European Association representing the trade in cereals, rice, feedstuffs, oilseeds, olive oil, oils and fats and agrosupply
Comité du commerce des céréales, aliments du bétail, oléagineux, huile d'olive, huiles et graisses et agrofournitures

Brussels, 2 December 2014

COCERAL Position Position on MiFID II – Level 2 legislation

Definition of regulatory and implementing technical standards

COCERAL would like to bring the views of agricultural commodities traders in the process of defining technical standards for the implementation of the Markets in Financial Instruments Directive (MiFID), level 2 legislation.

COCERAL are in favor of consistent and well-functioning futures markets, with sound rules that take into account the particular nature of agricultural commodities markets so that the operators in the food supply chain can hedge the typical risks linked to their physical businesses. Level 2 legislation needs to provide technical rules that:

- Do not jeopardize fair competition, increase financial and administrative burden of food chain operators by making them subject to the same provisions of financial services providers;
- Do not unduly impact the liquidity of futures markets or curb the development of new risk management tools;
- Avoid threatening convergence by limiting the use of financial instruments or reducing liquidity in the market;
- Ensure that the costs for farmers and other non-financial entities to access the exchanges are not be prohibitively high;
- Guarantee coordination at European and international level for new legislation and apply a sector adapted approach when introducing new rules.

It is necessary to understand that not all commodity markets are the same. The appropriateness of rules depends on the detailed factors affecting the specific market, including, for example, the availability of delivery points, the duration of the contract and the perishability of the goods. It would be a mistake to impose a one-size-fits-all solution on all commodity markets. Financial instruments in agricultural commodity markets are directly linked to the movement of physical goods and serve as a true tool for the commercial operators in the real economy.

COCERAL would like to bring specific views and practical examples on three main elements of MIFID for the development of level 2 legislation, and in particular on:

1. Definition of financial instrument
2. Position limits and portfolio hedging
3. Ancillary definition

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1. Definition of financial instrument

A physical forward contract as it is used for agricultural commodities is not a financial instrument and as such not to be reported under EMIR nor to be included under the scope of MiFID II/MiFIR.

A forward contract in agricultural commodities is a physical contract. A physical contract is in almost all cases a forward contract. In the minority of cases it can be a spot contract (as defined in point 8 at page 288 of the ESMA consultation paper), whereby it then automatically falls outside the scope of MIFID.

The physical forward contract does not fall under section C5 because it is a contract that must not be settled in cash. The physical forward contract does not fall under section C6 because it is not traded in regulated markets or with publicly quoted prices. It does not fall either under the scope of Section C7 because all physical forward contracts are for commercial purpose.

By commercial purpose we understand the following:

"A contract for a commercial purpose is concluded between entities that produce, store, manufacture, process, merchandise, transport or trade an agricultural commodity and need to sell or purchase it to perform their commercial activity.

When the contract is for commercial purpose the commodity, quantity, quality, delivery conditions (period, location, and processing), price (or modalities to fix it), terms of payment and transfert of the ownership and risk are specified in the terms of the contract."

The present definition of a contract for commercial purposes is narrowly framed and limited to the energy sector. We support a broadening of article 38.1 as proposed here above, so that this category can be as well applied to agricultural contracts.

Without a broad definition of contracts for commercial purposes encompassing truly physical contracts for the sale and purchase of agricultural products, many such contracts could fall within the scope of Section C7 of Annex 1. At every link of the supply chain there are sellers and buyers of commodities who trade according to standard terms. Standard contracts increase legal certainty between the parties by providing clear terms for the sale, purchase, transport and delivery of agricultural products in order to bring agricultural raw materials from places of surplus to places of deficit. A standardised physical forward contract used as part of the commercial activities of any business that is actively involved in producing, processing, shipping or merchandising that physical commodity should be considered to be for commercial purposes.

Practical examples

Here follows examples to illustrate why physical forward contracts for agricultural commodities should NOT be included under the scope of MIFID II/MiFIR.

