ISDA Safe, Efficient Markets

July 31, 2014

ISDA MiFID CP Submission

Section 3.3. – the definition of systematic internaliser

Q128: For the systematic and frequent criterion, do you agree that the thresholds should be set per asset class? Please provide reasons for your answer. If you consider the thresholds should be set at a more granular level (sub-categories) please provide further detail and justification.

Calculations and Thresholds

We note that, contrary to the implication inherent in the question, at paragraph 20 of Section 3.3 of the CP, ESMA states that 'for emissions allowances and derivatives [it] intends to use the segmentation of asset classes into sub-categories presented in Annex 3.6.1 of the DP … in order to identify at what level the threshold for qualifying as a systematic internaliser". Annex 3.6.1 of the DP sets out multiple categories and sub-categories of derivatives and it is therefore unclear to which sub-categories ESMA is referring.

In our view it is necessary to distinguish between: (i) the level at which the calculations should be conducted and (ii) the level at which the thresholds should be set.

Level at which the calculations should be conducted

We are of the view that the calculations for the purposes of "frequent and systematic" and "substantial" should be conducted at the level of the instrument sub-categories set out in the fourth column (recommended liquidity sub-categories) of the relevant taxonomy table below (e.g. a 3 month EUR interest rate swap should be considered to be a different instrument to a 6 month EUR interest rate swap). We are of this view for the following reasons:

1. this level of granularity most closely aligns with the ISIN approach which ESMA proposes to adopt for bonds and structured finance products and with recital (19) of MIFIR which states that 'the requirement for systematic internalisers … should apply to an investment firm only in relation to each single financial instrument, for example on ISIN-code level, in which it is a systematic internaliser';

2. Articles 18(1) and (2) impose different obligations in respect of instruments for which there is a liquid market than for those for which there is not a liquid market. For the sake of consistency and avoidance of confusion, the calculation levels in respect of the definition of systematic internaliser should align with the sub-categories at which the liquid market test will be conducted; and

3. if the calculations were carried out at an asset class level, investment firms which had a large or dominant presence in a particular sub-category of derivative contract, could fall

outside the scope of the definition of systematic internaliser if its trading in a particular class of derivative represented an insubstantial part of the relevant firm's total trading and/or an insubstantial part of the total trading of the relevant class of derivative in the EU. In our view, such an outcome would frustrate the purpose of the systematic internaliser regime.

Level at which the thresholds should be set

We recognise that it would be burdensome for ESMA to calculate and set different thresholds for each of the instrument sub-categories set out in the fourth column (recommended liquidity sub-categories) of the relevant taxonomy table below. In our view, this would also add unnecessary operational complexity for investment firms.

Therefore, for derivatives, we propose that the relevant thresholds for the purposes of "frequent and systematic" and "substantial" should be set per sub-product types set out in the third column of the relevant taxonomy table below (e.g. thresholds would be set at the level of each of fixed-to-floating (vanilla), fixed-to-floating (basis) and inflation Interest Rate Swaps).

As stated above, in calculating whether it falls within the definition of a Systematic Internaliser, an investment firm would calculate whether the relevant threshold (e.g. the threshold set for fixed-to-floating (vanilla) interest rate swaps) is exceeded in respect of a specific sub-category of instrument (e.g. a 3 month EUR fixed–to-floating interest rate swap).

Taxonomy tables

For the avoidance of doubt, the tables produced below are identical to those we have proposed in response to question 115 of the Discussion Paper.

Interest Rate Derivatives

Financial Instrument	Product Types	Sub-Product Types	Recommended Liquidity sub-categories
Interest Rate Derivatives	Futures	N/A	Notional currency
	Options	ETD Options	
		Caps, floors & collars	
		Debt options	Tenor
		Swaptions	
	Interest Rate Swaps	Fixed-to-fixed	Forward-Starting Term
		Fixed-to-floating (vanilla)	
		Fixed-to-floating (basis)	Plain vanilla products vs products incorporating non-
		Inflation	

		OIS	standard features (e.g. embedded options, conditional notional, etc) At the money (for options Sub-product) Out of the money (for options Sub-product)
	Cross-Currency Swaps	Basis	
		Fixed-to-floating	
		Fixed-to-fixed	
	Forward Rate Agreement	N/A	
	Others	Exotic	

Equity Derivatives

Financial Instrument	Product Types	Sub-Product Types	Recommended Liquidity sub-categories
Equity Derivatives	Futures	Equity	Type of underlying asset (Single Name / Single Index / Basket / Hybrid)
		Dividend	
		Volatility	
		Variance	
	Forwards	Equity	
	Swaps	Equity - Open	Liquidity of underlyer
		Equity - Term	Underlying Maturity At the money (for options Product Type) Out of the money
		Dividend	
		Correllation	
		Variance and Forward Variance	
		Volatility	
	Options	ETD (Listed) Options	
		Equity (OTC) Options	
		Dividend	

			(for options Product Type)
		Volatility	
		Variance	
	Other	Equity Multi Asset Path Dependency	
		Equity Multi Asset non-Path Dependency	
		Explicit Hybrid	
		Equity Single Asset Path Dependency	
		Other	
	Portfolio Swaps	N/A	

Commodity Derivatives

Financial Instrument	Underlying Product (grouped for ease of illustration)		Sub-Product Types	Recommended Liquidity sub-categories
Commodity Derivatives	Metals (ME)	Underlying - to be delineated at the most granular level	Non-Exotics (Spot fwd / Future / Swap / Option / Loan lease / Transmission)	Maturity
	Energy (EN)			
	Index (IN)			
	Agricultural (AG)			
	Environmental		Exotic	
	Freights			
	Emission Allowances			

Credit Derivatives

Financial Instrument	Product Types	Sub-Product Types	Recommended Liquidity sub-categories
Credit Derivatives	Single name	Corporate financial	Maturity
		Corporate non-financial IG *	
		Corporate non-financial HY **	
		Recovery CDS	
		Loans	

		Muni	
		Sovereign	Currency
		ABS	
	Total Return Swaps	N/A	
	Swaptions	iTraxx	
		Muni	
		CDX	
		MCDX	
		Sovereign	
		Corporate	
	Exotic	Coprporate	
		Structured CDS	
		Other	
	Index Tranched	CDX	"on-the-run" vs "off-the-run"
		LCDX	
		MCDX	
		CDX Structured Tranche	
		iTraxx	
		iTraxx Structured Tranche	
		ABX	
	Index Untranched	CDX	Currency
		LCDX	
		MCDX	
		iTraxx	
		ABX	
		CMBX	
		IOS	
		MBX	
		PO	
		PrimeX	
		TRX	

* For Investment Grade ("IG"), market convention is to consider a credit rating of BBB- or higher by Standard & Poors or Fitch or Baa3 or higher by Moody's to be Investment Grade. We recommend ESMA adopt this definition.

** All single names not qualifying as IG would be deemed High Yield ("HY").

Draft technical advice in respect of non-equity instruments

Definition of transaction

In our view it is necessary for ESMA to clarify that the following shall be excluded from the 'number of transactions executed by the investment firm on own account' and from the 'total number of transactions in the same financial instrument in the EU':

a) inter affiliate trades purely for risk management;

b) give-ups;

c) trades arising out risk mitigation/trade compression (Trioptima);

d) repo settles;

e) OTC clearing flows; and

f) post-trade allocations of transactions amongst multiple beneficial owners where the collection of transactions was originally transacted as a block trade.

In the absence of such exemptions total trade figures are unlikely to be accurate.

When executing client orders

Article 4(1)(20) MiFID II defines a Systematic Internaliser as 'an investment firm which, on an organised, frequent, systematic and substantial basis, deals on own account by executing client orders outside a regulated market, an MTF or an OTF without operating a multilateral system'. The definition specifies that 'the frequent and systemic basis shall be measured by number of OTC trades in the financial instrument carried out by the investment firm on own account when executing client orders' and that the substantial basis shall be measured by reference to 'the size of the OTC trading carried out the by investment firm' (i.e. it is also referable to the number of OTC trades carried out by the investment firm on own account when executing client orders). We note, however, the draft technical advice proposes to measure whether the trading is frequent, systemic and substantial by reference to the number of OTC trades carried out by the investment firm on its own account (irrespective of whether the firm is executing client orders). This approach is inconsistent with the Level 1 requirements and we propose that the technical advice is amended to include references to 'when executing client orders'.

In assessing whether it is an Systematic Internaliser an investment firm will need to be able to distinguish between trades (i) carried out on own account when executing client orders, (ii) carried out on own account without executing client orders and (iii) entered into with a third party which is not its client. These distinctions are already relevant in the context of the best execution obligations under MiFID and CESR and the Commission issued guidance on these issues in 2007 (CESR/07-320). In the interests of clarity, we urge ESMA and the Commission to provide guidance on these issues in the context of the Systematic Internaliser regime.

The obligations under Article 18 of MiFIR apply to investment firms in respect of 'bonds, structured finance products, emissions allowances and derivatives … for which they are systematic internalisers'. As discussed above, the reference to 'executing client orders' is integral to the definition of a systematic internaliser. Accordingly, an investment firm will only constitute a systematic internaliser where it is proposing to execute a client order. If the investment firm is not proposing to execute a client order, in our view the obligations under Article 18 should not apply (even where the thresholds are met or the relevant investment firm has chosen to opt-in to

the systematic internaliser regime). We therefore urge ESMA and the Commission to provide clarity on this issue.

Liquid instruments

In addition we propose that, for the sake of consistency and for the avoidance of confusion, ESMA should amend paragraph 1 (i) of the draft technical advice to refer to 'instruments for which there is a liquid market' rather than 'liquid instruments'.

Q129: With regard to the 'substantial basis' criterion, do you support thresholds based on the turnover (quantity multiplied by price) as opposed to the volume (quantity) of instruments traded. Do you agree with the definition of total trading by the investment firm? If not please provide alternatives and reasons for your answer.

No. In our view the threshold for the 'substantial basis' criterion should be based on notional rather than based on turnover. A notional based approach is constituent with existing market practice. By contrast, a turnover based approach introduces the possibility that price volatility could influence the assessment of a firm's status as a Systematic Internaliser, or even result in arbitrage if firms attempt to price in a manner that avoids exceeding relevant thresholds.

