FESE

Response to the ESMA Consultation Paper on MiFID II Position Limits and Position Management in Commodity Derivatives

Brussels, 8th January 2020

Introductory remarks

FESE members welcome the possibility to respond to the ESMA Consultation Paper on the impact of position limits on liquidity, market abuse and orderly pricing and settlement conditions in commodity derivative markets.

As highlighted in our response to the Call for Evidence, we believe that the current MiFID II position limits regime has so far been able to function in a reasonable manner for a number of well-developed benchmark contracts. However, for the development of new products and further growth of the existing illiquid commodity derivative markets, the position limits regime has proven to be a substantial barrier.

To solve the issues deriving from the current provisions, we would suggest a fundamental review of the scope with the aim of moving towards a more proportionate and efficient position limit regime. This can be achieved by focusing the application of the regime on a more limited set of important, critical commodity derivative contracts. This would not only allow new and nascent products to develop but would also better fulfil the overall objective of MiFID II to 'improve the functioning and transparency of commodity markets and address excessive commodity price volatility'.

Having said this, although we support a review of the scope at Level 1, we also believe that there is an urgent need to limit the negative impact the position limits regime, in its current form, has on new and nascent contracts. For this, we recommend a two-tier approach whereby Level 2 is amended immediately (and changes are implemented quickly), while the more fundamental reform is dealt with as part of the Level 1 review. Such a change of Level 2 should build upon the policy recommendations proposed by ESMA under the so-called Option 2.

Questions

Q1: Which option (Option 1 or Option 2) do you support for dealing with competing contracts? Please explain why. If you support Option 1, do you have any suggestions for amending the definition of "same contract" in Article 5(1) of RTS 21? If you support another alternative, please explain which one and why.

FESE supports Option 2. We understand and agree with the rationale for levelling the playing field for competing commodity derivatives traded on different venues which are classified as liquid and have the same physical underlying. Indeed, the open interest figure which serves as a basis for setting "Other Months" limit should be provided by the trading venue with the largest average open interest over a certain period, i.e. one year. The position limit

of the most liquid commodity derivative contract should be applied identically to competing contracts that are deemed liquid and have the same physical underlying. Such an approach would prevent any discriminatory outcomes of the MiFID II position limits regime towards trading venues with lower open interest in a contract with the same physical underlying, and would allow the EU markets development to continue.

In case of Option 2 three different scenarios might arise:

1. If two trading venues list a commodity derivative contract with the same physical underlying, but neither of these contracts meets the criteria to be deemed liquid (or critical in the case we move to a limited scope of application to critical contracts only – for details please refer to our response to Q4) then no position limit applies.
2. If one of the two contracts meets the criteria to be considered a liquid (or critical) contract, the position limit should apply only to the venue listing the liquid (or critical) contract and not to the venue listing the commodity derivative contract with the same physical underlying that is not deemed liquid (or critical).
3. Should both contracts be considered liquid (or critical), then the position limit of the liquid (or critical) contract with the highest open interest should apply to the other liquid (or critical) contract(s) on other venues with the same physical underlying.

At the same time, FESE disagrees with the proposal to amend the definition of the "same [commodity derivative] contract". First, it should be emphasised that, in practice, commodity derivatives traded on different trading venues can never be considered as the "same contract", even if they have the same physical underlying. This is because a contract is designed by the trading venue, whereby the rules and conditions, including those related to pricing and settlement, differ across venues. Thus, commodity derivatives traded on different trading venues cannot and should not be netted against each other for position limits or other purposes. Also, for that reason, the removal of the condition for contracts to "form the same pool of open interest" would not remedy the level playing field problem which ESMA is trying to solve. In addition, Option 2 would be a more pragmatic way forward given the current set-up of national competent authorities (NCAs) towards position limits reporting and monitoring. It would for example be impossible for trading venues to have access to information on positions in contracts offered by other venues.

Q2: Do you agree that the C(6) carve-out creates an unlevel playing field across trading venues and should be reconsidered? If not, please explain why.

