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Regulation of Commodity Derivatives markets within MiFID

Position limits and position management rules

Introduction

It is important that commodity derivatives markets are underpinned by a sound regulatory framework to limit the potential for abusive behaviour on these markets.

ISDA, FOA and EFET (hereafter *the associations*) represent major commodity producers, commodity dealers, financial firms and institutional investors and support regulation that will foster orderly markets, prevent market manipulation, enhance market efficiency and transparency[1].

In this perspective, the associations consider that a pragmatic approach consisting of granting regulators powers to put in place position management rules with the capacity, under certain conditions such as market dislocation, to set temporary position limits, is the right one. Position limits should therefore only be, within a position management regime, the last option to tackle market dislocation.

The associations fully recognise that exchanges and regulators need information on commodity derivatives positions to enable them to monitor the market (position information) and need mechanisms subject to appropriate conditions to allow them to intervene if any abusive behaviour or market distortion occurred or is likely to occur (position management).

In addition to position information and to position management, ex-ante position limits are being debated at both European and international level. In Europe the MiFID reform, released on 20 October 2011, intends to address these issues for commodity derivatives markets.

This note explains in particular why position management rules are recognised by most stakeholders as an effective and sensitive tool to ensure that the markets function well and to help preventing market manipulation without negatively affecting liquidity, while the effectiveness of position limits is doubtful.

The associations note that the impact of investors' behaviour on price volatility is often raised as a justification for introducing position limit regimes. However we would highlight that it is fundamentals, not investors, which drive commodity prices in the medium and long term, and while in the short term, investors might intensify price trends, they cannot create them.[2].

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[1] Apart from the MiFID reform, REMIT (applicable to gas and power markets) and the Market abuse directive reform also will also help achieve this purpose.

[2] See ISDA/FOA/EFET note on « *regulation of Commodity derivatives markets within MiFID – price formation drivers* ».

The effectiveness of a position management regime

- The associations believe that the optimal regulatory approach would be to allow exchanges to determine the appropriate position management tools to maintain orderly markets.

  A position management approach enables exchanges to use information on market concentration and price to monitor activity while providing market users with the flexibility to manage risks appropriately. Position management allows the detection of large net positions throughout the trading day and allows exchange market supervision experts to determine whether those positions are having a disproportionate effect on price or are enhancing market liquidity before instructing firms to reduce the position, rather than imposing an arbitrary limit. This approach includes appropriate reporting and full recognition of net positions across both physical and financial.

- The associations highlight that position management is an appropriate and effective tool for dealing with market manipulation risks because these measures can be tailored to the contract concerned. The experience in exchanges that have set-up position management rules underlines this[3].

  With a position management approach, market participants such as members of exchanges are required to abide by the position reporting requirements as set out by the rules of the exchange. For example, holders of warrant positions on the London Metal Exchange are required to lend metal into the market once pre-defined thresholds are reached at fixed rates to maintain an orderly delivery process, thus preserving market integrity.

  These requirements give the exchanges (under the control of the national regulator) authority to manage positions throughout a contract's life cycle and to instruct a participant to close or reduce a position, if that is necessary, to secure fair and orderly markets. If the participant does not comply, the exchange has the power to close the position unilaterally. A position management approach takes account of contract liquidity as well as the scale and nature of participants involved at any given point in time together with the wider market including the physical markets; this is not necessarily the case with a position limit regime.

- Adaptability is needed in particular for the purposes of commodity markets which are characterised by concentration of production and which therefore are more vulnerable to unpredictable shocks (geopolitical instability, climate shocks…); e.g. cocoa or wheat[4]. In the event of such a shock, we are concerned that hard position limits may prevent market participants from being able to physically deliver the commodity; as a result the derivative market becomes dysfunctional; only a position management regime can offer the needed adaptability.

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[3] On ICE, it has been observed that although position limits aim to prevent excessive volatility, they might actually increase it in some circumstances, if they mean some market participants have to pull positions because of them, or cannot participate further to challenge an extreme price value because of an arbitrary fixed position size limit. Ultimately an inflexible position limit acts as a limitation on market activity. There is clear evidence that without an active futures market, prices of the underlying commodity will be more, rather than less, volatile. A real-life example of the US onion futures market (oil) confirms this.

