July 19, 2013

MiFID – Article 59 – Definition of appropriate position limits - ESMA level 2 work

The Associations and their members fully support transparency in both physical commodity markets and financial commodity derivatives markets and recognise the need for exchanges and regulators to have accurate information about commodity derivatives positions to enable them to carry out their supervisory and enforcement mandates.

They also underline that commodity and energy derivatives play a crucial role for the real economy as hedging tools tailored to meet the specific needs of an end-user (e.g. an airline using jet fuel, an aluminium producer consuming power).

We wish to provide views as to how to make the supervisory framework for commodity derivatives markets most effective for market participants and in particular end-users. With this in mind we have set out proposals on how position limits should be calibrated in future ESMA regulatory technical standards in order to achieve these objectives optimally.

We note that the article 59.7 of MiFID states that ESMA shall take account, in its RTS, of the following:

"(a) whether the financial instruments can be physically settled or are cash settled;
(b) the maturity of the commodity derivative contracts;
(c) the deliverable supply in the underlying commodity;
(d) the overall open interest in the respective commodity derivative contracts;
(e) the overall open interest in other financial instruments with the same underlying commodity;
(f) the level of volatility in the relevant markets, including substitutable derivatives and the underlying commodity markets;
(g) the number and size of the market participants;
(h) the characteristics of the underlying commodity market, including patterns of production, consumption and transportation to market;
(i) the experiences with the position limits that have been employed by investment firms or market operators operating a trading venue."

Our view is that the future regime should be calibrated around the following principles:

- Limits should only apply to the delivery (spot) month, other more flexible methods should be used for longer dated contracts;
- Limits should apply to net long and short positions, across global trading venues and across ETD and economically equivalent OTC contracts;

- Limits should be ‘dynamic’ and flexible in that they should be regularly reviewed and adjusted according to underlying market conditions. They should be tailored to the specific characteristics of the contract, and the specific commodity market. This includes characteristics such as historical and current liquidity;
- Aggregation of positions applies for positions that are either held and/or directly or indirectly controlled;
- Position limits should be set by market operators (i.e. exchanges) who are experts in their given market in conjunction with competent authorities (i.e. national regulators). Position limit enforcement should form part of the local supervisory and enforcement regime in that given jurisdiction.

1. In future ESMA regulatory technical standards, the associations support the following principles

Principle 1: Position limits should only apply to the delivery (spot) month

Position limits may be an appropriate regulatory tool when used for contracts where there could be a risk of market disruption/manipulation: this is relevant for contracts near settlement or delivery i.e. in the spot month[1].

Modern financial markets are structured to achieve price convergence between physical and financial markets. It is critical that any position limit regime does not interfere with the fundamentals that drive the price discovery mechanism particularly in the spot month. Indeed, for futures markets to act as effective risk hedging venues for physical commodities, their settlement price should converge with the physical market price at expiry. Further down the curve we would question whether position limits would be effective given the decrease in liquidity in long-dated contracts.

The Associations note that the application of position limits in the delivery month[2] is primarily appropriate for physically settled contracts. Physically settled contracts carry a risk of market manipulation and squeezes either through the cornering of the underlying deliverable supply or by participants seeking to make or take delivery beyond the physical capacity of the market within the relevant delivery period[3]. For this reason, spot or 'delivery' month limits restrict how many contracts a participant can hold in the period during which delivery of the physical commodity is to be made. Generally this is when possible market squeezes can occur and dominant market positions can have the most acute effect; market squeezes and dominant market positions are more difficult to achieve further down the curve because the markets have sufficient time to react to and counter them, which is another reason that position limits in future periods are less effective or, arguably, not necessary.

For technical purposes, we believe that the 'deliverable supply' should be defined as the estimated size of the physical market underlying the commodity derivative. This should be estimated also with regard to stressed conditions in order that markets particularly affected by seasonality and location would not be unfairly affected by position limit levels. ESMA will therefore need to conduct research to determine the definition of 'deliverable supply' for each commodity.

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[1] The spot month as defined by US exchanges for purposes of position limits is sometimes shorter than the last calendar month (e.g. for energy contracts it is the last 3 trading days) and sometimes longer. Therefore, there should be some flexibility permitted in setting the length of the settlement period, depending on the commodity contract, and not a one size fits all time period.
On the LIFFE, the limits are the maximum position that may be taken to delivery in any individual delivery month (except where a delivery limit exemption is permitted in specific circumstances, and subject to clear demonstration of need). Positions must be managed to be at or below the limit by the close of business on the Expiry Day of the contract month. Under normal circumstances, LIFFE reviews the delivery limits every six months and the limits set vary, depending on the commodity. The delivery limits are: Cocoa 7,500 contracts, Robusta Coffee 7,500 contracts, White Sugar 5,000 contracts, Feed Wheat 2,000 contracts.

[2] Futures contracts are standardized by the exchange and all listed commodity futures contracts have several designated months during the year when they can be delivered. . Some commodity contracts can have delivery periods every month throughout the year (e.g. energy commodities), whereas others only have four or five delivery months per annum (e.g. March, May, July, September and December for wheat).