FESE continues to support the policy rationale for the exemption of physically settled gas and power contracts from the EU financial regulatory framework for the following reasons:

First, due to their specific characteristics carved out energy commodity contracts are subject to the energy-specific anti-market abuse regime of the Regulation on Wholesale Energy Market Integrity and Transparency (REMIT). Their inclusion in the complex and far-reaching matrix of the requirements under MiFID II/MiFIR, predominantly designed for investment firms and banks, could undermine their actual economic functions. In this context it is important to note that they play an important role in the liberalisation and further development of the EU's internal gas and electricity market. Moreover, they constitute important instruments for the energy transition as well as for the broader shift to a green and carbon-neutral economy in Europe.

Second, while there might be differences according to geography, market structures and specific asset classes, the overall trend of increased trading on regulated markets has not reversed since the beginning of the application of MiFID II/MiFIR. We therefore currently do not see evidence that the C(6) carve-out has led to a shift in volumes to Organised Trading Facilities (OTFs).

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Finally, FESE believes that the focus of the upcoming MiFID II review should be on making MiFID II fit for firms trading commodity derivatives classified as financial instruments. Hence, ESMA should give priority to addressing the main flaws in the position limits regime by limiting its scope to critical contracts. The limitation in scope is urgently needed to allow Exchanges in Europe to develop new and nascent contracts and successfully compete globally. Other unrelated policy changes could distract from this central aim.

Q3: Do you agree that the position limit framework should not apply to securitised derivatives? If not, please explain why.

Yes, FESE agrees with the assessment conducted by ESMA and fully supports the recommendation of excluding securitised derivatives from the scope of position limits in Art. 57 MiFID II.

Also, FESE strongly recommends that cash settled derivatives on broad-based indices composed of commodities related items should not be included in the scope of the position limits regime which has been introduced with the policy objective to avoid market abuse and ensure orderly pricing and settlement in the commodities derivatives market.

In our response to the Call for Evidence, we have explained that the MiFID II position limits regime did neither contribute to the prevention of market abuse, nor to the improvement of orderly pricing and settlement. Rather exchanges' market oversight systems, including compliance, supervision and surveillance activities, have been calibrated prior to the MiFID II position limits regime to effectively prevent market abuse and ensure orderly pricing and delivery, while allowing new and illiquid products to develop.

Especially for cash-settled derivatives on broad-based commodities index underlyings, it does not seem reasonable to have an additional limit on the index derivatives, as the individual components are already under position limit regime on the exchanges where these are traded. Moreover, these contracts are cash-settled, and it is not possible to squeeze (corner) a market link in physical delivered derivatives contracts.

Hence, we believe that derivatives on broad-based commodity indices are wrongly addressed in the scope. While we acknowledge that regulators and legislators might be concerned that the exclusion from the scope might open opportunity for loopholes, we would like to suggest again that product design and mechanisms of derivatives on broad-based commodity indices - already fulfilling the objectives of the regime - should be taken into consideration when the definition of scope will be revisited. The position limits regime does not provide a reasonable measure for increasing market integrity but impairs the growth of and demotivates clients' flow to shift to transparent and electronically traded markets. It also limits the capability of liquidity providers to fulfil their role and comply with the regulatory requirements, as these are stemming from a mis-categorisation into the scope of the regime.

Q4: Which option do you support to address the negative impact of position limits on new and illiquid commodity derivatives: Option 1 or Option 2? Please explain why. If you support another alternative, please explain which one and why.

FESE believes a more fundamental review is needed to effectively overcome the negative impact of the current regime on new and illiquid commodity derivatives and hence supports Option 1.

FESE believes that, to solve the issues deriving from the current provisions as laid down in our response to the ESMA's Call for Evidence, **we need to move towards a more proportionate and efficient position limit regime. This can be achieved by focusing the application of the MiFID II position limit regime on a more limited set of important,**

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critical commodity derivative contracts, i.e. Option 1. This would not only allow new and nascent products to develop but would also better fulfil the overall objective of MiFID II to "improve the functioning and transparency of commodity markets and address excessive commodity price volatility".