Draft technical advice in respect of non-equity instruments

Definition of transaction

In our view it is necessary for ESMA to clarify that the following shall be excluded from the 'total trading by the investment firm' and from 'total turnover in the EU':

a) inter affiliate trades purely for risk management;

b) give-ups;

c) trades arising out risk mitigation/trade compression (Trioptima);

d) repo settles;

e) OTC clearing flows; and

f) Post-trade allocations of transactions amongst multiple beneficial owners where the collection of transactions was originally transacted as a block.

In the absence of such exemptions total trade figures are unlikely to be accurate.

When executing client orders

Article 4(1)(20) MiFID II defines a Systematic Internaliser as 'an investment firm which, on an organised, frequent, systematic and substantial basis, deals on own account <u>by executing client</u>

orders outside a regulated market, an MTF or an OTF without operating a multilateral system'. The definition specifies that 'the frequent and systemic basis shall be measured by number of OTC trades in the financial instrument carried out by the investment firm on own account when executing client orders' and that the substantial basis shall be measured by reference to 'the size of the OTC trading carried out the by investment firm' (i.e. it is also referable to the number of OTC trades carried out by the investment firm on own account when executing client orders). We note, however, the draft technical advice proposes to measure whether the trading is frequent, systemic and substantial by reference to the number of OTC trades carried out by the investment firm on its own account (irrespective of whether the firm is executing client orders). This approach is inconsistent with the Level 1 requirements and we propose that the technical advice is amended to include references to 'when executing client orders'.

In assessing whether it is an Systematic Internaliser an investment firm will need to be able to distinguish between trades (i) carried out on own account when executing client orders, (ii) carried out on own account without executing client orders and (iii) entered into with a third party which is not its client. These distinctions are already relevant in the context of the best execution obligations under MiFID and CESR and the Commission issued guidance on these issues in 2007 (CESR/07-320). In the interests of clarity, we urge ESMA and the Commission to provide guidance on these issues in the context of the Systematic Internaliser regime.

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Liquid instruments

In addition we propose that, for the sake of consistency and for the avoidance of confusion, ESMA should amend paragraph 1 (i) of the draft technical advice to refer to 'instruments for which there is a liquid market' rather than 'liquid instruments'.

Q131: For derivatives, do you agree that some aggregation should be established in order to properly apply the systematic internaliser definition? If yes, do you consider that the tables presented in Annex 3.6.1 of the DP could be used as a basis for applying the systematic internaliser thresholds to derivatives products? Please provide reasons, and when necessary alternatives, to your answer.

Calculations and Thresholds

We note that, contrary to the implication inherent in the question, at paragraph 20 of Section 3.3 of the CP, ESMA states that 'for emissions allowances and derivatives [it] intends to use the

segmentation of asset classes into sub-categories presented in Annex 3.6.1 of the DP … in order to identify at what level the threshold for qualifying as a systematic internaliser". Annex 3.6.1 of the DP sets out multiple categories and sub-categories of derivatives and it is therefore unclear to which sub-categories ESMA is referring.

In our view it is necessary to distinguish between: (i) the level at which the calculations should be conducted and (ii) the level at which the thresholds should be set.

Level at which the calculations should be conducted

We are of the view that the calculations for the purposes of "frequent and systematic" and "substantial" should be conducted at the level of the instrument sub-categories set out in the fourth column (recommended liquidity sub-categories) of the relevant taxonomy table below (e.g. a 3 month EUR interest rate swap should be considered to be a different instrument to a 6 month EUR interest rate swap). We are of this view for the following reasons:

1. this level of granularity most closely aligns with the ISIN approach which ESMA proposes to adopt for bonds and structured finance products and with rectial (19) of MIFIR which states that 'the requirement for systematic internalisers … should apply to an investment firm only in relation to each single financial instrument, for example on ISIN-code level, in which it is a systematic internaliser';

2. Articles 18(1) and (2) impose different obligations in respect of instruments for which there is a liquid market than for those for which there is not a liquid market. For the sake of consistency and avoidance of confusion, the calculation levels in respect of the definition of systematic internaliser should align with the sub-categories at which the liquid market test will be conducted; and

3. if the calculations were carried out at an asset class level, investment firms which had a large or dominant presence in a particular sub-category of derivative contract, could fall outside the scope of the definition of systematic internaliser if its trading in a particular class of derivative represented an insubstantial part of the relevant firm's total trading and/or an insubstantial part of the total trading of the relevant class of derivative in the EU. In our view, such an outcome would frustrate the purpose of the systematic internaliser regime.

Level at which the thresholds should be set

We recognise that it would be burdensome for ESMA to calculate and set different thresholds for each of the instrument sub-categories set out in the fourth column (recommended liquidity sub-categories) of the relevant taxonomy table below. In our view, this would also add unnecessary operational complexity for investment firms.

Therefore, for derivatives, we propose that the relevant thresholds for the purposes of "frequent and systematic" and "substantial" should be set per sub-product types set out in the third column

of the relevant taxonomy table below (e.g. thresholds would be set at the level of each of fixed-to-floating (vanilla), fixed-to-floating (basis) and inflation Interest Rate Swaps).

As stated above, in calculating whether it falls within the definition of a Systematic Internaliser, an investment firm would calculate whether the relevant threshold (e.g. the threshold set for fixed-to-floating (vanilla) interest rate swaps) is exceeded in respect of a specific sub-category of instrument (e.g. a 3 month EUR fixed–to-floating interest rate swap).

Taxonomy tables

For the avoidance of doubt, the tables produced below are identical to those we have proposed in response to question 115 of the Discussion Paper.

Interest Rate Derivatives

Financial Instrument	**Product Types**	**Sub-Product Types**	**Recommended Liquidity sub-categories**
Interest Rate Derivatives	Futures	N/A	Notional currency Tenor Forward-Starting Term Plain vanilla products vs products incorporating non-standard features (e.g. embedded options, conditional notional, etc) At the money (for options Sub-product) Out of the money (for options Sub-product)
	Options	ETD Options	
		Caps, floors & collars	
		Debt options	
		Swaptions	
	Interest Rate Swaps	Fixed-to-fixed	
		Fixed-to-floating (vanilla)	
		Fixed-to-floating (basis)	
		Inflation	
		OIS	
	Cross-Currency Swaps	Basis	
		Fixed-to-floating	
		Fixed-to-fixed	
	Forward Rate Agreement	N/A	
	Others	Exotic	

Equity Derivatives

Financial Instrument	Product Types	Sub-Product Types	Recommended Liquidity sub-categories
Equity Derivatives	Futures	Equity	Type of underlying asset (Single Name / Single Index / Basket / Hybrid)
		Dividend	
		Volatility	
		Variance	
	Forwards	Equity	
	Swaps	Equity - Open	Liquidity of underlyer
		Equity - Term	Underlying Maturity At the money (for options Product Type) Out of the money (for options Product Type)
		Dividend	
		Correllation	
		Variance and Forward Variance	
		Volatility	
	Options	ETD (Listed) Options	
		Equity (OTC) Options	
		Dividend	
		Volatility	
		Variance	
	Other	Equity Multi Asset Path Dependency	
		Equity Multi Asset non-Path Dependency	
		Explicit Hybrid	
		Equity Single Asset Path Dependency	
		Other	
	Portfolio Swaps	N/A	

Commodity Derivatives

<table>
<tr><th>Financial Instrument</th><th colspan="2">Underlying Product (grouped for ease of illustration)</th><th>Sub-Product Types</th><th>Recommended Liquidity sub-categories</th></tr>
<tr><td rowspan="7">Commodity Derivatives</td><td>Metals (ME)</td><td rowspan="7">Underlying - to be delineated at the most granular level</td><td rowspan="5">Non-Exotics (Spot fwd / Future / Swap / Option / Loan lease / Transmission)</td><td rowspan="5">Maturity</td></tr>
<tr><td>Energy (EN)</td></tr>
<tr><td>Index (IN)</td></tr>
<tr><td>Agricultural (AG)</td></tr>
<tr><td>Environmental</td></tr>
<tr><td>Freights</td><td rowspan="2">Exotic</td><td rowspan="2"></td></tr>
<tr><td>Emission Allowances</td></tr>
</table>

Credit Derivatives

<table>
<tr><th>Financial Instrument</th><th>Product Types</th><th>Sub-Product Types</th><th>Recommended Liquidity sub-categories</th></tr>
<tr><td rowspan="22">Credit Derivatives</td><td rowspan="8">Single name</td><td>Corporate financial</td><td rowspan="6">Maturity</td></tr>
<tr><td>Corporate non-financial IG *</td></tr>
<tr><td>Corporate non-financial HY **</td></tr>
<tr><td>Recovery CDS</td></tr>
<tr><td>Loans</td></tr>
<tr><td>Muni</td></tr>
<tr><td>Sovereign</td><td>Currency</td></tr>
<tr><td>ABS</td><td rowspan="13"></td></tr>
<tr><td>Total Return Swaps</td><td>N/A</td></tr>
<tr><td rowspan="6">Swaptions</td><td>iTraxx</td></tr>
<tr><td>Muni</td></tr>
<tr><td>CDX</td></tr>
<tr><td>MCDX</td></tr>
<tr><td>Sovereign</td></tr>
<tr><td>Corporate</td></tr>
<tr><td rowspan="3">Exotic</td><td>Coprporate</td></tr>
<tr><td>Structured CDS</td></tr>
<tr><td>Other</td></tr>
<tr><td rowspan="2">Index Tranched</td><td>CDX</td></tr>
<tr><td>LCDX</td></tr>
</table>

		MCDX	"on-the-run" vs "off-the-run"
		CDX Structured Tranche	
		iTraxx	
		iTraxx Structured Tranche	
		ABX	
	Index Untranched	CDX	Currency
		LCDX	
		MCDX	
		iTraxx	
		ABX	
		CMBX	
		IOS	
		MBX	
		PO	
		PrimeX	
		TRX	

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Liquid instruments

In addition we propose that, for the sake of consistency and for the avoidance of confusion, ESMA should amend paragraph 1 (i) of the draft technical advice to refer to 'instruments for which there is a liquid market' rather than 'liquid instruments'

Q132: Do you agree with ESMA's proposal to set a threshold for liquid derivatives? Do you consider any scenarios could arise where systematic internalisers would be required to meet pre-trade transparency requirements for liquid derivatives where the trading obligation does not apply?

Yes, we agree with ESMA's proposal to set a threshold for liquid derivatives on the basis that we consider it is likely that FX derivatives will be sufficiently liquid for the pre-trade transparency requirements to apply notwithstanding the clearing obligation (and therefore the trading obligation) should not apply.

