The guidelines included in this report are of an optional nature, i.e. they are not envisaged in any Regulation, but are issued in line with Article 16 of ESMA Regulation in order to ensure uniform, consistent and coherent application of Union Law.

4. The choices or options envisaged by ESMA while drafting these guidelines were therefore limited to whether to issue these guidelines and ensure a consistent application of EMIR within the Union (which is one of ESMA's tasks) or not issuing them.

5. With reference to the classification of the financial instruments covered by these guidelines, different options were considered in view of the different applications and local specificities. ESMA considered that the lowest impacts in terms of costs for market participants was provided by the option supported and implemented by the majority of the NCAs.

II. Should these guidelines be issued?

6. The consistent application of MiFID aside, there are a number of directly applicable provisions in EMIR that would not apply in a uniform, consistent and coherent way within the Union in the absence of a clarification from ESMA on the classification of financial instruments as derivatives.

7. These directly applicable obligations relate to: the clearing obligation, the reporting obligation to TRs, the calculation of the clearing thresholds, risk mitigation techniques for OTC derivatives not cleared by a CCP and margin requirements for CCPs.

8. The costs implied by these guidelines can be summarised as the cost of changing current market practices, where necessary, and potentially enlarging the scope of MiFID and EMIR to financial instruments that were not initially considered to be covered by the regulation. These costs could be associated and would be to an extent similar to the costs of implementation of EMIR, which have already been analysed when the Commission proposal on EMIR was published[10].

9. As proved by the impact assessment of the Commission on EMIR, the benefits brought by the proposal significantly outweigh the costs. These guidelines aim at ensuring the uniform, consistent and coherent

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[9] Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC.

[10] http://ec.europa.eu/internal_market/financial-markets/derivatives/index_en.htm#maincontentSec1

application of MiFID and EMIR across the Union, which is an essential component of an EU Regulation that by its nature is directly applicable in all MS.

10. The absence of guidelines to clarify the classification of certain financial instruments as derivatives would have the following consequences:

    (a) An un-level playing field between entities subject to MiFID and EMIR established in different MS;

    (b) A lack of clarity among stakeholders on the classification of financial instruments and on the applicable rules;

    (c) Difficulties in implementing consistent approaches for groups or entities operating on a cross-border basis; and

    (d) Legal risks for stakeholders in view of the uncertainty resulting from the absence of a clear and consistent classification of financial instruments.

11. On the basis of the analysis above, ESMA concludes that the benefits of issuing guidelines on the classification of certain financial instruments as derivatives outweigh the costs.

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Annex III: Draft guidelines

I. Scope

Who?

2. These guidelines apply to national competent authorities.

What?

3. These guidelines apply in relation to the application of the definition of commodity derivatives under C6 and C7 listed in Section C of Annex I of MiFID.

When?

4. These guidelines apply from [*date*].

II. Definitions

5. Unless otherwise specified, terms used in the Markets in Financial Instruments Directive have the same meaning in these guidelines. In addition, the following definitions apply:

competent authority	an authority designated under Article 48 of the Markets in Financial Instruments Directive
Markets in Financial Instruments Directive	Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments

III. Purpose

6. The purpose of these guidelines is to ensure a common, uniform and consistent application of the definitions of commodity derivatives under C6 and C7 of Annex I of the Markets in Financial Instruments Directive.

7. According to Article 2(5) of Regulation (EU) No 648/2012 (EMIR) 'derivative' or 'derivative contract' means a financial instrument as set out in points (4) to (10) of Section C of Annex I to MIFID as implemented by Article 38 and 39 of Regulation (EC) No 1287/2006. The obligations resulting from Title II of EMIR and the related Commission Delegated Regulations (EU) No 148/2013 and 149/2013 (RTS on OTC derivatives) apply to derivatives or OTC derivatives. In addition, certain requirements for CCPs, as specified in Commission Delegated Regulation (EU) No 153/2013 (RTS on CCPs) only apply to OTC derivative contracts.

8. As explained in Recital 12 of EMIR, uniform rules are required for derivatives contracts set out in points (4) to (10) of Section C of Annex I to MiFID.

9. The application of MiFID in the different Member States gave rise, for certain types of instruments or contracts, to different interpretations among competent authorities on what should constitute a financial instrument and what should be classified as a derivative contract. These different interpre-

tations may lead to an inconsistent application of MiFID, EMIR and potentially other directives and regulations that rely on MiFID definitions of financial instruments.

10. A Regulation that is directly applicable in all the Member States cannot be applied differently in view of national interpretations of definitions included in a Directive. This is contrary to the spirit and objectives of the Regulation.

11. Against this background and in line with Article 29 of the ESMA Regulation, ESMA should ensure uniform and consistent application of directly applicable provisions, by ensuring consistent approaches throughout the Union. For this reason, a clarification for certain financial instruments for which different interpretations among Member States have been identified is needed.