Although, as indicated in our response to the ESMA Call for Evidence, the MiFID II position limits regime did not contribute to the prevention of market abuse, nor to the improvement of orderly pricing and settlement, we understand the view of policymakers that there might be a value in setting position limits to avoid excessive speculation adversely affecting prices. To achieve this objective - which is identical to the objective of the US position limits regime - it is sufficient to consider only those contracts that are relevant for the price formation in the underlying commodity. This means mature products which serve as a benchmark for the respective market. New and nascent products constitute a minor share of commodity markets. Such contracts are unlikely to influence price movements in the underlying physical commodity markets and thus do not negatively impact consumers.

The other (non-significant) contracts would remain subject to the position reporting regime under Art. 58 MiFID II, the pre-existing position monitoring and position management measures by exchanges and the market oversight practices of the exchanges' market supervision and market surveillance departments that apply the principles laid down in REMIT and the Market Abuse Regulation (MAR) (see also our response to Q9). Thus, removing position limits for such contracts would not pose any risk to the transparency and functioning of the respective markets. On the contrary, attracting more volume to regulated venues would contribute to a more transparent trading environment.

Having said this, although we are supportive of Option 1, we believe that there is an urgent need to limit the negative impact the position limits regime in its current form has on new and nascent contracts. For this, **we recommend a two-tier approach whereby Level 2 is amended immediately, while the more fundamental reform is dealt with as part of the Level 1 review. In this case, it must be ensured that any policy changes suggested under Option 2 can be introduced quickly to provide for short term relief until a more fundamental review is achieved in Level 1.**

Such a change of Level 2 should build upon the policy recommendations proposed by ESMA under Option 2. Against this background, FESE supports a transitional period for new contracts during which no position limit shall apply. However, based on our experience, a 12-month period is too short to develop a contract. Therefore, this period should be extended to 24 months. Secondly, we are concerned that a 50% position limit for contracts below 20,000 lots open interest might not be sufficient, especially for contracts with a very low open interest and typically a one-digit figure of market participants. If after 24 months the combined open interest has still not exceeded 20,000 lots, ideally a 10,000 lots limit should apply. Only such an approach can facilitate rapid growth as well as provide sufficient time for NCAs to set a bespoke position limit.

These transitional measures would only include an amendment of Articles 5 and 15 of the Delegated Act 591/2017. In particular, it should include a revision of the distinction between the 'illiquid' (below 10,000 lots) and 'less liquid' (below 20,000 lots) categories in Art. 5 while introducing one basic category of 'illiquid and less liquid' contracts, i.e. all contracts below 20,000 lots of open interest. In line with this change, Art. 15 should be amended accordingly, i.e. defining a new position limit of 10,000 lots. Art. 15(1) would subsequently become redundant.

Furthermore, to facilitate the growth of fast-moving contracts of both illiquid as well as liquid contracts, we would like to recall our support for the introduction of a forward-looking model in which the position limit is calculated based on a form of extrapolation of the market's historical development of open interest in the case of other month contracts and deliverable supply in the case of spot month contracts. This approach would be particularly

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well suited to accommodate for periods of strong market growth and should not only apply to setting the limits, but also to classifying contracts as liquid or not.

Q5: If you support Option 1 and would suggest different or additional criteria to determine whether a contract qualifies as a critical contract, please explain which ones.

Exchanges use various criteria to assess the liquidity of a market. They include, inter alia, open interest, share of open interest versus deliverable supply, number of active trading participants, churn ratio (for physically settled contracts), share of screen execution and average trading horizon. However, based on FESE members' assessments, we have come to the conclusion that these parameters are highly correlated and therefore open interest is sufficient to determine whether a contract qualifies as a 'critical' contract or not. It would be redundant to set additional parameters.

In addition, FESE would not oppose adding "underlying asset" as an additional factor.