Q133: Do you consider a quarterly assessment by investment firms in respect of their systematic internaliser activity is adequate? If not, what assessment period would you propose?

Yes, we agree with ESMA's suggestion of a quarterly assessment.

Q134: Within the ranges proposed by ESMA, what do you consider to be the appropriate level? Please provide reasons for your answer. If you consider that the threshold should be set at a level outside this range, please specify at what level this should be with justifications and where possible data to support them.

The Minimum Trading Frequency of once per week should apply to instruments in which there is a Liquid markets

We encourage ESMA to ensure greater consistency between the thresholds to qualify as an SI in liquid and illiquid instruments than is implied by the table on page 198 of the CP. If we take the examples provided on page 127 of the DP, an instrument could be deemed liquid if it trades just 240 times per year. The range of percentages for liquid instruments presented on page 198 of the CP (2 to 5% across bonds and SFPs) imply that firms could qualify as an SI in a liquid instrument that it trades fewer than 5 times per year. This appears inconsistent with the minimum frequency required for illiquid instruments of once per week. Therefore, we recommend that ESMA adopt a Minimum Trading Frequency of once per week for liquid instruments, in addition to illiquid instruments.

The "Systematic and Frequent thresholds (liquid instruments)", and "Substantial Basis (criteria 2)" should be calibrated with the objective of capturing approximately 80-90% of addressable liquidity in each instrument type

We propose that ESMA set the SI thresholds for "frequent and systematic (liquid instruments)" and "substantial (criteria 2)" such that 80 – 90% of addressable liquidity in a given instrument is captured in the SI regime. We believe this will ensure that the vast majority of liquidity provided by market making firms and other liquidity providers in any given instrument is brought into scope, and will help ensure a level playing field among investment firms in the relevant markets. For "substantial" category 1, we agree with the proposed percentages of 25% for derivatives.

If ESMA agrees with our proposal, the percentage thresholds that should be set for each asset class – both for the "frequent and systematic (liquid instruments)" and "substantial (criteria 2) tests – will need to differ depending on the number of investment firms that are actively engaged in providing liquidity to each asset class. ESMA will require a greater understanding of the composition of market shares in each asset class, both in terms of the number of market makers, and their relative market shares. As ESMA notes in DP 3.13 paras 1 and 2, in order to make this

assessment, ESMA will need to obtain robust, high quality data for each asset class or instrument as relevant from trading venues and APAs so that the percentages are calibrated based on actual and representative market data. We welcome ESMA's efforts in this regard as we consider this to be the most important factor in setting the thresholds appropriately and we would welcome the opportunity to work with ESMA to calibrate the thresholds.

To reiterate we believe it is necessary to draw a distinction between (i) the level at which the thresholds should be set and (ii) the level at which the calculations should be conducted. In our view the relevant thresholds for the purposes of "frequent and systematic" and "substantial" should be set per sub-product types as set out in the third column of the relevant taxonomy table below (e.g. thresholds would be set at the level of each of fixed-to-floating (vanilla), fixed-to-floating (basis) and inflation Interest Rate Swaps). However, the calculations for the purposes of "frequent and systematic" and "substantial" should be conducted at the level of the instrument sub-categories set out in the fourth column (recommended liquidity sub-categories) of the relevant taxonomy table below (e.g. a 3 month EUR interest rate swap should be considered to be a different instrument to a 6 month EUR interest rate swap).

Proposed table of thresholds

We recommend that ESMA put forward the following table of thresholds as part of its draft technical advice :

		Derivatives
Frequent and systematic basis threshold (liquid instruments)	Minimum trading frequency	At least once a week AND to be calibrated by sub-product types as set out in the third column of the relevant table below in order to ensure that 80% - 90% of addressable liquidity in the sub-product types as set out in the third column of the relevant table below is captured
	Number of transactions executed by the investment firm on own account OTC / total number of transactions in the same financial instrument in the EU	
Frequent and systematic basis threshold (illiquid instruments)	Minimum trading frequency	At least once a week
Substantial basis threshold Criteria 1	Size of OTC trading by investment firm in a financial instrument on own account / total turnover in the same financial instrument executed by the investment firm	25%
Substantial basis threshold Criteria	Size of OTC trading by investment firm in a financial instrument on own account / total	To be calibrated by sub-product types as set out

2	turnover in the same financial instrument in the European Union	in the third column of the relevant table below in order to ensure that 80% - 90% of addressable liquidity in the sub-product types as set out in the third column of the relevant table below is captured

Taxonomy tables
For the avoidance of doubt, the tables produced below are identical to those we have proposed in response to question 115 of the Discussion Paper.

Interest Rate Derivatives

<table>
<tr><th>Financial Instrument</th><th>Product Types</th><th>Sub-Product Types</th><th>Recommended Liquidity sub-categories</th></tr>
<tr><td rowspan="14">Interest Rate Derivatives</td><td>Futures</td><td>N/A</td><td rowspan="14">Notional currency

Tenor

Forward-Starting Term

Plain vanilla products vs products incorporating non-standard features (e.g. embedded options, conditional notional, etc)

At the money (for options Sub-product)

Out of the money (for options Sub-product)</td></tr>
<tr><td rowspan="4">Options</td><td>ETD Options</td></tr>
<tr><td>Caps, floors & collars</td></tr>
<tr><td>Debt options</td></tr>
<tr><td>Swaptions</td></tr>
<tr><td rowspan="5">Interest Rate Swaps</td><td>Fixed-to-fixed</td></tr>
<tr><td>Fixed-to-floating (vanilla)</td></tr>
<tr><td>Fixed-to-floating (basis)</td></tr>
<tr><td>Inflation</td></tr>
<tr><td>OIS</td></tr>
<tr><td rowspan="3">Cross-Currency Swaps</td><td>Basis</td></tr>
<tr><td>Fixed-to-floating</td></tr>
<tr><td>Fixed-to-fixed</td></tr>
<tr><td>Forward Rate Agreement</td><td>N/A</td></tr>
</table>

	Others	Exotic	

Equity Derivatives

Financial Instrument	Product Types	Sub-Product Types	Recommended Liquidity sub-categories
Equity Derivatives	Futures	Equity	Type of underlying asset (Single Name / Single Index / Basket / Hybrid)
		Dividend	
		Volatility	
		Variance	
	Forwards	Equity	
	Swaps	Equity - Open	Liquidity of underlyer
		Equity - Term	Underlying
		Dividend	
		Correllation	
		Variance and Forward Variance	Maturity
		Volatility	
	Options	ETD (Listed) Options	
		Equity (OTC) Options	At the money (for options Product Type)
		Dividend	Out of the money (for options Product Type)
		Volatility	
		Variance	
	Other	Equity Multi Asset Path Dependency	
		Equity Multi Asset non-Path Dependency	
		Explicit Hybrid	
		Equity Single Asset Path Dependency	
		Other	
	Portfolio Swaps	N/A	

Commodity Derivatives

Financial Instrument	Underlying Product (grouped for ease of illustration)		Sub-Product Types	Recommended Liquidity sub-categories
Commodity Derivatives	Metals (ME)	Underlying - to be delineated at the most granular level	Non-Exotics (Spot fwd / Future / Swap / Option / Loan lease / Transmission)	
	Energy (EN)			
	Index (IN)			Maturity
	Agricultural (AG)			
	Environmental			
	Freights		Exotic	
	Emission Allowances			

Credit Derivatives

Financial Instrument	Product Types	Sub-Product Types	Recommended Liquidity sub-categories
Credit Derivatives	Single name	Corporate financial	Maturity
		Corporate non-financial IG *	
		Corporate non-financial HY **	
		Recovery CDS	
		Loans	
		Muni	
		Sovereign	Currency
		ABS	
	Total Return Swaps	N/A	
	Swaptions	iTraxx	
		Muni	
		CDX	
		MCDX	
		Sovereign	
		Corporate	
	Exotic	Coprporate	
		Structured CDS	
		Other	
	Index Tranched	CDX	

		LCDX	"on-the-run" vs "off-the-run"
		MCDX	
		CDX Structured Tranche	
		iTraxx	
		iTraxx Structured Tranche	
		ABX	
	Index Untranched	CDX	Currency
		LCDX	
		MCDX	
		iTraxx	
		ABX	
		CMBX	
		IOS	
		MBX	
		PO	
		PrimeX	
		TRX	

* For Investment Grade ("IG"), market convention is to consider a credit rating of BBB- or higher by Standard & Poors or Fitch or Baa3 or higher by Moody's to be Investment Grade. We recommend ESMA adopt this definition.

** All single names not qualifying as IG would be deemed High Yield ("HY").

Q135: Do you consider that thresholds should be set as absolute numbers rather than percentages for some specific categories? Please provide reasons for your answer.

No we do not consider that thresholds should be set as absolute numbers rather than percentages.

Section 3.8 - Pre-trade transparency for systematic internalisers in non-equity instruments

Q141: Do you agree that the risks a systematic internaliser faces is similar to that of an liquidity provider? If not, how do they differ?

Yes, we agree that the risks an SI faces is similar to that of a liquidity provider.

On a more general note, we would like to draw to ESMA's attention that certain key features of the pre-trade transparency regime for non-equity instruments have been omitted from the summary of Article 18 of MIFIR which appears at paragraphs 2 to 6 of Section 3.8 of the CP. In particular, we would note that:

1. As per Article 18(6), an exemption to the duty to publish firm quotes is available where the relevant NCA has suspended the Article 8 pre-trade transparency requirements due to a fall in the liquidity of the relevant instrument below a certain threshold (Article 9(4)). Paragraph 6 of Section 3.8 of the CP implies this exemption is available only in relation to the duty to make the quote available to other clients.

2. The summary fails to acknowledge that the SI is 'allowed to decide on the basis of their commercial policy and in an objective and non-discriminatory way, the clients to whom they give access to their quotes'. This contrasts with Section 3.10 of the DP which specifically acknowledges this right.

Given the impact of the above on the scope of the pre-trade transparency regime for non-equity instruments, in our view they should have been expressly addressed in paragraphs 2 to 6 and should be included in any future summaries.

Q142: Do you agree that the sizes established for liquidity providers and systematic internalisers should be identical? If not, how should they differ?

Yes, we agree that the sizes established for liquidity providers and SIs should be identical.

Section 7.1 - Financial instruments definition - specifying Section C 6, 7 and 10 of Annex I of MiFID II

Q213: Do you agree with ESMA's approach on specifying contracts that "must" be physically settled and contracts that "can" be physically settled?