Example 1 – string transaction in corn

Commercial contract in a string transaction illustrates the concept of commercial purpose of a forward (Annex I, C7) even in the absence of an actual physical settlement:

August 15th: commodity merchant X decides to buy 25 MT corn, to be shipped between 1 and 15 October FOB Ukrainian port - as he is confident that he will be able to find a feed processor in Egypt to buy the corn at an interesting price in October.

Beginning of October however, merchant X could not find any buyer in Egypt as the crop has been larger than expected; prices are low and the merchant expects them to drop further. He therefore decides to take his loss and to sell the corn to another merchant (Y) now, before the shipment actually takes places. Merchant Y now has the commitment to load the vessel.

Although there is no physical delivery, this appears as a genuine commercial contract supported by a physical transaction; indeed the merchant had the intention to deliver the crop. His commercial added value was to take the risk of buying the corn without any certainty on the sell price, thus allowing the farmer to sell his crop. The merchant has decided to manage his risk and limit his loss, in the absence of feed processors to buy at a reasonable price, by selling back the corn to another commercial user, who will actually load it on a vessel between 1 and 15 October as per initial contract.

Example 2 – string transaction in rapeseed

FOB Dutch Mill/Ex-Tank Rotterdam Rapeseed oil is traded under NOFOTA Terms. This is a physical forward contract, not traded on a Regulated Trading Platform and not publicly quoted, but traded (and quoted) through physical brokers, which can be executed in different ways, depending upon agreement between the parties.

Potential executions of the physical forward contract:

- Simple physical delivery execution: S sells to B a fixed quantity of the standard quality under the standard terms of NOFOTA for delivery in a specific forward month. When that forward month becomes the spot month, B executes the contract by taking physical delivery and paying S.
- String execution: S sells to A, A sells to C, C sells to D, D sells to E, and E sells to B (with much more in between parties possible), all at different moments and at potentially different prices, but all for the same fixed quantity of the standard quality under the standard terms of NOFOTA for delivery in the same specific forward month. When that forward month becomes the spot month, B goes through the string to execute the contract by taking physical delivery and learns that the first seller is S. Agreement is reached in the string to have the physical execution between the first seller (S) and the last buyer (B) at an agreed price (to be paid by B to S upon physical delivery) and that the differences between this agreed string price and the individual contract prices shall be settled between the individual contracting parties (between S and A, between A and C, between C and D, between D and E and between E and B).
- Circle execution: S sells to A, A sells to C, C sells to D, D sells to E, E sells to B and B sells to S (with much more in between parties possible), all at different moments and at potentially different prices, but all for the same fixed quantity of the standard quality under the standard terms of NOFOTA for delivery in the same specific forward month. When that forward month becomes the spot month, S alerts the string that a circle is established (whereby the first seller and the last buyer are the same) and that therefore no physical delivery will follow. The parties of the circle agree on the circle price and that the differences between this agreed circle price and the individual contract prices shall be settled between the individual contracting parties - between S and A, between A and C, between C and D, between D and E, between E and B and between B and S.

Regardless of what execution is actually happening, the execution can only proceed when the forward month of the contract becomes the spot month. Hence, price differences between purchase and sale of the physical forward contract can only be cashed/paid upon execution - when the forward month of the contract becomes the spot month - contrary to futures where market price differences are due/receivable from the day of trading.

This is a further reason why physical forward contracts should not be considered as financial instruments. They are either physically executed under the normal physical commercial operations of the company or they are hedges which cover the risk of not being able to cover the normal physical commercial operations of the specific company at that time. In that case the company needs to unwind this hedge (with an opposite hedge) once the normal physical

commercial operations of the specific company can be realized - and the price difference between the hedge and the opposite hedge, payable/receivable at the moment of physical execution serves to reach the first intended price.