[4] In 2010, the unilateral decision made by Russia to ban export on Wheat created the conditions of market disruptions and affected price discovery on wheat across the world.

This principle is valid for non-storable as well as storable commodities, for perishable as well as non-perishable commodities, even if non storable or perishable commodity markets are more susceptible to shocks than the others.

- A position management regime should apply to all participants, should not consider activity by financial participants to be de facto manipulative and consequently should focus on combating "large positions that lead to manipulation" irrespective of whether they are held by financial participants or others.

Proposal for a sound EU regulatory framework

The European Commission states in the MiFID II proposal[5] that "*Member States shall ensure that regulated markets, operators of MTFs and OTFs which admit to trading or trade commodity derivatives apply limits on the number of contracts which any given market members or participants can enter into over a specified period of time, or alternative arrangements with equivalent effect such as position management with automatic review thresholds, to be imposed in order to:*

(a) support liquidity;

(b) prevent market abuse, or;

(c) support orderly pricing and settlement conditions.

The limits or arrangements shall be transparent and non-discriminatory, specifying the persons to whom they apply and any exemptions, and taking account of the nature and composition of market participants and of the use they make of the contracts admitted to trading. They shall specify clear quantitative thresholds such as the maximum number of contracts persons can enter, taking account of the characteristics of the underlying commodity market, including patterns of production, consumption and transportation to market."

The associations strongly welcome that position management is explicitly mentioned as a regulatory tool to prevent market manipulation.

However, we consider that the most appropriate regulatory regime should be based on the following three pillars:

- Firstly, the general regime should be a sufficiently harmonised position management regime within which position limits should be only one tool among others and more specifically the tool that would be used only in the last resort.
- Secondly, to avoid discrepancies between various national regimes, guidelines for a position management regime should be included within the directive.
- Thirdly, the choice, within the 'position management toolbox', of the appropriate tool to address market disturbances, should remain in the hand of the exchanges under the control of national regulators and with a reporting obligation to ESMA whose responsibility would be to gather information on existing regulatory regimes across the European Union.

We also question whether it is appropriate to refer to 'equivalent effect' in the MiFID proposals given the arbitrary and unproven nature of hard position limits.

[5] COM (2011) 656/4, proposal for a directive on markets in financial instruments repealing Directive 2004/39/EC (MiFID), article 59.

In application to the three pillars, the associations call for the addition of the following guidelines relating to effective position management regime:

- The exchange shall monitor market activity of and the positions being taken by market participants. A member of an exchange will be required to submit daily reports of positions held for its own account and those held on behalf its clients. For each contract, the Exchange will determine if any participant is potentially building a position which raises a threat to the orderly functioning and integrity of financial markets, given the specific circumstances of the underlying market and taking into account such factors as the levels of open interest, liquidity and the supply of the underlying commodity.
- Where the exchange determines that a position has arisen which has the potential to have an undue influence on price of the contract, the exchange will call for all necessary information about the positions, including related physical positions, held by individual market participants or controlling traders to understand the purpose of the activity. Having called for such information, the exchange should be able to determine at its discretion whether or not it is appropriate for the position to be maintained. Where the exchange determines that the position needs to be reduced or potentially closed to secure fair and orderly market they may instruct the market participant to do so. If the participant does not comply with such instruction, the exchange has the power to close the position unilaterally, under the control of the national regulator;
- The entire position management regime is designed by the exchange, its effectiveness monitored by the national regulator who regularly reports to ESMA. Exchanges in conjunction with national regulators and following consultation with market participants may consider implementing other position management measures which consider the specific circumstances and structure of that market concerned. An example is the London Metal Exchange "Market Abortions Regime"[6]

In this perspective, we would support, instead of the current wording of article 59, a wording as close as possible to the G20 outcome[7]: '*market authorities are granted with intervention powers such as formal position management powers, including the authority to set ex-ante position limits, as well as discretionary powers'*. That would highlight the idea that position management is the normal regime and position limits only a tool (under the control of the national regulator) within the position management regime which is employed as last resort measure in individual cases, if there is a threat to the orderly functioning and integrity of financial markets. In this context, we consider that article 59 should only mandate position management by market operators.