Q6: Which open interest and participant threshold would you suggest for qualifying a commodity derivative as a critical one?

FESE considers a commodity derivative contract to be "critical" once it has developed into a highly liquid instrument with open interest levels that imply that all the various more detailed liquidity criteria have been met. Furthermore, the price signal of a "critical" contract should be broadly recognised in the wider market as a relevant benchmark price for its underlying commodity.

Based on these criteria which exchanges use to determine which markets should be considered mature and developed, we recommend a contract should have at least 300,000 lots of open interest on average over a year to qualify as 'critical'. This threshold is based on the open interest calculated by individual exchanges. This approach would produce an outcome broadly comparable with the US regime for position limits, whereby we expect around 20 commodity derivative contracts offered for trading in Europe to be classed as critical.

In relation to the 'type and variety of market participants', we consider this indicator to normally be highly correlated with open interest. In the interest of transparency and simplicity of the regime, we therefore recommend that this criterion is not considered.

However, should ESMA wish to take it into account, we recommend that there should be at least 20 actively trading market participants in a contract on average over a one year period. This number of market participants is also a factor to be considered by NCAs when setting position limits under the implementing legislation of Art. 57 MiFID II. To qualify as critical, a contract would have to breach the thresholds for open interest and actively trading participants.

Q7: Would you support a position limit exemption for financial counterparties under mandatory liquidity provision obligations? If not, please explain why.

Yes, FESE fully supports a position limit exemption for financial counterparties under mandatory liquidity provision obligations, similar to the one outlined in Art. 2(4) MiFID II.

Furthermore, such an exemption should not be limited to financial counterparties only but expanded to non-financial counterparties, too, as in many cases, non-financial counterparties fulfil mandatory liquidity obligations as well.

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This is in particular necessary for new contracts that need financial or non-financial entities to incentivise trading in the contract, at least if the position limit regime continues to include the restrictive 2,500 lots limit on new and illiquid contracts. If no such exemption is available and the 2,500 lots limit continues to apply, exchanges have to contract a "panel" of liquidity providers to ensure that none of these firms exceed the 2,500 lots limit. In nascent markets, it is highly possible that there may not be the required number of counterparties to build such a "panel" and even where this is the case, it adds significant costs for the exchange.

In order to avoid such a situation, FESE recommends that the position limits regime includes such an exemption based on the same conditions as the liquidity provision exemption outlined in Art. 2(4) MiFID II and the ESMA Q&A on MiFID II/MiFIR commodity derivative topics, and implemented similarly to the hedging exemption under the position limit regime.

Q8: Would you support introducing a hedging exemption for financial counterparties along the lines described above? If not, please explain why.

FESE supports introducing a hedging exemption for financial counterparties along the lines described in the paper. However, FESE does not agree with ESMA's view expressed in the consultation paper that the compliance monitoring of such exemptions by regulators would not be possible or efficient.

As stated in our response to the Call for Evidence, FESE commodity exchanges have extensive experience with operating an internal position management system based on hedging exemptions. Under their regimes, they can grant such exemptions from limits of positions to any market participant, regardless of their legal status, provided that the hedging intention is adequately documented and demonstrated. This ensures that the genuine hedging activity is not restricted and allows commodity market participants to manage their risks efficiently.

Exchanges propose that an analogous regime – including financial counterparties – could be operated by financial regulators across the EU, all the more given the amount of information the NCAs receive about the activities of such entities, and introduced within the context of MiFID II/MiFIR package to allow proper monitoring by regulators.

Q9: Do you agree with ESMA's proposals to amend Article 57(8)(b) of MiFID II and to introduce Level 2 measures on position management controls? If not, please explain why.

No, FESE does not believe that Level 2 measures are necessary for a more convergent understanding and implementation of position management controls. Rather, as position monitoring, management and control activities are already subject to REMIT, MAR and MiFID II principles, we are convinced there is already sufficient consistency across trading venues.

