Deutsches Aktieninstitut

Comment on ESMA's Consultation Paper "Guidelines on the Application of C6 and C7 of Annex I of MiFID"

Take or Pay Clauses used in Commodity Contracts by the Real Economy are by no means Derivatives

Deutsches Aktieninstitut, 5th January 2015

Introduction

Deutsches Aktieninstitut[1] welcomes the opportunity to comment on ESMA's consultation regarding the definition of commodity derivatives under MiFID. We represent the view of non-financial companies using derivatives almost exclusively for risk-mitigating purposes. Our member companies have to comply with regulations like EMIR, which refer to the definitions discussed in the consultation paper. According to EMIR non-financial companies have to fulfil a number of obligations (e.g. reporting, risk mitigating techniques like timely confirmation and portfolio reconciliation etc.).

Therefore, we are very interested in an appropriate definition of "commodity derivative" to keep the administrative burden of compliance with the above mentioned requirements as lean as possible. This should apply in particular to contracts including take or pay clauses, as mentioned in Q3, which are by no means derivatives according to the respective MiFID-definitions. This was already clarified by the German supervisory authority BaFin and should be clarified by ESMA as well.

Please find below our answers to selected questions.

1 Deutsches Aktieninstitut represents the entire German economy interested in the capital markets. Its about 200 members are listed corporations, banks, stock exchanges, investors and other important market participants. Deutsches Aktieninstitut keeps offices in Frankfurt am Main, Brussels and in Berlin.

Our Answers to selected 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?

We oppose the approach of ESMA to define contracts that "must be physically settled" which is not covered by the level-1-text of MiFID I. MiFID I only refers to the term "can be physically settled" with the intention to define those contracts which are a financial instrument and which are, hence, in the scope of MiFID I.

The term "must be physically settled" is newly introduced under MiFID II. The intention is clearly different as it defines those instruments which are ***not*** covered as financial instrument. Therefore, we strongly urge ESMA to not address the definition of "must be physically settled" in the context of the proposed guidelines. This problem should exclusively be dealt with under the new definition of MiFID II.

Furthermore, to avoid competitive disadvantages for the European economy ESMA should better align its regulatory approach with the US regulation. This applies especially to physical forward commodity contracts which are exempted from the scope of Dodd-Frank where the critical factor is "the intent to make or take delivery".

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.

Contracts including "take or pay" clauses are broadly used in the real economy and should not be confused with financial instruments. These clauses are part of contracts for the delivery of commodities, e.g. gas, oil, coal, paper or metals. In addition, these contracts are used for the purchase of industrial parts, e.g. aluminium wheels in the automotive industry. The terms of the contracts are agreed bilaterally between the supplier of the commodities / parts and the corporate – trading on a regulated market or MTF does not take place.

According to "take or pay" a payment becomes due in the case the customer does not *take* the commodities physically as agreed in advance. In this case the customer has to *pay* a compensation. Take for example the delivery of 1.000 tons of steel. For the case that the corporate takes only 800 tons, e.g. due to changes in production plans, the supplier receives a payment of compensation for the 200 tons that are not being delivered. This compensation payment reflects the costs of the supplier for the readiness to deliver the commodities in due time. It could hence also be called a reservation fee, as the clear intention of this type of contract is always physical delivery of commodities required in operative businesses.

The German supervisory authority BaFin has already discussed whether these contracts should be treated as financial instruments / derivatives under MiFID. The BaFin came to the conclusion that this should not be the case.

We very much welcome this clarification for several reasons:

- These contracts should not be classified as derivative under C6 of MiFID as they are bilaterally agreed and not traded on a trading venue;

- In addition, they should not be treated as a derivative under C5 as the "pay-component" in "take or pay" clauses should not be confused with a cash settlement in a derivative contract. The main intention of the contracts in question is the purchase of a pre-defined amount of commodities at a pre-determined price. However, due to changing market conditions it might turn out that the amount agreed has been too high. For cases like this "take or pay" clauses provide the flexibility to adjust the amount of commodities to current needs. This flexibility, however, comes at a price for the purchaser which is expressed in the "pay component" of the contract. This component should therefore be interpreted as the cost for the flexibility to adjust contractual conditions.

- Furthermore, take or pay clauses do not provide the option of a cash settlement for one party as required under C5. In the case that the full amount of commodities is not purchased the customer is *obliged* to pay the compensatory payment – there is no optionality in fact.

For these reasons we would very much welcome the inclusion of a clarification that "take or pay" clauses used in commodity supply contracts of the real economy are not understood to be "settled in cash" and therefore are not MiFID-derivatives under the above mentioned conditions.

In addition, we do not share the view expressed in footnote 8 that ESMA is "not 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." Obviously, ESMA again confuses cash settlement with a cash compensation due to circumstances defined by both

contract partners in advance, e.g. force majeure or insolvency. These contracts should be continued to be classified as "can be physically settled".

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

We do not agree with ESMA's view to include forwards under the definition C.6 (p. 9) as the MiFID II text keeps the text of MiFID I unchanged. Therefore, it was the intention of the legislator to not include forwards in the definition of C6 which should not be "over-ruled" by ESMA.

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