We generally agree with the approach proposed by ESMA, however we would like to point out some clarifications because the differentiation of 'can' and 'must' be physically settled may be difficult to assess upon entry into a contract for those wholesale energy products and energy derivatives that are eventually settled physically where transfer of ownership takes place upon execution.

In any case our understanding is that:

- where contracts must be settled in cash or have an option to settle in cash at the option of one of the parties, these should be assessed under C.5;
- only contracts without (option for) cash settlement that 'can be' or 'must be' physically settled need to be assessed under C.6 or C.7, depending on the place of execution and the other conditions set out in these sections. However when cash settlement takes place 'by reason of default or other termination events', this should not give reason to any assessment under Annex I Section C, as this is merely an exception to the normal settlement of the contract. The wording in C5 and the spirit of C6 and C7 confirm this understanding; and
- a commodity derivative contract that is cash-settled by mutual consent must explicitly contain provisions for cash-settlement by mutual agreement. In our experience this does not happen very frequently. In any case it is most likely that if mutual agreement between the parties to cash settle is reached, this would result in the contract being categorised as falling under section C.5.

In legal terms primary and secondary contractual obligations have to be distinguished. A contract is classified as a derivative financial instrument within the meaning of C.5, if a party has the primary contractual right to cash settle or opt for a cash settlement. In contrast, if cash settlement takes place because of early termination or because of an event of default, the compensation for damages is a secondary obligation which replaces the primary obligation.

In relation to the draft technical advice we understand the 'waterfall' of the definitions in a way that contracts which are excluded from the definition of financial instruments under Annex I Section C.6 (must be physically settled wholesale energy products and traded on a OTF), are not be required to be tested further against the criteria defined in C.7 and the related implementing rules. The wording "*not otherwise mentioned in point 6*" included in C.7 highlights that C.6 prevails over C.7 in this regards. Similarly, we expect that the transitional exemption for energy derivatives in coal and oil according to article 95 is valid also for those contracts that must be physically settled and that are traded bilaterally.

The carve-out in C.6 for wholesale energy products would be deprived of their purpose if the same contracts would have to be assessed against the requirements of C.7.

Q214: Which oil products in your view should be caught by the definition of C6 energy derivatives contracts and therefore be within the scope of the exemption? Please give reasons for your view stating, in particular, any practical repercussions of including or excluding products from the scope.

The Directive 2014/65/EU does not provide a restricted definition of oil products to a subset of contracts.

Thus, the term 'oil' should encompass crude oils as well as any other refinery feedstocks, as well as all grades of refined petroleum and related products traded in the commodity markets including liquefied petroleum gas, fuel oil, middle distillates, gas to liquids fuels, jet, kerosene, avgas, mo.gas. (or motor gasoline), biofuels, base oils, chemical feedstocks and chemicals. We would suggest the following definition: "*mineral oil, of any description and petroleum gases, whether in liquid or vapour form, including products, components and derivatives of oil and oil transport fuels*".

Such a definition of oil would be consistent with the rationale expressed in other sections of the Consultation/Discussion Papers, e.g. ancillary activity section, which do not disaggregate the 'oil' asset class. In addition, this approach and definition would be in line with national legislation, such as the UK FCA Handbook's and the 2008 Glossary Amendment Instrument which include bio-fuels within the scope of 'oil market activity'. It will be important, too, that oil transportation fuels relating to oil including biofuels are included in the definition considering that biofuels are a mandated component of gasoline and diesel.

If the products, components and derivatives of oil and transportation fuels are excluded from the scope of C.6 energy derivative contracts, there are likely to be significant additional cost and liquidity implications for these markets and for end consumers. This is because many firms would have to clear this physical business and pay significant resulting daily risk margin (initial and variation). This would reduce working capital for commercial and industrial activities.

In addition, we should note that the hedging exemption provided by the European Market Infrastructure Regulation (EMIR) to non-financial counterparties (NFCs) would not solve the problem as it applies to the calculation of the threshold (used to identify NFC+) but not to the clearing obligation when this is triggered. Participants who are NFC+ by virtue of other activity would still have to clear or margin all derivative transactions.

If these oil derivate products are not excluded or are included on a restricted basis of interpretation, the regulatory burden in trading energy commodities would significantly increase discouraging market participation and depressing liquidity.

Q215: Do you agree with ESMA's approach on specifying contracts that must be physically settled?

Yes, in general we agree with the approach proposed by ESMA. However we believe that the wording proposed by ESMA does not fully acknowledge the obligation for physical settlement applicable under standard contracts, nor it reflects the concepts expressed in Recital 10 of MiFID II, which defines the conditions of an enforceable and binding obligation of physical delivery. Therefore we provide our suggestions for redrafting at the bottom of this answer.

Firstly, the terms '*unrestricted and unconditional right to physical delivery*' may create legal uncertainty. According to Recital 10 of MiFID II mentioned by ESMA (point 11, p.279 CP), the contracts must have an 'enforceable and binding obligation to physically deliver which cannot be unwound'. This must be understood to uphold that the exemption is defined in a way that an enforceable and binding obligation of physical delivery is a rule which allows for certain exceptions, but excludes an option to pay or receive cash instead of fulfilling the obligation to physically deliver. The terms used in the Recital are more appropriate on a legal point of view and more in line with the level I text compared with the proposals of the draft technical advice.

Moreover exceptions should be made clear in case of default and termination events, including the right to pay financial compensation for an event of default. The draft technical advice should clearly state that default provisions are not be characterized as an option for one party to replace physical delivery with cash settlement. In civil law a cash payment obligation as compensation for damage caused by a failure to deliver or accept the relevant commodity is considered as a damage compensation payment and not a cash settlement – and merely a secondary obligation as opposed to a primary obligation of physical settlement agreed in the contract. It would be inconsistent to apply a different standard in the implementing rules for C.6 (and C.7) which define physically settled commodity derivative financial instruments.

Most importantly, whilst we appreciate ESMA's consideration of the implications of 'operational netting' in power and gas markets, we highlight in this context that the offset of deliveries for operational reasons in the gas and electricity markets is normally an obligation stemming from the transmission systems operators' operational rules and it should not be understood to be a 'right to offset transactions'. Similarly the right to net payments obligations should be acknowledged without compromising the status of the contract as 'must be physically settled'.

In consideration of the comments above, we suggest the following amendments to the draft technical advice:

1. In accordance with Article 4.2(a) of Directive 2014/65/EU, a contract shall be considered as 'must be physically' settled if it satisfies the following conditions:
i. it establishes the enforceable and binding obligation to physically deliver the commodity;
ii. it does not include a right to cash settle or to offset transactions, except in the case of force majeure, default or any other contractually agreed termination event;

2. The existence of force majeure provisions does not prevent a contract from being characterised as "must be physically settled"

3. The existence of other bona fide clauses rendering it impossible to perform the contract on a physical settlement basis does not prevent a contract from being characterised as "must be physically settled"

3a. The offset of deliveries for operational reasons or a right to net payments are not to be considered a right to offset transactions within the meaning of paragraph (1)(ii).

4. For the purpose of Section C.6 and C.7 of Annex I to Directive 2014/65/EU contracts that are physically settled including but not limited to the following delivery methods:
i. physical delivery of the commodities;
ii. a transfer of title of the commodities, including the delivery of a document giving rights of an ownership nature to the relevant commodities or the relevant quantity of the commodities concerned (such as a bill of lading or a warehouse warrant); or
iii. any other method of transferring the title to the commodities or rights of an ownership nature in relation to the relevant quantity of the commodities including notification, scheduling or nomination to the operator of an energy supply network, that entitles the recipient to the relevant quantity of the commodities.

[to be added to the definitions and subject to further refinements] 'Offset of deliveries': means the obligation of counterparties to a physical trading agreement to submit net nominations and/or schedules to the system operators of the facility at which the title of ownership is transferred in accordance with the rules and guidelines of operations of such system operators.

These amendments are suggested to ensure that terms used are appropriate and provide sufficient legal certainty and consistency.

Q216: How do operational netting arrangements in power and gas markets work in practice? Please describe such arrangements in detail. In particular, please describe the type and timing of the actions taken by the various parties in the process, and the discretion over those actions that the parties have.

We are delighted that ESMA acknowledges that operational netting in power and gas markets is distinct from cash settlement. We also agree that neither operational netting nor obligations to submit net schedules should cause a contract to be excluded from the definition of 'must be physically settled'.

Physically settled gas and electricity transactions involve the delivery of the underlying commodity and the change in the ownership of the commodity. These contracts include spot products (where delivery occurs within a short time period) and forward contracts (for delivery at some point in the future).

The operational arrangements for delivery in gas and power markets may produce an offset of physical deliveries, however no netting takes place between contracts or transactions which could be considered equivalent to cash settlement: as the obligation under each individual contract to physically deliver and transfer title remains legally binding and enforceable.

In this and the next answers the terms nomination and scheduling are used as synonymous.

Nominations/Schedules timelines to TSOs

In gas and power physical markets participants have to enter into contractual arrangements with system operators of transportation pipelines/transmission lines in order to become network/system users to be able to deliver the energy produced or acquired to wholesale counterparties or retail consumers. Network codes and General Terms & Conditions of Transport/Transmission and the technical annexes are the main contractual and operational documents regulating the relationship between network/ users (or market participants) and the Transmission System Operators or (or TSOs).

Users may have direct access to energy production facilities (e.g. a power plant) or may acquire energy from other users. In all cases, the acquisition (and sale) of energy at a wholesale level takes place through contractual agreements (e.g. EFET master agreements) which stipulate the obligation for the selling party to a transaction to physically deliver and transfer the rights of title in the respective commodity and the obligation of the buying party to accept such delivery and transfer of title, including on a net basis (see for example EFET General Agreement concerning the delivery and acceptance of Natural Gas §4). Such a stipulation can also arise by virtue of the market structure itself.

A user must notify the TSO of how much energy it intends to deliver or accept at each entry and exit point to the system in each time unit (day or hour) and from whom it will receive or to whom it will deliver the energy at such point (a unique identification code for each user must be provided for this purpose). Generally TSOs require an initial nomination or schedule to be made by the user on the day before delivery and, depending on the system, these nominations or schedules can be updated throughout the relevant day of delivery (renominations), up to the hour before delivery in most energy markets.