12. Under EMIR the reporting obligation to trade repositories applies to all derivatives. This obligation is directly applicable across the Union. Different classifications of what constitutes a derivative contract may lead to the reporting of certain transactions in one Member State and not in others. This would lead to a non-uniform and inconsistent application of EMIR within the Union and eventually it would lead to an un-level playing field, which is contrary to the spirit of a Regulation.

13. Under EMIR the clearing obligation applies to OTC derivatives. The power to determine the classes of derivatives subject to the clearing obligation has been given to ESMA to ensure, amongst other things, one single uniform and consistent application of this obligation across the Union. If competent authorities adopt different classifications of what constitutes a derivative contract, the clearing obligation would not apply in a uniform manner across the Union, contravening the objectives of EMIR.

14. Under EMIR and the RTS on OTC derivatives, the calculation of the clearing threshold by non-financial counterparties is made on the basis of positions on OTC derivatives. From the calculation of the clearing threshold derives directly applicable obligations for non-financial counterparties. Different classifications of what constitutes a derivative contract would determine the inclusion of certain financial instruments in the calculation of the clearing threshold for financial counterparties established in some Member States (MS) and the exclusion of those for non-financial counterparties established in other MS. This would determine a non-uniform application of EMIR across the Union and an un-level playing field amongst non-financial counterparties, which is contrary to the principle of the direct applicability of EMIR across the Union.

15. Under EMIR and the RTS on OTC derivatives, the relevant obligations on risk mitigation techniques for OTC derivatives contracts not cleared by a CCP apply to OTC derivatives contracts. All of these obligations are directly applicable in the Union and should therefore apply in a uniform and consistent manner. Different classifications of what constitutes a derivative contract by different NCAs would lead to an inconsistent application of EMIR across the Union, which again is contrary to the Regulation.

16. Under the RTS on CCPs, higher margin requirements apply to OTC derivatives than to other financial instruments. If NCAs apply different classifications of what constitutes a derivative contract, a CCP established in one MS may face higher margin requirements than a CCP established in a different MS. Therefore, different classifications of what constitutes a derivative contract would lead to an un-level playing field among CCPs operating in the Union.

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IV. Compliance and reporting obligations

Status of the guidelines

17. This document contains guidelines issued under Article 16 of the ESMA Regulation[11]. In accordance with Article 16(3) of the ESMA Regulation competent authorities and financial market participants must make every effort to comply with guidelines and recommendations.

18. Competent authorities to whom the guidelines apply should comply by incorporating them into their supervisory practices, including where particular guidelines within the document are directed primarily at financial market participants.

Reporting requirements

19. Competent authorities to which these guidelines apply must notify ESMA whether they comply or intend to comply with the guidelines, with reasons for non-compliance, within two months of the date of publication by ESMA to secondary-markets-team@esma.europa.eu. In the absence of a response by this deadline, competent authorities will be considered as non-compliant. A template for notifications is available from the ESMA website.

20. Financial market participants are not required to report whether they comply with these guidelines.

V. Guidelines on the application of C6 and C7 of Annex 1 of MiFID

Application of C6 of Annex 1 of MiFID

21. ESMA considers that definition C6 of Annex 1 of MiFID applies in the following way:

    a. C6 has a broad application, applying to all commodity derivative contracts, including forwards, providing that:

        i. they can be physically settled; and

        ii. they are traded on a regulated market and/or an MTF.

    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 goods concerned; or,

        iii. 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.

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[11] Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC.

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Application of C7 of Annex 1 of MiFID I

22. ESMA considers that definition C7 of Annex 1 applies in the following way:

    a. C7 forms a category that is distinct from C6 and applies to commodity derivative contracts that can be physically settled which are not traded on a regulated market or an MTF providing that the commodity derivative contract:

        i. is not a spot contract as defined under Article 38(2) of Regulation 1287/2006/EC;

        ii. is not for the commercial purposes described under Article 38(4) of Regulation 1287/2006/EC; and

        iii. meets one of the three criteria under Article 38(1)(a) and also the separate criteria under Article 38(1)(b) and 38(1)(c) of 1287/2006/EC.

    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 goods concerned; or,

        iii. 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.

23. Physically settled commodity derivatives which do not fall within the definition of C6, i.e. are not traded on a Regulated Market or an MTF, may fall within the definition of C7and the definitions of C6 and C7 form two distinct categories as C7 applies to commodity derivatives "*that can be physically settled not otherwise mentioned in C.6*".

24. The other characteristics of commodity derivatives under C7 - "*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*" - are further defined under Article 38 of the MiFID I implementing regulation 1287/2006/EC.

25. ESMA notes that the conditions defined in Article 38 of Regulation 1287/2006/EC, whilst set out separately below, are to be applied cumulatively.