[6] On the LME, there is obligation on the holder or holders of a dominant position to lend at required levels (but no obligation on the holder of a long position that is not dominant), being underlined that in our view, a dominant position does not mean that the market participant is destabilising per se the market but that his position, due to its size, shall be followed in order. The calculation of a dominant position is :

- numerator: the total of a market participant's warrant, net physical trading positions and net cash trading positions;
- denominator: total live warrant;
- The exchange shall define the threshold that characterised the dominant position, as regards the characteristics of the underlying commodity.

[7] FSB 'Report to the G20 on the Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability', 4 November 2011.

The lack of effectiveness of a hard ex-ante position limit regime

The cost benefit analysis of hard ex-ante position limits rules shall be made. Many market participants observe that the effectiveness of ex-ante position limits is unproven and that they are likely to have a detrimental impact on the functioning of the market.

- The association consider that there is no conclusive empirical study which proves that position limits either contain upward price movements in commodity derivatives or their associated underlying, or more broadly that they deter manipulative practices[8]. In the case of a number of markets where position limits already apply there is no evidence that suggests that positions limits have brought about a reduction in volatility or price movements compared to contracts that aren't subject to such limits[9].
- Position limits are likely to result in reduced market liquidity and consequently impaired price discovery, which in turn can contribute to greater volatility. We believe this will reduce hedging opportunities and this may create potential cost increases for end-users.
- Position limits ignore the fact that risk management in the commodity markets is not simple; specifically, the underlying desire to tie contracts traded back to a physical commodity ignores that risks are managed as a portfolio; risk in a portfolio is hedged on a net basis and for many reasons individual trades cannot be tied back to specific commodities; many risks will offset each other, options will require delta-hedging, risks will be correlated between commodities, and inflation and another financial risks will be correlated with commodities.
- A hard position limit regime will create arbitrary limits to participants' activity and can restrict the ability of commercial users to hedge their risks. Positions limits assume that market activity should be limited to a 'natural' size and that activity greater than this amount suggests abusive behaviour, which in our view is a false assumption. They also assume that positions below the threshold never can distort prices, which is also wrong. In theory two or more firms each taking a large position below a fixed limit could have a cumulatively disruptive impact.
- Both large swap dealers and commercial participants with trading and marketing operations serve a valuable purpose by using their capital, experience, and diversified platforms to structure unique risk management and financing solutions for important infrastructures projects and their corporate sponsors. A market in which these intermediaries of scale are unable to continue to provide risk management for large and/ or complex customer exposures will ultimately increase costs for these types of projects and reduce overall capital investment in these sectors.

For these reasons, the associations consider that the most effective approach is not position limits but some form of position management. We believe that position management supports liquidity, prevents market abuse and supports orderly pricing and settlement conditions.

[8] See ISDA/FOA/EFET note on "*regulation of commodity derivatives markets within MiFID – price formation drivers*".

[9] Concerning for instance Oil markets, see "The oil trading markets, 2003-2010: analysis of market behaviour and possible policy responses", The Oxford Institute for Energy Studies, April 2011, p. 5: "The key focus for public policy makers should be medium-term price trends because of the potentially harmful economic impact these can have. However, we consider the objective of controlling medium-term price movements through financial market regulation alone to be both misaligned and unachievable. This is because the financial regulatory tools currently being considered, such as position management techniques (including position limits), would not have a meaningful impact on this key issue. The overall conclusion is that, if there are policies which can make a difference to the key economic issue they would have to address the fundamental drivers of instability, rather than issues solely related to the operation of the financial markets".

Harmonisation and coordination between European regulators

The associations acknowledge that harmonisation is one of the key objectives of the MiFID reform and that national discretionary powers should be limited.

However, we underline that commodity derivatives markets are -with the exception of gas and power markets[10]- not European by nature but concentrated (for example, food commodity derivatives in UK and France, metals and oil derivatives markets in UK).

Coordination between regulators is therefore needed when similar contracts are traded on the same underlying commodity in exchanges whose functioning is comparable (for instance Liffe and Matif on wheat).

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[10] In this perspective, the associations have supported the implementation of REMIT and expect enhanced coordination between energy and financial regulators and effective coordination of the mechanisms aimed at preventing market manipulation.