A user may buy and/or sell energy for delivery on a specific day or hour at a specific delivery point on numerous occasions with different counterparties in the time before the actual delivery takes place, depending on the portfolio of its commercial activities (e.g. production of energy, sales of energy) and a series of factors (e.g. weather forecast, price forecasts, availability of infrastructures etc.). Therefore, depending on their trading patterns, two users may end up with more than one trade between them at a particular delivery point for a delivery period and these may include both ”buys” and ”sells”. TSOs or service providers, who are responsible for the management and secure operations of the transportation networks on a physical and commercial point of view, process the information received and match the schedules submitted by each counterparty also to ensure that the instructions of sellers and buyers are consistent in order to take into account the flows required by each network user (or group of network users). Any inconsistency must be rectified before the delivery period occurs.

Some TSOs (for example National Grid Gas in the UK) simply require each pair of users to give them notice (by nominating) of every trade between them and the TSO will then aggregate the trades and set the buys off against the sells (if applicable) to produce a net position for the pair for each delivery period and delivery point. Other TSOs, for reasons of administrative

convenience only, require the users to calculate the net position and to nominate or schedule such net number to them.

It must be noted that a failure by a user to nominate or schedule correctly and in time to a TSO is stipulated to be a default under the trading contact as it will lead to incorrect quantities of energy being delivered and will lead to damages being payable to the counterparty. This may also lead to imbalances toward the energy system (see below).

As a result, in gas and power markets delivery is performed by submitting the nominations of the injections into/withdrawals from the energy system and the transactions with other wholesale counterparties to the operator of the designated delivery point.

An example on how nominations works in electricity markets can be found at this link, referring to the Belgian electricity system: http://www.elia.be/~/media/files/Elia/Products-and-services/ProductSheets/E-Evenwicht/E3_E_E-Nomination.pdf

For Gas for example:
http://www.grtgaz.com/fileadmin/clients/fournisseurs/documents/en/operationnel/1_Find_out_more_about_nominations_confirmations.pdf
(http://www.grtgaz.com/en/acces-direct/customer/shipper-trader/peg.html#tabs3)

For completeness we would like to provide some background information on how the framework concerning balancing between supply and demand in gas and electricity markets as this is an essential element of liberalised markets.

In conclusion

The most relevant aspect is that operational arrangements do not involve the netting of contracts or transactions which remain separate and provide title transfer. Physical settlement is legally binding and enforceable. The offset of deliveries is merely the result of Nominations/Schedules submitted to TSOs according to their instructions and operational rules. Netting arrangements based on essential operational activities must be acknowledged and remain outside of the scope of derivative financial instruments. Indeed:

- the submission of nominations according to the operational rules provided by system operators is the way in which counterparties perform the obligation to settle physically their contracts; and

- at the opposite, contracts that are not for physical settlement do not require entering into contractual arrangements with system operators, do not require the submission of schedules nominations and are not subject to balancing rules.

These are substantial elements. A failure to recognise operational netting practices as a means of physical delivery within ‘must’ be physically settled contracts would render the exclusion for physically settled wholesale energy products traded on an OTF, as defined in level 1, completely void.

We urge therefore ESMA to consider such substantial characteristics when compiling the draft technical advice to the EU Commission for the delegated acts on the definition of commodity derivative.

Q217: Please provide concrete examples of contracts that must be physically settled for power, natural gas, coal and oil. Please describe the contracts in detail and identify on which platforms they are traded at the moment.

Power and natural gas

Bilateral trading standard agreements in gas and electricity include contracts such as:

- The EFET General Agreements concerning the Delivery and Acceptance of Natural Gas / Electricity, including their annexes and appendices
- Trading Terms & Conditions Short Term Flat NBP 1997 (NBP 1997, UK Gas)
- Zeebrugge Hub Natural Gas Trading Terms & Conditions (ZBT 2004, Belgian Gas)
- Grid Trade Master Agreement 2004 (GTMA 2004, UK Power),
- Standard Terms and Conditions for Sale and Purchase of Natural Gas for UK Short Term Deliveries at the Beach (Beach 2000, UK Gas)
- ISDA Master Agreement (1992/2002) with physical trading annexes (GTMA Transactions; NBP; ZBT)
- Zeebrugge Beach Natural Gas trading Terms and Conditions (ZBT 2004)
- BP General Terms and Conditions for the sales and purchases of Crude il/ Petroleum Products
- Standard Coal Trading Agreement (SCoTA)
- Any long form confirmation referring to the above mentioned master agreements

These are examples of standard contracts for physical delivery used by parties that are trading bilaterally, including when trading through brokers. These Master Agreements stipulate the primary obligation for the selling party to a forward transaction to physically deliver and transfer the title in the respective commodity and the obligation of the buying party to accept such delivery and transfer of title.

Fulfilling such obligation of delivery requires that the counterparties to a transaction have a separate contractual relationship with operators of transmission systems or transportation networks and/or service providers responsible for the management and operations of the

nomination platforms. Delivery is performed arranged by submitting the schedules of the transactions to the operator of the designated delivery point.

Key terms of the Trading Contracts

- Obligation under each trade to physically deliver and transfer rights of title in the agreed quantity of the relevant commodity by the means applicable at the relevant delivery point. In order to deliver or accept the parties are obliged to nominate/schedule accurately and on timely basis. There is no 'cash out' or 'book out' option whereby a party can elect to pay cash or liquidated damages to the other party in lieu of fulfilling its obligations to deliver or accept commodity. Remedies for failure to deliver or accept the correct contract quantity in each delivery period for each trade – generally calculated as the difference between the contract price and the price paid or received by the non defaulting party in replacing short positions or selling long positions caused by the defaulting party.

- Force majeure –generally defined as an occurrence beyond the reasonable control of one of the parties which it could not reasonably have avoided or overcome and which it makes impossible for one of the parties to perform its obligations according to the contract terms.

- In a natural gas contract, what happens in the event that Off Specification natural gas is delivered.

- Invoicing and payment – the quantities delivered under each trade are separately invoiced on a monthly in arrears basis and VAT paid (or the reverse charge applied) to such amounts.

- Credit and security requirements.

- Termination rights – The Framework Agreement and the Individual Contracts can only be terminated ordinary or early in the event of specified material reasons. An ordinary termination does not affect the existing Individual Contracts and the existing delivery obligation. in the case of material default such as accrued failures to pay or the insolvency of the counterparty or the failure of credit support, the non defaulting party generally seeks to have the right to terminate all outstanding trades and to claim damages for both quantities already delivered but not paid for and its future losses arising due to losing the contract early i.e. for its loss of bargain (Mark to Market losses). In practice these clauses are usually only invoked on the insolvency of the counterparty and whether they are enforceable depends on the insolvency laws of the country of incorporation of the party that is insolvent (NB: the laws of many countries prevent the termination of contracts on the grounds of insolvency). Contracts often provide an intermediate right for the non defaulting party to suspend deliveries in the event of material default by the other party before invoking termination rights. If all trades are so terminated the non-defaulting party must calculate its losses or gains in respect of each trade and aggregate and offset these i.e. it cannot just claim for its losses whilst benefiting from its gains.

Some of these master agreements may provide for an option to elect early termination without notice requirement (Automatic Termination), usually in case of insolvency or similar conditions endangering the claims of a party, in which the EFET General Agreement itself and all Individual Contracts terminate automatically at a pre-defined point in time if automatic early termination has been elected in the Election Sheet. The background of the Automatic Termination is the different national legislation on insolvency in respect of close out netting as explained above.

Trades can be entered into bilaterally by means of the parties contacting each other (i.e. without the intermediation of a broker) or via brokers by voice/screen services (e.g. Prebon, Spectron). Even if trades are entered into via a broker, the parties to the trade are the buyer and the seller who must have access to and the ability to move physical energy to or from the relevant delivery point. The broker merely matches the two parties up and has nothing to do with physical delivery. Our current understanding is that energy brokers may classify as Organised Trading Facilities according to MiFID II.

The standard trading agreements mentioned in this answer are not available to non-sophisticated counterparties or to trading of non-standard/ non-liquid physical products (such as trading of gas directly from production wells, for example). Any non- standard energy trading agreement entered into bilaterally between two counterparties which reflects terms similar or equivalent to those key terms listed above and provides for a binding primary obligation to physically delivery should also be considered as a "contract that must be physically settled" within the meaning of C.6.

Finally, consideration should be given to those contracts in gas and electricity that must be physically settled and are concluded through an OTF (located in the EU) and whose delivery takes place outside of the EU, especially within Europe. In fact, such contracts are not strictly wholesale energy products i.e. 'contracts for the supply of electricity or natural gas where deliver is in the Union' (Article 2.4, Regulation 1227/2011/EC). However it would be illogical to include them into the definition of derivative financial instrument.

Oil, oil products and coal

The vast majority of transactions in the ***physical oil markets*** are concluded on a bespoke basis between the parties incorporating seller's General Terms & Conditions (GT&Cs) appropriate to the transaction structure in question (i.e. FOB/CIF/DES). Examples of such GT&C's include those produced by Shell and BP, which are widely used in the industry. The parties have the obligation to make and receive physical delivery of the commodity at the specified location in the absence of an event of force majeure or other event of default giving rise to the normal contractual remedies and with no unilateral right for either party to replace its physical performance obligations with cash settlement. In liquid markets where 'chains' of sales occur for operational convenience (i.e. X sells to Y which on-sells to Z) delivery of the physical cargo will be made directly to the location of the ultimate buyer in the chain but the obligation to deliver and receive the commodity as well as the documents of title (i.e. bills of lading) are nevertheless transferred from each party to the next in the chain of linked sales and purchases.

Such contracts may be traded on the Platts e-Window and through the support of energy brokers which do not have the characteristics of multilateral trading facilities, e.g. via voice brokering. Such contracts may also be traded bilaterally.

The North Sea Brent, Forties, Oseberg Ekofisk (BFOE) traded crude oil market trades full cargo crude oil contracts on a forward basis. Forward full BFOE cargoes are physical trades and in the normal course will be placed into a nominated cargo chain with obligation for physical delivery and acceptance in the relevant terminal delivery programme. Where a chain of sale and purchases in relation to a full cargo BFOE delivery involves two or more of the same parties at different stages of the chain, the parties may enter into a subsequent and separate agreement and book out their obligations on the basis of net payment. Such agreement would be assessed according to the relevant applicable definitions.

These arrangements are necessary for the efficient operation of the North Sea physical crude markets. It will be important that regulation properly construes them to ensure the status of the BFOE contract as a trading instrument for the delivery of physical cargoes of crude oil is effectively preserved. All BFOE Partials and Full Cargoes are governed by SUKO 90 15 Day Brent GTC's with updated amendments (now 25 day Brent)

Not considering the above described contracts with operational netting as "must be physically settled" would reduce liquidity in these key markets and drive up costs for consumers unnecessarily.

