Annex 10 Commodity Derivative Definitions

USA

In the USA, the G20 commitments on derivatives have built on decades of commodity derivative regulation and been implemented through the Dodd Frank Act.

Dodd-Frank's definition of swaps excludes "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled." This is commonly referred to as the "forward contract exclusion". Towards further clarification around the interpretation of the exclusion and the meaning of "physical settlement", the CFTC and the SEC jointly issued an Adopting Release in August 2012 to help market participants understand the factors to be considered in applying the exclusions and exemptions.

The Adopting Release is consistent with the CFTC's historical Brent Interpretation. The Brent Interpretation dates from 1990. The salient aspects of this are as follows:

- Participants entering into crude oil contracts created a binding obligation to make or take delivery "without providing any right to offset, cancel or settle on a payment-of-differences basis".

- The parties subsequently entered into a book-out agreement, which effectively extinguished the delivery obligation:

- This agreement was new and separate to the original contracts and individually negotiated.

- The participants were not under an obligation to enter into the book-out agreement.

The Brent Interpretation concluded that the book-out did not alter the nature of the original transactions, which retained a commercial character. This test applies to "commercial market participants that regularly make or take delivery of the referenced commodity in the ordinary course of their business" (book-outs are also, of course, undertaken by financial market participants who may wish to trade in physical-delivery products, but who do not want to make or take physical delivery). The term "commercial" is further clarified to be "related to the business of a producer, processor, fabricator, refiner or merchandiser". In other words, the regulator believes that if a commercial market participant requires the physical goods as part of its daily business, all its transactions related to such physical goods relate to a genuine demand and are excluded from regulatory framework. This means that even if a forward contract does not actually lead to a delivery of physical goods, as long as the parties enter into the contract with the ability and intent of taking and delivering the physical goods, such transactions would be excluded. Intent is inferred from the inclusion of a binding obligation within the contract.

However, in practice, transactions in the USA can be assessed on a case by case basis whereby other information can be brought to bear as well. This could include the size of contract (e.g. if it is large), a demonstrable commercial need for the product, and the underlying purpose of the contract.

The Adopting Release [102]has extended such exemptions to all non-financial commodities. This would include agriculture commodities and other exempt commodities. Intangible commodities can qualify provided that ownership can transfer and the commodity in question can be consumed.

The Energy Exemption was an extension of the Brent Interpretation to other energy derivatives apart from oil. Many transactions where a physical delivery of energy products occurs have product-specific settlement conventions, whereby delayed settlement provides for — inter alia — the reconciliation of physical deliveries and the book-out of transactions between the counterparties at delivery points, e.g. North American Physical Powerand European Physical Natural Gas transactions settle on a monthly cycle 20 days after the end of the delivery month. The Brent Interpretation therefore had relevance more broadly than in Brent crude.

Since the Brent Interpretation has now been extended to all non-financial commodities the Energy Exemption itself has been withdrawn. The Energy Exemption expressly permitted market participants to use different settlement mechanisms, i.e. resulting in non-physical settlement including:

- Pre-transaction netting agreements — such as the Edison Electric Institute Master Power Purchase and Sale Agreement — which contains provisions contemplating potential future offsetting transactions which could affect the physical delivery obligations. The test remains that the parties must have had the intent to take or make delivery when they entered into the transaction.
- Passing title to an intermediate buyer in a chain, provided that physical delivery is required and the delivery obligations create substantial economic risk to the parties required to make or take delivery.
- Physical exchange of one quality, grade or type of physical commodity for another quality, grade or type of physical commodity (i.e. similar to a barter trade).
- "Bona fide termination rights", provided the exercise of these was not expected at the time the contract was entered into. These include force majeure provisions, and upon counterparty insolvency, default or other inability to perform not anticipated at the time of entry into the contract.

The CFTC has confirmed that these considerations have not changed, i.e. they represented an appropriate interpretation of the Energy Exemption and hence of the Brent Interpretation. By extension, then, this pre-existing Energy Exemption guidance may now be seen as a basis for interpreting the new rules across all non-financial commodities.

The CFTC also clarified in the same Release that:

"market participants that regularly make or take delivery of the referenced commodity in the ordinary course of their business meet the commercial participant standard of the Brent Interpretation … Intent to make or take delivery can be inferred from the binding delivery

[102] CFTC and SEC, "Further Definition of ''Swap,'' ''Security-Based Swap,'' and ''Security-Based Swap Agreement''; Mixed Swaps; Security-Based Swap Agreement Recordkeeping; Final Rule", August 2012. In particular 48228–9, "(B) Brent Interpretation" and (C) Energy Exemption.

obligation for the commodity referenced in the contract and the fact that the parties to the contract do, in fact, regularly make or take delivery of the referenced commodity in the ordinary course of their business."

Physical commodity forwards are subject to widespread legislative and regulatory treatment, albeit typically separate from financial market regulation. This includes arrangements around delivery:

Participants to commodity physical forward transactions must ascertain that this ancillary infrastructure, such as facilities to transport or store the commodity, is created and maintained. This requires direct capital investment or contractual commitments generally undertaken in the medium or long term. Market participants will also need to have access to the infrastructure, either through direct access to the physical asset or through a contractual right to use the physical asset.

For example, NYMEX's Rulebook specifies with respect to its Light Sweet Crude Oil[103] contracts that — by a date set with reference to the delivery date of the contract — a clearing member taking delivery must not simply notify of intent but set out in a specified template details such as delivery method (taking into account the normal capabilities of the incoming facility) and also identifying the outgoing facility.

