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The Definition Of Derivative Contracts Under EMIR

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Introduction

EMIR (the Regulation on OTC derivative contracts, central counterparties and trade repositories) came into force in August 2012 as part of an international drive to increase the stability of OTC derivatives markets and to reduce systemic risk. Under the EMIR trade reporting requirements, which came into effect on 12 February 2014, counterparties to trades are required to report all trades in derivative contracts to a registered trade repository.

However, concerns have been raised about the lack of harmonisation between the EU Member States on the definition of derivatives, in particular the precise delineation between FX forward contracts and FX spot contracts, and whether FX forwards are subject to the reporting obligation under EMIR. Similarly, there is no single, commonly adopted definition of commodity derivatives, particularly in relation to physically settled commodity forwards.

ESMA is currently consulting on this issue and has published draft guidelines with the aim of harmonising the definition of derivative contracts. The guidelines are seen as a stop-gap until the issue is clarified under MiFID II and its associated implementing measures, which come into application on 3 January 2017.

Definition of derivative contract under EMIR

A derivative is defined in Article 2(5) of EMIR as a financial instrument set out in points (4) to (10) of Section C of Annex 1 to MiFID, which can generally be categorised as options, swaps and forward rate agreements relating to underlyings such as securities, currencies, interest rates, commodities, emission allowances and weather derivatives.

However, the implementation of MiFID in the different Member States has given rise to different interpretations among national competent authorities (NCAs) as to what should constitute a financial instrument. The main issues are:

(i) a lack of consistency as to what is a 'spot' and what is a 'forward' for FX contracts; and

(ii) whether FX forward contracts, which are intended to be physically settled and whether those which are entered into for 'commercial purposes' should be regarded as derivatives.

This is the case in particular for FX forwards and physically settled commodity forwards. This lack of a common definition is preventing a consistent application of EMIR, as NCAs have been forced to formulate their own individual interpretations.

Action to date to reach consensus among Member States

In February this year, ESMA wrote to the European Commission, drawing its attention to the issue of the definition of derivative contracts under EMIR.

In its first response, the Commission stated that it was not able to provide clear guidance on the boundary between a spot and a forward, although it was of the view that FX forwards would fall within the scope of MiFID. It then published a consultation concentrating on the dividing line between a spot and a forward and set out its feedback in a second letter in July this year. The Commission noted that a broad consensus on the definition of an FX spot contract appeared to have been reached, which included the use of a T+2 settlement period to define FX spot for European and other major currency pairs. The Commission also stated that it was currently unable to deal with the issue, as the powers granted to it under MiFID to issue an implementing act expired on 1 December 2012, but that it would be resolved as part of the MiFID II implementing measures.

ESMA and the European Commission consider that on the basis that major currency pairs use a T+2 settlement period to define FX spot, it follows that any trade with a T+3 settlement period will be deemed an FX forward.

This is not the view of all Member States. The FCA, for example, has indicated that it considers FX forwards to fall outside the scope of MiFID and, as a result, it will not require firms to report their FX forwards to a trade repository, in direct contravention to the European consensus. The FCA intends to follow this stance until the entry into force of MiFID II. Using the definition of derivatives under MiFID, the UK excludes FX forwards, non-deliverable currency forwards and spot transactions for both FX and commodities, as long as they satisfy a commercial purpose test.

ESMA guidelines

As mentioned earlier, ESMA has recently published a consultation paper setting out draft guidelines relating to the definition of derivative contracts (ESMA/2014/1189), which can be found at: http://www.esma.europa.eu/consultation/Consultation-draft-guidelines-application-C6-and-C7-Annex-I-MiFID. ESMA considers that the adoption of the guidelines will ensure the consistent classification of certain financial instruments as derivatives within the EU. This will allow NCAs to take a consistent approach towards the implementation of EMIR from the date the guidelines start applying until MiFID II and the relevant implementing regulation come into force.

The guidelines are not binding, so it is not clear whether NCAs will adopt the interpretation of 'spot' suggested by ESMA or simply wait for the Commission's definitive implementing act under MiFID II. The FCA, on the other hand, has made its position quite clear on FX forwards, as set out above.

Next Steps

The draft guidelines are open to comments until 5 January 2015. ESMA will then consider the responses it receives and expects to publish a final report and final guidelines after that.

If you have any questions at all on the above or any aspect of EMIR and would like to discuss further, please contact Claire Cummings at:
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October 2014

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