[3] In this respect, we note that the CFTC proposal of 2012 proposed limits to cover only cash settled contract for 27 commodities out of a total of 28.

We note that in the US, the CFTC rules currently apply a spot-month limit (limit of 25% of "deliverable supply") bluntly across some specific products and some specific trading venues. This approach does not seem advisable in EU, where the market structure of national power and gas markets, in particular are fundamentally different in terms of, among other things, market structure, supply, demand, economics and regulation. In addition, the non-spot limits in this proposed US regime would be 10% of open interest for the first 25,000 contracts and 2.5% thereafter. The Associations do not believe this this approach is optimal for non-spot month contracts for two reasons: 1. it does not take account of the characteristics of each contract and each underlying commodity market; 2. limits on relatively illiquid futures contracts would lead to market distortion both in terms of liquidity and price. ESMA should also conduct research and determine the appropriate limits for pan-European commodity contracts taking into account the specifics of the relevant markets.

For example: in the energy markets, liquidity 2 years down the curve can be limited and the market structure requires and benefits from the presence of market makers and/or providers of liquidity to keep price discovery fair and transparent. In the absence of a specific exemption, we strongly recommend that non-spot month limits be avoided as market evolution and transparency would be constrained, thus running counter the principles of MIFID.

If limits are applied to other contract months or against total positions, these should be 'soft' limits that trigger regulatory enquiry. Market participants should be given the opportunity to provide evidence to the relevant venue/regulator that justifies the position held. In times of market stress, the appropriate regulatory response may be to request the participants to reduce its position but in the absence of such issues, participants should be able to hold large positions if they can be justified. The flexibility afforded by this approach would be important to maintain the market's ability to quickly respond and adjust to periods of market stress or extreme volatility.

Principle 2: In calculating the size of positions, the net long (short) positions entered by a market participant, across venues and OTC, shall be taken into account

The calculation of a market participant's "position" should be with respect to its net position on a portfolio basis for identical or obviously correlated underlying commodities (e.g. gasoil/ oil) across different and sometimes global markets.

This principle is provided also in the short selling regulation (*see article 3 for the general concept of short and long positions and article 20.1 for CDS*) for the calculation of sovereign credit default swaps positions.

We provide in the annex some examples demonstrating how a regime can accurately reflect a net position across contracts with the same intrinsic characteristics.

We believe that without the ability to net positions across relevant contracts, markets, and venues, the possibility to effectively manage risk would be restricted. Market participants enter into commodity derivative positions as part of their ordinary activity in commodity markets and this activity of price discovery supports the hedging of commercial risks. The position taken however is normally closed in a relatively short timeframe.

Principle 3: Position limits should be flexible and tailored to the specific characteristics of each contract and commodity market. Limits should be regularly reviewed and adjusted to maintain their effectiveness.

Position limits should be based on and tailored to the characteristics of each referenced contract, taking into account *the specific characteristics of the market in question to which they apply and any exemptions thereto* (*Recital 86, MiFID proposal*). The Associations believe that a general approach across commodity markets globally would be unsuitable for EU markets which are so different in terms of structure and fundamentals.

It is critical to clearly assess the size, volume, liquidity, and the trading activity of any markets in respect of which position limits are being considered before setting those limits. This should be done through careful analysis of available data and where this does not already exist, by collation of such data. In this sense the elements mentioned in article 59.7 of MiFID, namely the maturity of contracts, the deliverable supply in the underlying commodity market, the overall open interest, the level of volatility in the relevant markets and the number and the size of the market participants should be carefully assessed and competent authorities in those underlying markets should be involved. Such an assessment requires a reasonable position reporting scheme to be in place, and a transitional period should be envisaged between the implementation of position reporting and the implementation of position limits. This period should be at least 12 months, depending on the commodity, on the availability of date and on the characteristics of contracts and markets.

The limits should avoid creating market disruption particularly in relatively illiquid forward contracts.

Where limits are set, they should be sufficiently large to accommodate market requirements under normal *and* stressed conditions, following an assessment/analysis of their impact on the market and liquidity.

As discussed in more detail below, the Associations consider that the role of ESMA should be to establish a framework for the implementation of a position limit regime, outlining the appropriate standards to be followed by market operators. It should then fall to the market operators to implement these standards in a manner appropriate for the relevant commodity contract. This approach has the dual benefits of consistency and flexibility. We also note that it is not possible to predict how the markets will react or adapt to whatever limits are imposed and that flexibility is therefore critical to avoiding market disruptions

Principle 4: Aggregation of positions should apply only for positions that are held and directly or indirectly controlled, without any ownership threshold (below 50%) that would assume and not demonstrate such control.

One of the key components of a position limit regime would be determining which accounts and positions a single market participant should aggregate.