Market participants can have access to substantial independent storage capacity. This applies also to financial market participants. For example, Morgan Stanley has been reported as having 55 million barrels of oil-storage capacity[104] (nearly three days' worth of U.S. consumption). On the other hand, several banks are understood to have scaled back activities in these markets due to balance sheet and regulatory pressure.

Singapore

The largest oil market in Asia is in Singapore. In 2012, Singapore transferred the oversight of commodity derivatives to the Monetary Authority of Singapore (MAS). In the consultation paper, MAS proposed to "exclude physically-settled commodity forward contracts from the scope of regulation under the SFA"[105] (Securities and Futures Act). The proposal is in line with how such contracts were already treated under the Commodity Trading Act (CTA)[106].

According to the CTA, "spot commodity trading" is defined as "the purchase or sale of a commodity at its current market or spot price, where it is intended that such transaction results in the physical delivery of the commodity."[107] There is no further clarification around the definition around what circumstances would constitute "intended".

[103] https://www.cmegroup.com/rulebook/NYMEX/2/200.pdf.

[104] http://www.wsj.com/articles/senate-report-says-banks-gained-unfair-advantages-in-commodity-markets-1416434539.

[105] IE Singapore (2012), "Transfer of Regulatory Oversight of Commodity Derivatives From IE to MAS".

[106] http://statutes.agc.gov.sg/aol/search/display/view.w3p;page=0;query=DocId%3A%226a1c2b2c-9451-4a6e-9b85-24f509f57914%22%20Status%3Ainforce%20Depth%3A0;rec=0.

[107] Singapore Commodity Trading Act (Revised Edition 2009).

Although the MAS has not set fixed parameters around the definition of "physical settlement", it has explicitly stated its intention of bringing the financial regulation in Singapore in line with global rules.

Table A5: OTC daily average foreign exchange turnover by country and FX instrument (net-gross basis[1], April 2013, millions of US$)[108]

	Total	% of Total	Spot (settlement ≤ 2 business days)	Outright forwards	Outright forwards (settlement ≤7 business days)	Outright forwards (settlement > 7 business days)	FX Swaps	FX Swaps (settlement ≤7 business 7 days)	FX Swaps (settlement > 7 business days)	Currency Swaps	Options
Austria	17,393	0.26	2,841	5,071	4,833	238	9,044	7,033	2,011	227	211
Belgium	21,597	0.32	3,294	901	276	625	16,764	14,079	2,685	160	478
Bulgaria	1,613	0.02	1,211	37	17	19	362	249	113	4	-
Czech Republic	4,912	0.07	681	258	183	76	3,821	2,745	1,076	59	92
Denmark	102,781	1.54	34,606	8,345	5,577	2,769	55,312	39,951	15,361	1,195	3,323
Estonia	95	0.00	35	3	0	2	55	27	27	1	2
Finland	14,884	0.22	648	428	115	313	13,436	11,854	1,581	76	296
France	189,878	2.85	37,213	8,999	1,512	7,487	134,921	94,423	40,498	3,357	5,388
Germany	110,882	1.66	24,151	4,042	809	3,233	79,137	56,924	22,213	884	2,668
Greece	2,529	0.04	830	67	8	60	1,598	678	920	-	33
Hungary	3,854	0.06	1,052	207	37	170	2,500	2,113	387	21	75
Ireland	11,393	0.17	4,142	2,270	483	1,787	4,716	2,754	1,962	258	7
Italy	23,694	0.36	6,692	795	130	665	15,216	10,410	4,806	198	793
Latvia	2,034	0.03	923	3	0	2	1,108	1,061	47	-	-
Lithuania	528	0.01	167	2	0	2	357	333	25	-	1
Luxem-bourg	51,157	0.77	11,936	14,788	3,214	11,573	24,131	17,084	7,047	42	260
Nether-lands	112,268	1.68	54,623	12,435	9,980	2,454	43,254	25,443	17,811	938	1,018
Poland	7,564	0.11	2,324	464	95	369	4,581	3,844	738	125	70

[1] According to the BIS Triennial Central Bank Survey, net-gross basis data are 'Adjusted for local inter-dealer double-counting… [and] Data may differ slightly from national survey data owing to differences in aggregation procedures and rounding'.

108 Europe Economics, Data gathering and cost-benefit analysis of MiFID II, L2, p. 228-230.

Portugal	3,569	0.05	1,453	176	23	153	1,743	941	802	-	197
Romania	3,354	0.05	908	65	4	61	2,369	1,979	390	-	12
Slovakia	838	0.01	121	49	27	22	636	496	140	0	32
Spain	43,034	0.65	13,595	3,186	608	2,578	24,896	19,588	5,309	286	1,071
Sweden	43,594	0.65	9,145	1,587	447	1,141	31,780	22,913	8,867	181	901
United Kingdom	2,725,993	40.86	1,031,908	308,808	156,623	152,185	1,126,586	796,499	330,087	32,167	226,524
EU Total	**3,499,438**	**52.45**	**1,244,498**	**372,986**	**185,003**	**187,983**	**1,598,324**	**1,133,422**	**464,902**	**40,179**	**243,451**
United States	1,262,799	18.93	619,357	227,281	75,988	151,293	340,991	204,365	136,626	4,397	70,773
Hong Kong SAR	274,605	4.12	51,172	37,305	9,502	27,804	174,130	131,426	42,704	2,528	9,469
Singapore	383,075	5.74	103,295	61,703	14,448	47,255	172,787	131,784	41,004	1,843	43,447
Japan	374,215	5.61	156,630	35,220	10,594	24,625	169,558	133,383	36,175	6,388	6,419
Global Total	**6,671,445**	**100**	**2,459,123**	**815,807**	**325,886**	**489,920**	**2,930,943**	**2,065,486**	**865,457**	**68,294**	**397,278**