In addition to the examples of contracts for power and gas transactions described above, we set out below examples of methods of physical settlement in relation to coal that is physically settled, including:

(i) FOB (Free on Board) – title/risk pass on loading, payment is affected after completion of loading and receipt of docs (Bill of Lading, Certificate of Analysis etc.)

(ii) CIF (Cost, Insurance and Freight) - title/risk pass on loading, payment is affected after completion of loading and receipt of docs (Bill of Lading, Certificate of Analysis etc.)

(iii) CFR (Cost and Freight) – same as CIF

(iv) DAT (Delivered at Terminal) – title/risk pass on arrival at discharge port, payment is affected after completion of discharge and receipt of docs (Draft Survey, Certificate of Analysis etc.)

(v) DAP (Delivered at Place) – same as DAT but includes further delivery possibly by barge or train etc.

(vi) EXW (Ex Works) – title/risk pass when tonnage is made available to buyer, initial payment is affected following completion of buyer lifting cargo or at the end of the month of delivery if not lifted during contract month, final payment is affected upon

completion of loading and receipt of docs (barge/train lifting docs, Certificate of Analysis, Invoice)

(vii) DES (Delivered ex Ship) – was removed from previous Incoterms version (replaced by DAT) but still traded regularly

There are other types of delivery but these are less commonly traded in coal (if at all). All of the above are subject to contract terms.

SCoTA is the industry recognised contract for a number of products with the most actively traded being DES ARA, FOB Richards Bay, FOB Newcastle and to a lesser extent FOB Colombia. Transactions under the SCoTA are from time to time cash settled in lieu of delivery, but as with the EFET Agreements cash settlement is not an option provided by the SCoTA but would be separately negotiated by the parties subsequent to their entering into the original transaction and in specific circumstances (i.e., where all parties in a relevant chain agree to cash settle). ESMA's Technical Advice should distinguish this situation from a situation where the relevant contract would fall within section C(5) as a contract which may be settled in cash at the option of one of the parties.

- Bookouts – where you have a long and short position with the same client, you may agree to offset physical obligations and net settle the difference between contract prices for the volume bought and sold (however, again this would be subject to mutual consent in specific circumstances by the parties subsequent to their entering into the original transaction).
- Circle outs / close-outs – same as a bookout but with more than 2 parties involved and the value is settled as the following example:
  - Party A sells 50,000mt FOB Richards Bay to Party B at $80.00 in August 14
  - Party B sells 50,000mt FOB Richards Bay to Party C at $85.00 in August 14
  - Party C sells 50,000mt FOB Richards Bay to Party A at $90.00 in August 14
  - The Parties agree that there is a circle and to offset the physical obligations from each other and to settle the contract prices against API4 for August 14
  - API4 for August 14 outturns at $82.00, therefore:
    - Party A pays Party B $100,000 (50,000 * minus $2 pmt)
    - Party C pays Party B $150,000 (50,000 * $3 pmt)
    - Party A pays Party C $400,000 (50,000 * $8 pmt)

Q218: How do you understand and how would you describe the concepts of "force majeure" and "other bona fide inability to settle" in this context?

Force Majeure is generally defined as an occurrence beyond the reasonable control of one of the parties which it could not reasonably have avoided or overcome and which it makes impossible for one of the parties to perform its obligations according to the contract terms. Please note that this definition is subject to national civil laws and case law and might evolve subject to new legislation being adopted or case law being made. In case of liquid gas and electricity markets for example, depending on the delivery point, this may be limited to failure of communication or IT systems of the relevant network (within system balancing points) or an

unplanned physical outages or failures of pipelines, terminals and transmission systems. In the case of the oil markets it may include a broad range of marine, port, pipeline or storage related events affecting the transmission and handling of cargoes of crude oil or refined products by sea and by pipeline.

In such circumstances, no breach, default, other termination event or other contractual event is deemed to have occurred and the counterparty claiming the Force Majeure is released from its contractual obligations for the period of time that force majeure prevents its performance. In practice this means that the defaulting party is not required to pay the damages that would otherwise be payable for a failure to deliver or accept the correct contract quantity under a trade.

Force Majeure provisions are not be characterized as an option for one party to replace physical delivery with cash settlement. This also follows from C.5 which defines the cash settled commodity derivatives which qualify as financial instrument under MiFID II by including all derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties "*other than by reason of default or other termination event*". It would be inconsistent applying a deviating standard in the implementing rules for C.6 (and C.7) which require the assessment of physically settled contracts.

Other bona fide inabilities to perform should be instead understood as any circumstance whereby the performance of a physical delivery or off-take does not take place for reasons that do not qualify as Force Majeure nor as reason of default or other termination event and which are objectively measurable as reasons defined in the contract terms for parties not to perform their obligations and set the contract aside. These other bona fide *inabilities to perform* may include *condition precedent* clauses or other circumstances that may suspend – but not terminate – the execution of the contract, annihilate *ab initio* or void and set aside the contract.

Civil law and common law list a number of such reasons (e.g. because the essential conditions for the formation of an agreement are not met, because of duress, because of conditions precedent, because of novations) which are accommodated through contractual clauses which can be qualified as bona fide inabilities to perform.

In all these cases the bona fide clauses which comply with the civil/common law rules of the formation of agreements do not change the nature of the contracts which are still to be considered as '*must be physically settled*' because the related clauses are only intended to protect the counterparties in cases where the underlying governing law prescribes the contract to be set aside and circumstances thus do not allow the ordinary execution of the contract i.e. delivery of the commodity.

Events of Default are objective circumstances designated in contracts as termination events, material reason, events of default or any other terms as may be chosen freely by the parties which may lead to the early termination of a physical trading agreement, thus excusing the delivery (and often providing for a secondary compensation obligation to step into the place of the primary unexecuted delivery obligation). These events of default or early termination events are consistently used in the industry agreements for the trading of physical commodities in

Europe (whether these are standard master agreements, customised master agreements or non-standard trading agreements).

Therefore, in all the cases mentioned above and namely Force Majeure, bona fide inabilities to perform and events of default/other termination events the physical delivery may be excused without changing at all the nature of contracts that 'must be physically settled'.

The examples mentioned in this answer should be intended only as illustrative and not exhaustive or conclusive because the main purpose of such concepts is to be sufficiently broad to accommodate unforeseen events impacting the commodity markets in question. Any attempt to define such cases in a granular way for all commodities would lead to additional legal uncertainty because the operational arrangements and practices in commodity markets differ extensively (see for instance the differences between the gas and oil markets referred to above).

In other words, it is impossible to provide a definitive list of reasons preventing the physical settlement of contracts as they can vary from case to case and similar outcomes for occasions of contractual non-completion may have fundamentally different drivers.

Q219: Do you agree that Article 38 of Regulation (EC) No 1287/2006 has worked well in practice and elements of it should be preserved? If not, which elements in your view require amendments?

We believe that article 38 of Regulation No 1287/2006 has worked well as it has provided sufficient guidance to identify the objective characteristics of contracts falling under C.7 of Annex I, Section C of Directive 39/2004/EC. Therefore we do not agree with most of the changes proposed in the draft technical advice as they may create confusion and legal uncertainty.

We believe that the standardisation criterion should be better specified and we suggest a reference to 'listed contracts' to limit an interpretation that can be otherwise subjective.

Also, we have some technical but substantial suggestions on the text of the technical advice that we urge ESMA to consider:

- the wording used 'as far as contracts are within the scope of C.6' does not seem technically appropriate, since contracts in scope of C.6 are by definition not subject to C.7, therefore a general approach is preferable to include OTF-traded contracts and explicitly mentioning the exception; and
- the case of third country venues performs similar functions to an OTF which for wholesale energy contracts, should be treated similarly as under MiFID I.

In consideration of the comments above we suggest the following amendments:

5. *For the purposes of Section C(7) of Annex I to Directive 2014/65/EU, a contract which is not:*

- *a spot contract within the meaning of paragraph [6],*
- *a contract for commercial purposes within the meaning of paragraph xx, or*
- *otherwise mentioned in section C(6) of Annex I to Directive 2014/65/EU (meaning carved out from the definition of financial instrument under the terms of C.6)*

shall be considered as having the characteristics of other derivative financial instruments and not being for commercial purposes if it satisfies all the following conditions:

(a) it is standardised so that in particular the price, the lot, the delivery date, the product quality specifications of the underlying, the delivery location and other terms are determined by reference to regularly published prices of listed contracts, standard lots or standard delivery dates, standard product specifications, benchmark grades, or delivery locations and other standardised terms;

(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 meets one of the following sets of criteria

i. "it is traded on a third country trading venue that performs a similar function to a regulated market, an MTF or an OTF except for wholesale energy contracts or energy derivative contracts that must be physically settled and that are traded on an OTF or a third country trading venue that performs a similar function to an OTF;

ii. it is expressly stated to be traded on, or is subject to the rules of, a regulated market, an MTF, an OTF except for wholesale energy contracts or energy derivative contracts that must be physically settled and that are traded on an OTF or a third country trading venue that performs a similar function to an OTF; or

iii. it is equivalent to a contract traded on a regulated market, an MTF, an OTF except for wholesale energy contracts or energy derivative contracts that must be physically settled and that are traded on an OTF or a third country trading venue that performs a similar function to an OTF, with regards to the price, the lot, the delivery date and other terms including equivalent margining and netting treatment to contracts that are traded on a trading venue.

Q220: Do you agree that the definition of spot contract in paragraph 2 of Article 38 of Regulation (EC) 1287/2006 is still valid and should become part of the future implementing measures for MiFID II? If not, what changes would you propose?

We consider the definition of 'spot' of key importance. The reference in Article 38.2.b to a 'period generally accepted in the market for that commodity', when this period is beyond 2 trading days, may lead to different results across the Member States and is therefore problematic. For instance in case of physical crude oil and refined oil trading, the complexity of the logistics for the production, transportation, delivery and storage of cargoes of oil and oil products is such that delivery almost never takes place within two trading days, nor would we feel confident in

saying that industry standards for scheduled delivery periods exist. Indeed such a period could be in the range between 25 days and three months ahead of delivery.