We note that in the CFTC regime proposed last year, the aggregation provisions require that unless a particular exemption applies, a person must aggregate all positions for which that person controls the trading decisions with all the positions for which that person has a 10 percent or greater ownership

interest in an account or position, as well as the positions of two or more persons acting pursuant to an express or implied agreement or understanding[4]. The Associations would respectfully argue that these rules appear unreasonably restrictive.

The Associations submit that an approach requiring evidence of direct or indirect control, rather than the use of an ownership threshold alone as the basis of aggregation, gives greater certainty to market participants and the likelihood of a more effective solution. In other words evidence must be given of direct or indirect control rather than the use of ownership threshold alone as the basis of the aggregation. Consequently, an entity could have a number of trading positions independently managed each of which would qualify for a separate position limit.

From a legal perspective, no aggregation should be required outside of parent/ subsidiary undertakings except where an entity is in a position to control, manage and/or acts in concert or otherwise has material involvement in that non-group entity's trading business but only where that entity has knowledge of that non-group's positions. In this context the Associations highlight that proprietary positions of undertakings must be differentiated from positions held on behalf of third parties..

We also highlight that the rules should not force aggregation where an investor has no knowledge of another entity's positions. We would agree that regulators prevent the sharing of transaction or position information that may facilitate coordinated trading, but would not support any ownership threshold that would lead to an assumption that there is always coordinated trading.

Whatever the ownership – under 50% - the Associations underline that regulators must still demonstrate that the 'owner entity' does not operate independently with regard to control of accounts or use of identical trading strategies. There must be a case by case analysis here and any ownership threshold would be irrelevant.

Principle 5: Position limits need to be set with close cooperation between regulators and market operators

The choice of the appropriate calibration of limits should be decided in close cooperation between exchanges and national regulators, with a possible reporting obligation to ESMA when limits are breached. It is critical to recognise the knowledge and expertise which market operators have in relation to the functioning and the characteristics of each market. Clear parameters for such decisions by any regulator or market operator should be published to the market at the time position limits are implemented with any subsequent changes notified in advance.

The Associations also strongly urge ESMA to consider existing exchange-administered limits as a sound basis for a position limit regime as we believe these are appropriately calibrated.

In practice a market participant, when reaching or anticipating reaching a spot limit in the market, should be able to request an exemption to hold a position above such limit from the market operator with valid

[4] In May 2012, the CFCT proposed exemptions from aggregation that would permit a person to disaggregate the position of an entity on which they own between 10%-50% interest subject to certain requirements (the person and entity do not have knowledge of each other's trading decisions; they have independent trading systems; they have written procedures to this effect …).

reason. In the course of such request he/she should provide all relevant information to justify any exemption from position limits.

We would welcome the opportunity to engage with ESMA and all other European regulatory authorities on the detail of a position limit regime and we would strongly urge them to continue to assess the impact and the appropriateness of the limits to ensure the continued good functioning of the commodity derivatives markets.

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Annex – Functioning of commodity derivatives markets

Examples demonstrating that the regime must occur on a net basis across identical or closely related contracts

For many commodities there exists both futures markets and swap markets that are respectively traded on different venues. To avoid market dislocation, it is critical that these markets should behave in identical ways and are therefore intrinsically linked without impediment.

The following two examples show how the linkage is taken into account between the different markets.

Scenario 1:

A position in one contract (e.g. a long position in the futures contract) is held in addition to a similar position in the other contract (e.g. a long position in the swaps contract). In this case the net position of the entity would be considered to be double the position in each of the two individual contracts.

In this case, if limits are imposed on a trading venue level, an entity would be able to take a net position equivalent to the sum of the limits on all trading venues that traded an identical or closely related contract. Entities with access to a larger number of trading venues would be able to take larger positions spread across multiple venues in orderto access multiple venue-level position limits. This will work counter to the objectives of regulators (and undermine competition between venues. This removes the freedom to favour a specific venue which may be more reliable, more efficient, cheaper, or generally better).

Scenario 2:

A position in one contract (e.g. the futures contract) is entirely offset by a position in the other contract (e.g. the swaps contract). In this case the net position of the entity would be considered to be flat (zero)

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In this case, if limits are imposed on a trading venue level without netting with other positions, an entity would be prevented from taking a net flat position composed of two large and offsetting positions.

This restricts the ability of market participants to trade freely between markets that should otherwise be fully and efficiently linked[5]. It limits the ability for price dislocations to be closed between markets that should fundamentally be linked. This risk potentially creates inefficient markets with bifurcated and incomplete price discovery. This is particularly the case where different market sectors naturally favour participation via a specific contract or venue. For example, customer business may typically favour swap contracts whilst financial institution hedging may typically favour the futures contract. Trading venues offering essentially identical contracts but based in different countries would likely be favoured by their respective domestic corporates which may have strongly differing bias towards "long" (consumer) and "short" (producer) positions.

5 For example the market in distillate products (e.g. heating oil) should have a close correspondence to the market in the underlying crude oil. Limits applied independently to each of two or more closely-related markets will restrict the ability to close price dislocations between two closely related markets.