

September 24th, 2013

MiFID – Article 59 – Position limits and position management controls

Definition of the hedging exemption

The European Parliament and the Council have opted in favour of mandatory position limits whose calibration shall be determined by ESMA through regulatory technical standards.

They also provided a hedging exemption which is currently not subject to further clarification by ESMA. We note that the Council and the Parliament continue to differ in their approach with regard to this exemption and we would like to address this.

	Parliament's text Adopted on 26 October 2012	Council's compromise adopted by ECOFIN on 21 June 2013
Text MiFID - Article 59.1	<i>[Position limits]</i> shall not apply to positions which in an objectively measurable way reduce risks directly related to commercial activities.	Position limits shall not apply to positions objectively measurable as reducing risks directly related to the commercial activity or treasury financing activity of a non-financial entity or of a person who acts on behalf of that non-financial entity.

ISDA and FOA welcome the fact that definition of hedging is aligned with the ESMA technical standards supporting Article 10 of EMIR as that the definition covers the same transactions. However, ISDA and FOA also strongly believe that the hedging exemption to position limits should cover *all* market participants entering into transactions whose purpose is to hedge commercial risks, without discriminating between financial and non-financial entities. It is the purpose of the transaction that must determine the exemption and not the class of market participant.

Through hedging, financial firms play a fundamental role in assuming the price and market risk that non-financial firms wish to hedge in relation to their physical businesses. In turn, financial institutions need to hedge the resulting risk by trading on their own account (see Annexe 1). The proposed position limit exemption under MiFID therefore should acknowledge this requirement.

ISDA and FOA members believe that the hedging exemption as defined in both texts needs further clarification through regulatory technical standards. We support ESMA's role in defining exemptions and highlight that attention shall be paid to the need of market participants to retain the ability to hedge their operating costs and manage their risks including on a portfolio basis. We support the idea that ESMA defines positions that are objectively measurable as reducing risks directly related to commercial activity.

If you want to know more about facts, data and research from government, academia and think tanks about the causes of commodity price changes and volatility, see www.CommodityFACT.org

In terms of the existing text FOA and ISDA would urge the adoption of the following de minimis amendment:

“Position limits shall not apply to positions objectively measurable as reducing risks directly related to an underlying commercial activity or treasury financing activity ~~by~~ ~~iesy of a non-financial entity or of a person who acts on behalf of that non-financial entity~~. *ESMA shall draft regulatory technical standards to define positions that in an objectively measurable way reduce risks related to commercial activities*”.

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Annexe – Use of derivatives transactions by financial firms to hedge commercial risks

The role that banks play in servicing corporates in commodities markets is critical to financing both upstream and downstream activities. Upstream activities include exploration, extraction and processing of raw commodities and downstream activities include onward trading through importers and exporters.

Along this supply chain the banks face two risks:

- credit risk in relation to the financing of these corporates;
- market risk related to the production and sales price of the commodity.

Credit risk assessment prior to financing uses important factors such as the profitability of production of the commodity, as well as the cost of trading it. The change in the commodity price usually means a change in the level of credit risk. Banks also use commodities as collateral for facing immediate and direct market risk that may crystallise when a deterioration of the credit portfolio occurs.