European Securities and Markets Authority

The Chair

Date: 14 February 2014
ESMA/2014/184

Michel Barnier
Commissioner for Internal Market and Services
European Commission
BERL 12/181
B - 1049 Brussels
Belgium

Re: Classification of financial instruments as derivatives

Dear Commissioner Barnier,

I am writing to you to draw your attention to an issue that could have a significant detrimental effect on the consistent application of Regulation (EU) No 648/2014 on OTC derivatives, central counterparties and trade repositories (EMIR).

The matter is linked to the definition of derivative or derivative contract in EMIR[1], which refers to the list of financial instruments in Directive 2004/39/EC (MiFID). The different transpositions of MiFID across Member States mean that there is no single, commonly adopted definition of derivative or derivative contract in the European Union, thus preventing the convergent application of EMIR. This is particularly true in the case of foreign exchange (FX) forwards and physically settled commodity forwards. Differences in the definitions of what constitutes a derivative or derivative contract will result in the inconsistent application of EMIR, whose primary objective is regulating derivatives transactions. Please find annexed to this letter more background information on this issue and on the consequences that it has on the direct applicability of EMIR.

In accordance with Article 4(2) of MiFID, the Commission may clarify the definitions contained in MiFID through an implementing act, in order to take account of developments on financial markets, and to ensure the uniform application of the Directive.

[1] 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 Directive 2004/39/EC (MiFID) as implemented by Article 38 and 39 of Regulation (EC) No 1287/2006.

ESMA considers that for ensuring a consistent application of EMIR it is essential that the references to the MiFID definitions in the context of EMIR are clarified. ESMA, therefore, invites the Commission to adopt as a matter of urgency an implementing act under Article 4(2) of MiFID, or any other measure that the Commission considers appropriate, to clarify the above mentioned definitions. In particular, it would be important to clarify the following:

1. The definition of currency derivatives in relation to:
    i) the frontier between spot and forward;
    ii) their conclusion for commercial purposes.
2. The definition of commodity forwards that can be physically settled.

In order to avoid the inconsistent application of EMIR across the EU, ESMA understands that, until the Commission provides clarification, and to the extent permitted under national law, National Competent Authorities will not implement the relevant provisions of EMIR for contracts that are not clearly identified as derivatives contracts across the Union, in particular FX forwards with a settlement date up to 7 days, FX forwards concluded for commercial purposes, and physically settled commodity forwards, as identified in the annex.

ESMA is of course available to provide any assistance the Commission might need on this matter.

Yours sincerely,

Steven Maijoor

c.c. Mr Giannis Stournaras, Chair of Ecofin
Ms Sharon Bowles, Chair of ECON

ANNEX I – Background and impacts of a common definition of derivatives

1. According to Article 2(5) of Regulation (EU) No 648/2012[2] (EMIR) 'derivative' or 'derivative contract' means a financial instrument as set out in points (4) to (10) of Section C of Annex I to Directive 2004/39/EC[3] (MIFID) as implemented by Article 38 and 39 of Regulation (EC) No 1287/2006 (MIFID L2).

2. 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.

3. 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.

4. The transposition of MiFID in the different Member States gave rise, for certain types of instruments or contracts, to different definitions among Member States on what constitutes a financial instrument and what should be classified as a derivative contract. These different definitions sometimes included in national laws may lead to an inconsistent application of MiFID, EMIR and potentially other directives and regulations that rely on MiFID definitions of financial instruments.

5. The revision of MiFID, at this stage, is not expected to completely resolve the situation (in particular with respect to FX forwards) and will in any case not become applicable earlier than the end of 2016. .

6. A Regulation that is directly applicable in all the Member States cannot be applied differently in view of national transpositions of definitions included in a Directive. This is contrary to the spirit and objectives of the Regulation, which should be applied in a convergent fashion.

Identification of the problems caused by the different classification of financial instruments

7. 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.