Please find hereafter a concrete example:

X is a rapeseed oil producer at Neuss, Germany and wants (on 1 Dec 2014) to sell rapeseed oil for March 2015 delivery ex his plant at Neuss at 665 €/ton. He does however not find a customer willing to buy rapeseed oil ex-Neuss at that price for March 2015 delivery. He calls a FOB Dutch Mill broker and sells on 1 Dec 2014 (through that broker) 500 tons of FOB Dutch Mill/Ex-Tank Rotterdam Rapeseed oil to Y at 665 €/ton for March 2015 delivery. On 15 Dec 2014, Z wants to purchase 500 tons of March 2015 delivery ex-Neuss at 680 €/ton from X. X checks with a FOB Dutch Mill broker and purchases on 15 Dec 2014 (through that broker) 500 tons of FOB Dutch Mill/Ex-Tank Rotterdam Rapeseed oil from W at 680 €/ton for March 2015 delivery and X sells to Z 500 tons of March 2015 delivery ex-Neuss at 680 €/ton (under the relevant physical terms). Arriving March, X physically delivers the 500 tons of rapeseed oil ex-Neuss to Z and receives the payment of 680 €/ton. Also in March, assuming that the agreed string price is 670 €/ton, X has to pay to Y 5 €/ton (sold at 665 against string price of 670) and has to pay to W 10 €/ton (bought at 680 against string price of 670). His total loss on the hedging operation is 15 €/ton and with the 680 €/ton obtained from his buyer Z, his final net sales price on the 500 tons rapeseed oil ex-Neuss is 665 €/ton (680 – 15), which is exactly the price he intended to sell at on 1 Dec 2014. So, the purpose of using physical forward contracts at another location than his plant was merely to book the intended sales price with a hedge and then unwind the hedge when the physical forward sales contract at his plant was possible.

Example 3 – Euronext future contract

In the agricultural commodities scope, the French sellers use the Euronext future contract based on quality specifications and delivery conditions. This contract is similar to a physical one with the possibility left to sellers to deliver the grain at maturity. The Euronext future contract deals with the LCH Clearnet clearing house to accredit the silos that receive the grain at maturity. This future contract defines all the terms of condition to secure the transaction and guarantee a price.

2. Position limits and portfolio hedging

The definition of risk-reducing trade under MiFID II should be linked to the definition applicable in EMIR, provided that portfolio hedging is included in the hedging definition.

Commercial firms use complex hedging instruments including portfolio hedging across many geographies, markets, products and time horizons to reduce the firm's wide risk on an overall aggregate basis. Consequently we believe that excluding portfolio hedging may result in increased risks and hedging costs resulting in higher costs pass-through to consumers.

We believe that any position that has the effect of reducing risk should qualify as a hedge.

3. Ancillary definition

Entities that trade agricultural commodity derivatives for accounts of direct customers/suppliers on ancillary basis should be effectively exempted from MiFID because their hedging practices do not pose any systemic risk and are essential for traders to mitigate risks.

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COCERAL members trade exchange-traded futures and OTC on agricultural commodities, freight, bunker fuel and exchange rates: this is essential to reduce the risks related to their main commercial activity consisting in trading physical agricultural commodities. Members have the physical commodity or will get it in the future and use the exchanges for hedging purposes.

The "minority of activities" criterion should be defined as "less than 50%" and harmonized all over the EU. The assessment of the threshold should be asset class-specific.

We believe that there may be merit in identifying the primary activity of the firm and assess the size of the activity relative to the size of the market in that primary activity. Such an approach may foster competition and investment in physical commodity markets and provide liquidity in their related derivative markets because trading in those non-primary activities would not be subject to the threshold test. An alternative could be to identify all the asset classes that a firm transacts in and compare the volume of the firm's activity in those asset classes combined to the total volume in those asset classes combined.

Furthermore, freight should not be a separate asset class but included in the activity of the related asset class because freight is embedded into the management of that related asset class.

COCERAL is the European association of trade in cereals, rice, feedstuffs oilseeds, olive oil, oils and fats and agrosupply. It represents the interest of the European collectors, traders, importers, exporters and port silo storekeepers of the above mentioned agricultural products. COCERAL's full members are 30 national associations in 19 countries and 1 European association. With about 2700 companies as part of COCERAL national members, the sector trades agricultural raw materials destined to the supply of the food and feed chains, as well as for technical and energy uses. COCERAL has an associated member in Switzerland.

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