Finally we would consider it valuable that a consultation/survey exercise with the industry is conducted at European level in order to identify a workable 'spot' definition for each commodity for any time beyond two trading days that reflects the market practice. Also, we suggest exploring in this context the possibility to distinguish spot contracts from derivatives also in terms of how such contracts are priced. Conventionally in some energy commodities e.g. in physical crude and refined oil trading, the price at which the product is ultimately sold is not pre-agreed in absolute terms, but rather by reference to prices prevailing at the time delivery to the vessel is actually made. For such contracts therefore, counterparties remain exposed to market risk until the defined period for pricing has elapsed, thus necessitating the use of e.g. futures if such market risk is to be hedge.

Q221: Do you agree that the definition of a contract for commercial purposes in paragraph 4 of Article 38 of Regulation (EC) 1287/2006 is still valid and should become part of the future implementing measures for MiFID II? If not, what changes would you propose? What other contracts, in your view, should be listed among those to be considered for commercial purposes?

The definition of a contract for commercial purposes is valid but too narrow. ESMA should improve it in order to make the concept of 'commercial purpose' applicable in different contexts and for different commodities.

This need also originates from the remark that ESMA suggests removing both the reference to "commercial purpose" from the original article 38(1) and the reference to "*characteristics of other derivative financial instruments*" from article 38(4). Although this proposal is not explicitly commented or explained, and we disagree with it, one can deduce from it that ESMA has the intention of giving a different definition of "commercial purpose". Other than contracts entered into for the purpose of balancing the supplies and uses of energy, it should also include for instance contracts entered into for the purpose of meeting regulatory requirements, such as Compulsory Stock Obligations (CSOs) and the Renewable Transport Fuel Obligation (RTFO).

In this sense we recommend ESMA takes the approach taken under the U.K. legislation[1] into consideration. The legislation makes explicit provisions for indications to be used to evaluate whether a contract is made for commercial purposes, namely: (a) where one or more of the parties is a producer of the commodity or other property, or uses the commodity in its business; (b) the seller delivers or intends to deliver the commodity or the purchaser takes or intends to take delivery of it.

This type of approach has demonstrated to work well in practice at national level and we strongly recommend ESMA to take a similar approach, in order to avoid the circumstance in which - by giving a closed and specific list of contracts being for commercial purpose - other contracts remain out of the definition without appropriate justification.

[1] See the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (2001 No. 544).

Further, we note that paragraph 4 of Article 38 of Regulation (EC) 1287/2006 refers both to C.7 **and C.10** and this is missing in the draft technical advice proposed by ESMA on the 'commercial purpose'.

We believe that it should be reinstate as it reflects the existing policy that contracts entered into for commercial purpose should also be regarded as not having the characteristics of other derivative financial instruments for the purposes of C.10 and, without evidence of any legislative intent to change this policy, should be carried forward into MiFID II.

A potential text that covers the cases mentioned above and applies also to C.10 contracts is the following:

"A contract shall be considered to be for commercial purposes for the purposes of Section C(7) of Annex I to Directive 2014/65/EU, 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:

1. *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;*
2. *for the purpose of meeting regulatory requirements to purchase, sell, hold or deliver a commodity*
3. *where one or more of the parties is a producer of the commodity or other property, or uses it in his business;*

or

4. *the seller delivers or intends to deliver the property or the purchaser takes or intends to take delivery of it."*

Q222: Do you agree that the future Delegated Act should not refer to clearing as a condition for determining whether an instrument qualifies as a commodity derivative under Section C 7 of Annex I?

No, we disagree.

We believe that the characteristic of contracts that are centrally cleared by CCPs or similarly margined bilaterally is a key characteristic. In fact, it is MiFID defining which contracts are classified as *derivative financial instruments*, whilst the clearing obligation under EMIR is only a consequence of such contracts being defined as financial instruments and will apply only to a subset of such contracts, after these have been determined to qualify as derivative financial instruments under MiFID. Hence the circularity between the two pieces of legislation does not exist if the rules are implemented taking into account the hierarchy between MiFID, which prevails, and EMIR.

Q223: Do you agree that standardisation of a contract as expressed in Article 38(1) Letter c of Regulation (EC) No 1287/2006 remains an important indicator for classifying financial instruments and therefore should be maintained?

Standardisation of contract terms is common practice of market development. Efforts to enhance standardisation should be favoured because the use of standard terms reduces legal uncertainty and independently from the fact that the contract may have the characteristics of other derivative financial instruments.

Therefore we advocate that such criterion should not be the only factor for consideration to avoid all contracts that satisfy a certain level of standardisation being considered as having the characteristics of other financial instruments. Also, other than standardisation in price, lot and delivery dates, commodity derivatives are characterised by standardised product specifications for the underlying commodity, or based on benchmark grades of product, to be delivered into pre-specified locations. We recommend ESMA to further specify such criterion in the draft technical advice.

Q224: Do you agree with the proposal to maintain the alternatives for trading contracts in Article 38(1)(a) of Regulation (EC) No 1287/2006 taking into account the emergence of the OTF as a MiFID trading venue in the future Delegated Act?

Yes, we agree with the intention to maintain the alternatives and to taking into account the introduction of OTFs. However we disagree with the proposed change to the third limb of the trading criterion from “expressly stated to be equivalent to” to “equivalent to”. The current test has worked well to date. The requirement for a contract to be "expressly stated to be equivalent to" a contract traded on a regulated venue provides clarity for all market participants, as it is possible to establish whether or not this criterion is met by looking at the terms of the contract.

Whilst we understand ESMA comments, we do not consider that the ESMA proposal achieves a more objective test. We believe that a mere concept of ‘equivalence’ is likely to introduce legal uncertainty since it introduces a subjective test under which the parties may adopt different positions on whether a contract is “equivalent”. Implementing regulations should absolutely avoid situations in which counterparties are not able to know whether a contract is a derivative financial instrument or not.

If ESMA wants to avoid that the classification in this respect depends on the choices of the counterparties, we suggest either to stick to the previous “expressly stated to be equivalent” or, alternatively, to provide a workable definition of equivalence, in order to avoid creating any regulatory uncertainty for market participants.

Also, we believe that to ensure consistency with the level 1 text a specific and equivalent treatment should be provided for contracts that are traded or are expressly stated to be traded on a third country trading venue that performs a similar function to an OTF which must be physically settled, namely C.6 energy derivatives and wholesale energy products.

Moreover, we reiterate that central clearing or margining of contracts is a relevant and substantial condition to classify contracts which have the characteristics of other derivative financial instruments; if not included as per our suggestion on 5(b), the existence of clearing/margining arrangements must at least be taken into account when considering the equivalence criterion of 5(c)(iii).

Q225: Do you agree that the existing provision in Article 38(3) of Regulation (EC) No 1287/2006 for determining whether derivative contracts within the scope of Section C(10) of Annex I should be classified as financial instruments should be updated as necessary but overall be maintained? If not, which elements in your view require amendments?

Yes, we partially agree with the proposal to maintain the text of article 38(3) or Regulation 1287/2006 broadly the same.

Firstly, we appreciate that ESMA acknowledges that the exclusion under C.6 applies to wholesale energy products including both contracts for the supply and transportation of electricity or natural gas. Therefore we agree with the suggestions to amend the implementing rules concerning C.10.

However we believe that to ensure consistency with the level 1 text a specific and equivalent treatment should be provided for contracts that are traded or are expressly stated to be traded on a third country trading venue that performs a similar function to an OTF and that must be physically settled, namely for contracts listed currently in article 38(4) that are energy derivatives or wholesale energy products. Also, some technical amendments are necessary.

We suggest therefore the following amendments:
"1. For the purpose of Section C 10 of Annex I of Directive 2014/65/EU, a derivative contract relating to an underlying referred there into, shall be classified as having the characteristics of other derivative financial instruments if one of the following conditions is satisfied:

- *i. the contract is settled in cash or may be settled in cash at the option of one or more of the parties to the contract, other than by reason of default or other termination event;*
- *ii. the contract is traded on:*
  - *a. a regulated market;*
  - *b. an MTF; or*
  - *c. an OTF except for wholesale energy contracts that must be physically settled and that are traded on an OTF*
- *iii. the contract fulfils the conditions imposed for derivative contracts under Section C 7 of Annex I of Directive 2014/65/EU."*

Q226: Do you agree that the list of contracts in Article 39 of Regulation (EC) No 1287/2006 should be maintained? If not, which type of contracts should be added or which ones should be deleted?

Yes, we agree.

Q227: What is your view with regard to adding as an additional type of derivative contract those relating to actuarial statistics?

We do not have a firm opinion on this; however we do not see the need for introducing such additional type of derivative contract in this context.

Q228: What do you understand by the terms "reason of default or other termination event" and how does this differ from "except in the case of force majeure, default or other bona fide inability to perform"?

The terms '*by reason of default or other termination event*' are generally open to interpretation. Although it may be argued that these requirements are restrictive in the sense that they do not include every termination event, a systematic, teleological and historic interpretation speaks in favour of understanding these terms in a way to include each and every termination event.

It should be noted that C.5 defines the cash settled commodity derivatives which qualify as financial instrument under MiFID II by including all derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties "*other than by reason of default or other termination event*". This is the case also for C.10, which defines the cash settled derivative contracts relating to climatic variables, freight rates or official economic statistics which qualify as financial instruments under MiFID II and alike definitions were already included in C.5 and C.10.

It must be noted also that a right to close-out-net in case of a termination does not at all change the nature of a physically settled derivative into a cash settled derivative if close-out netting, which results in a cash payment extinguishing all future physical delivery obligations, is only possible following termination of the agreement rather than as means to fulfil an obligation under an existing and valid agreement.

Hence, based on this interpretation, these terms should be understood differently from *force majeure* and *bona fide inability to perform* and should be categorised as being circumstances which may lead to termination of the contracts. The meaning of "*reason of default or other termination event*" is equivalent in all terms to the meaning of "*default and early termination events*" in line with the amendment that we suggest on the draft technical advice to C.6. In fact, it would be inconsistent to apply a different standard in the implementing rules for C.6 and C.7 which define physically settled commodity derivative financial instruments.

In this context, the concept of *force majeure* should be intended as an occurrence beyond the reasonable control of one of the parties which it could not reasonably have avoided or overcome and which it makes impossible for one of the parties to perform according to the contract terms.