As laid down in detail in our response to ESMA's Call for Evidence, besides being subject to position management regimes, exchange-traded gas and power derivatives markets are also under close scrutiny of the exchanges' market supervision and market surveillance departments. These departments apply the principles set out in REMIT and MAR, which both apply to gas and power derivatives markets. While REMIT introduces a sector-specific legal framework for identifying and penalising insider trading and market manipulation in wholesale energy markets across Europe, MAR establishes a pan-European regime to prevent and detect market abuse, market manipulation and insider dealing in financial markets, including in energy derivatives markets. These pre-existing regulations as well as the work of market supervision and market surveillance departments have been effective in preventing market abuse and excessive speculation.

In addition, FESE fully supports the current approach whereby a substantial responsibility for position monitoring, management and control is delegated to exchanges. Trading venues are best placed to conduct these tasks and have operated sophisticated position management regimes since before MiFID II. These regimes generally include:

1. Accountability levels above which members are required to report certain information to the exchange (e.g. their positions in a contract in question and the beneficiaries thereof);
2. Position, expiry and delivery limits indicating maximum positions that can be held by members in the contract in question at a given time;
3. Exchange rules providing compliance teams with powers to:
   - Request information from members as to the purpose of the positions they hold in a contract in question,
   - Order members to decrease their position,
   - Discipline members that do not comply with the above.

Furthermore, these regimes are operated by compliance teams with sufficient staff and technologically advanced tools to monitor on a daily basis the open interest in contracts admitted to trading, positions held in those contracts by exchange members and the activity in physical markets underlying the commodity derivatives admitted to trading.

These position management regimes are cautiously calibrated and tailored to the circumstances of each individual exchange such as the nature of its membership, characteristics of the contracts it admits to trading and their underlying markets. There is no 'one size fits all' position management regime.

Against this backdrop, FESE does not believe that the design of position management regimes should be codified in Level 2 technical standards.

Last but not least, we would like to emphasise that the overall regime needs to be reconsidered for what it concerns cash settled derivatives on broad-based indices composed of commodities related items (please also see the response to Q3). To our experience, the regime unfolds its value for market integrity in physically delivered contracts. The underlying is usually a single instrument or a very narrow defined basket, and not a broad-based index.

Q10: Do you agree with the revised proposed minimum threshold level for the open interest criterion for the publication of weekly position reports? If not, please state your preferred alternative for the definition of this threshold and explain why.

FESE supports the revision of the proposed threshold level for the publication of weekly position reports. However, we believe that the proposed threshold would be too low to prevent that market participants with open positions in a particular contract become easily identifiable. We therefore suggest a new threshold which simply equals deliverable supply.

Q11: Do you have any comment on the current number of position holders required for the publication of weekly position reports?

FESE supports the current number of position holders required for the publication of weekly position reports, provided that the open interest is higher than the size of deliverable supply.

However, the total number of position holders must be combined with a minimum threshold in each category for preserving the anonymity of market participants. Effectively, if the number of position holders in one category is too low, their positions might be deduced by other market players (primarily by others in the same category), putting at risk their strategy and economical position. Accordingly, we consider that for each category of position holders,

there must be at least four different entities. This will provide increased transparency, also with regard to contracts that do not longer fall within the scope of the position limits regime, while preventing a situation in which market participants can be easily identified.

The Federation of European Securities Exchanges (FESE) represents 36 exchanges in equities, bonds, derivatives and commodities through 19 Full Members from 30 countries, as well as 1 Affiliate Member and 1 Observer Member.

At the end of November 2020, FESE members had 8,838 companies listed on their markets, of which 14% are foreign companies contributing towards European integration and providing broad and liquid access to Europe's capital markets. Many of our members also organise specialised markets that allow small and medium sized companies across Europe to access capital markets; 1,342 companies were listed in these specialised markets/segments in equity, increasing choice for investors and issuers. Through their RM and MTF operations, FESE members are keen to support the European Commission's objective of creating a Capital Markets Union.

FESE is registered in the European Union Transparency Register with number 71488206456-23.