8. 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 National Competent Authorities (NCAs) or national legislators 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.

[2] OJ L 201, 27.7.2012 p. 1

[3] OJ L145, 30.4.2004 p. 1

9. 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 derive 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 lead to a non-uniform application of EMIR across the Union and an un-level playing field amongst non-financial counterparties..

10. Under EMIR and the RTS on OTC derivatives, the relevant obligations on risk mitigation techniques for 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 Member States would lead to an inconsistent application of EMIR across the Union, which again is contrary to the Regulation.

11. Under the RTS on CCPs, higher margin requirements apply to OTC derivatives than to other financial instruments. If Member States 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.

Instruments for which the classification as derivatives is not uniform across the EU

FX derivatives

12. Differences arise, in particular for FX forwards, depending on the settlement or delivery date, i.e. the frontier between an FX spot and an FX derivative. From the analysis carried out by ESMA, it is not controversial that contracts that settle within two trading days are considered spot contracts and that contracts that settle after seven trading days are FX forwards. In certain countries the contracts that settle up to 7 days are not deemed to be derivatives. Therefore, for contracts with a settlement date between 3 and 7 trading days there are different national laws, in some Member States, determining whether they are or not a derivative. For these FX forwards there is not a common definition and, therefore, they are not clearly identified as derivatives across the Union.

13. Other differences arise because of the commercial nature of the transaction. Currency derivatives are mentioned in point (4) of Section C of Annex I to MIFID. Such a definition does not contain any reference on whether the currency derivatives are concluded for commercial purposes. The only reference to commercial purposes in the MiFID definitions is included in point (7) of Section C of Annex I to MIFID, which deals with commodities derivatives.

14. The European Commission issued a Q&A specifying the scope of MiFID provisions for the provision of investment services, stating that "*Even if FX forwards are qualified as a financial instrument in section C of Annex I to MiFID, their intermediation will be subject to MiFID requirements only in the case there is an investment service or activity performed in the sense of MiFID. In this respect, Annex I section B(4) of MiFID lists "foreign exchange services where connected to the provision of investment services" as an ancillary service, not as an investment service. Thus, FX forward transactions not connected to the provision of an investment service, i.e. commercial FX forward transactions, are not covered by MiFID. The qualification of FX forwards as a financial instrument is not important if there is no investment service or activity performed in the sense of MiFID.*"

15. Some Member States have therefore transposed MiFID by not considering as financial instruments FX forward transactions concluded for commercial purposes. These contracts are, therefore, not clearly identified as derivatives across the Union.

16. It should be noted that when ESMA developed the technical standards for the definition of the clearing threshold for non-financial counterparties, it considered the basic definition of MiFID, i.e. a potentially wide scope for the definition of FX derivatives. At that time National Competent Authorities and stakeholders did not raise issues of different definitions of FX derivatives among Member States and possible carve outs by some Member States of FX derivatives concluded for commercial purposes.

17. In addition, it should be noted that derivatives concluded for hedging purposes are already excluded from the calculation of the clearing threshold and specific criteria need to be met by transactions concluded by non-financial counterparties to qualify as hedging transactions (as defined in technical standards developed by ESMA). The concept of commercial purposes might potentially be broader than the hedging one.

Physically settled commodity forwards

18. With reference to physically settled commodity forwards, it should be noted that the interpretation and application of definitions in points 6 and 7 of Section C of Annex I to MIFID (C6 and C7) is not convergent across the EU. These definitions have given rise to the following queries:

    a. C7 explicitly applies to "futures" and "forwards" whereas C6 omits any reference to forwards. Consequently, there are divergent views with regard to whether physical forwards traded on a regulated market or a MTF fall within MiFID's scope.

    b. C6 and C7 apply 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 should be considered for the identification of the contracts that fall within the definition of derivatives.

19. Contracts under point a. above and for which the definitions under point b. are relevant, are not clearly identified as derivatives across the Union.