Default or termination events may be specific cases of inability to perform of one of the counterparties which include cases like inadequate performance assurance, insolvency or credit support documentation that determines the inability to perform the contract (see also below). For instance according to EFET General Agreements there is the possibility of termination for a 'material reason': a party may give the other party unilateral notice of early termination and in such case all further payments and performance in respect of all Individual Contracts as well as

the EFET General Agreement itself shall be released and all existing duties and obligations replaced by the obligation of one party to pay damages for non-fulfilment to the other party (i.e., as according to the aggregated and netted settlement amounts).

The EFET General Agreements define such material reason as certain cases of non-performance, cross default and acceleration, winding-up, insolvency or attachment, failure to deliver or accept and representation of warranty (e.g. failure to deliver agreed guarantee or credit standard downgrading below a certain level).

Furthermore, to reduce the counterparty risk, the EFET General Agreements provide for an option to elect early termination without notice requirement, usually in case of insolvency or similar conditions endangering the claims of a party, in which all Individual Contracts as well as the EFET General Agreement itself terminate automatically at a pre-defined point in time if automatic early termination has been elected in the Election Sheet.

We provide further examples of events of default or early termination event here below. However, we reiterate our view that these examples should be intended only as illustrative and not exhaustive or conclusive because the main purpose of such concepts is to remain sufficiently broad to accommodate unforeseen events. Any attempt to define these cases in a granular way for all commodities would lead to additional legal uncertainty.

Events of default/early termination events:

- **Breach of Agreement/ non-performance**. When a party breaches its obligations under the master agreement (other than failure to deliver).
- **Credit Support Default**. When a party or its credit support provider (e.g. a guarantor or provider of letter of credit) defaults under a credit support document or the credit support document expires, is terminated or rejected.
- **Misrepresentation**. If a representation made by a party under the master agreement proves to been materially incorrect or misleading.
- **Default under other agreements**. If the counterparties to a master agreement are equally bound by another separate agreement and one of the parties defaults under the other separate and specified agreement.
- **Cross-default**. If a party or its guarantor defaults under an agreement it has in place with a third party, generally with respect to repayment of financial indebtedness.
- **Bankruptcy/Insolvency**. A party experiences a bankruptcy/insolvency event. Typically, a list of events relevant to the jurisdiction of incorporation of the party will be referenced.
- **Change in Law / Illegality**. As a result of an adoption or change in law, it becomes unlawful for a party to or its credit support provider to perform under the master agreement, or any credit support document (as applicable).
- **Tax Events**. As a result of a change in tax law, a party's tax position under the master agreement is materially prejudiced (e.g. withholding tax will be applied).
- **Credit Event upon Merger**. If a party merges with or is consolidated into another entity, and the resulting entity is materially less creditworthy than the original entity.
- **Failure to deliver**. When a party under a master agreement consistently and over a longer period fails to deliver a contractually agreed volume of commodity.

- **Material error case**: this clause entails the possibility to maintain the validity of the contract whilst material errors may have pre-empted the delivery of the commodity as initially agreed.
- **Failure to provide credit support documentation**: the failure or delay to provide a guarantee to a counterparty may be defined in contracts as a reason for suspension of the contract or termination.

Section 7.2 - Position reporting thresholds

Q229: Do you agree with the proposed threshold for the number of position holders? If not, please state your preferred thresholds and the reason why.

We broadly support ESMA's proposals.

Q230: Do you agree with the proposed minimum threshold level for the open interest criteria for the publication of reports? If not, please state your preferred alternative for the definition of this threshold and explain the reasons why this would be more appropriate.

We broadly support ESMA's proposals.

Q231: Do you agree with the proposed timeframes for publication once activity on a trading venue either reaches or no longer reaches the two thresholds?

We broadly support ESMA's proposals.

Section 7.3 - Position management powers of ESMA

Q232: Do you agree that the listed factors and criteria allow ESMA to determine the existence of a threat to the stability of the (whole or part of the) financial system in the EU?

We broadly support ESMA's proposals although we urge regulators to ensure flexibility if the criteria would practically prove ineffective in some situations.

Q238: Do you agree that the listed factors and criteria allow ESMA to determine the appropriate reduction of a position or exposure entered into via a derivative?

We broadly support ESMA's proposals although we urge regulators to ensure flexibility if the criteria would practically prove ineffective in some situations.

Q241: Do you agree that the listed factors and criteria allow ESMA to adequately determine the situations where a risk of regulatory arbitrage could arise from the exercise of position management powers by ESMA?

We broadly support ESMA's proposals although we urge regulators to ensure flexibility if the criteria would practically prove ineffective in some situations.

Section 8 - Portfolio compression

Q244: What are your views on the proposed approach for legal documentation and portfolio compression criteria?

Methods of portfolio compression

Today there are robust solutions for multilateral compression operating in the market. In this regard, generally speaking the criteria for compression outlined in the consultation paper are in line with the services offered by compression service providers today. However, we would note that as compression services have evolved it has become apparent that certain steps in the process are not necessarily required for all compression cycles. For example it is not always necessary to have a dress rehearsal.

Compression is not a price forming event and therefore, we request that the technical advice ESMA provides to the commission is not overly prescriptive. Rather we would suggest that the advice should set out a high level framework which provides participants with sufficient flexibility. Furthermore, it is important that counterparties retain control over their own risk profiles. Having prescriptive methodology and rules may not work for all counterparties and we would note that it is important that post trade risk reductions services should not be subject to other regulatory requirements that are designed for price forming transactions.

There is currently no standard industry process for bilateral compression direct between two parties, although we do acknowledge that compression services providers may support compression exercises between just two participants. While we suggest that the criteria and steps for direct bilateral compression activity should be aligned with those for multilateral compressions, adjusted as necessary to reflect the absence of a compression service provider, it should be recognised that bilateral compression exercises will often involve bespoke manual processes which are negotiated and established between the parties. Therefore, we would recommend that ESMA advises the Commission that any requirements should be sufficiently high level and should not undermine parties' ability to enter into bespoke arrangements.

Finally, we note that unilateral compression is also offered in the market today. This allows counterparties to reduce notional values and/or trade volumes on their books against a CCP. It is important that ESMA advises the Commission of the existence of such unilateral compression methods and advises the Commissions to include it as a suitable form of portfolio compression.

Legal Documentation

We agree that it is imperative that relevant legal documentation should be in place between the parties to a compression exercise and that such documentation should adequately cover the activities such as reduction, termination and replacement of derivative transactions as will be caused by the compression process. In our view it is not necessary that the form of that

documentation should be prescribed in the rules rather that firms participating in any form of compression exercise should satisfy themselves that the documentation in place is suitable for its purpose We would also note that while compression can result in some derivative transactions being reduced and terminated or terminated and replaced, compression can also (i) result in fewer transactions, without any reduction in notional amounts (e.g. in the case of a compression recouponing exercise) or (ii) involve the addition of new trades with the effect of the risk, notional and/or number of trades is/are reduced overall.

Criteria and process steps:

As noted above we would suggest that any post trade compression service, be it multilateral, bilateral or unilateral, should comply with a set of framework criteria enshrined in a delegated act. We would suggest the following criteria:

1. the exercise is designed to be overall market risk neutral;

2. the participants of the exercise do not submit bids and offers to enter into a specific position;

3. the exercise is cycle-based and must be accepted in full by all participants or it will not be executed;

4. the exercise is designed to reduce secondary risks emerging from existing derivatives transactions, such as counterparty credit risk and operational risk.

In terms of process steps we would suggest the following high level description:

1. identifying participants for the relevant compression exercise;

2. derivative transactions submission – directly by participants or indirectly via a third party such as a clearing house;

3. appropriate methodology for identifying transactions eligible for compression, e.g. transaction linking;

4. compression proposal generation; and

5. compression execution.

As discussed above, we do not believe more prescriptive requirements as described in paragraphs 8 to 16 of Section 8.6 of the Discussion Paper are required.

Q245: What are your views on the approach proposed by ESMA with regard to information to be published by the compression service provider related to the volume of transactions and the timing when they were concluded?

As explained above, compressions (in which ever form) are not a price forming events. As such, we question the value of reporting such information although we note that at an aggregate level, such published information (combined with other metrics of turnover) may convey information to market participants. Regardless of the objective, it is important to note that the approach for publishing information related to a compression exercise needs to recognise differences between multilateral, bilateral and unilateral processes. The primary concern of our members is that any information published should not disclose identities of firms and any actual positions. We are aware that on occasion there may only be one firm from a particular participant category participating in a multi-lateral compression exercise and therefore we would suggest that reporting by participant type should not be required by the regulation. Similarly, by their nature, direct bilateral compression exercises could disclose information that is attributable to a participating firm. We would therefore caution against requirements to publish this information for these types of compression processes until further consideration has been given to how this can be achieved without unduly disclosing sensitive information.

Regarding the actual information that needs to be reported we suggest that the critical information relates to the notional amount of transactions compressed. We therefore suggest that the information published is restricted to i) the notional amount of transactions submitted (and accepted) to be part of the compression exercise, and ii) the notional amount of transactions terminated as a result of the exercise. This information should include all transactions in the compression cycle irrespective of whether the participant is in scope for EMIR and be published at an aggregated market level by product type and currency for each compression cycle. In the case of product type we suggest that this should be interpreted as per asset class only. In our view, a more granular designation will be more challenging to implement and provide limited added value. To the extent that ESMA is inclined to advise the Commission to adopt a more granular approach, for the interests of certainty and avoidance of confusion, such granular approach should be consistent with the ISDA taxonomy.

In the context of APA reporting and the time at which transactions subject to portfolio compression were concluded we suggest that this should be the time at which the compression service provider communicates to all participants that the compression exercise proposal has become legally binding. However, it should be noted that the compression exercise can have taken legal effect at another point in time in accordance with the compression contract between the compression participants.

As close to real time as possible

As explained above there are differences between bilateral, multilateral and unilateral compression techniques and the infrastructure around the compressions exercises. Such differences involve timing constraints.

In respect of multilateral or unilateral compression services and provided the safeguards in relation to sensitive information we have proposed above are adopted, in our view information can be reported almost immediately, subject to any constraints of the providers of such compression services.

By contrast, there is currently no developed infrastructure for direct bilateral compression services and they rely on bespoke arrangements. In our view it will not be possible for bilateral services to report within the same time frame as multilateral and/or unilateral services. Until a suitable mechanism has been developed to support reporting of direct bilateral compression services and can provide the requisite safeguards in relation to sensitive information, the requirement to report should be deferred in respect of direct bilateral compression services. In the interim regulators would have visibility of the results of a direct bilateral portfolio compression exercise through reports made under the EMIR transaction reporting regime.