December 5th, 2012

MiFID – Article 59 – Position limits and checks

Council working group – Definition of appropriate position limits

Following the G20 commitment to *improve the regulation, functioning, and transparency of financial and commodity markets to address excessive commodity price volatility*, position management versus position limits has been a much debated issue.

ISDA, EFET and FOAhave always supported transparency in both physical commodities markets and financial commodity derivatives markets; we also fully recognise that exchanges and regulators need information on commodity derivatives positions to enable them to monitor the market and need appropriate mechanisms to allow them to intervene if any abusive behaviour or market distortion occurred or is likely to occur.

In this respect, we believe that the optimal regulatory approach is to allow exchanges, in close cooperation with regulators, to determine the appropriate position management tools to maintain orderly markets, one of such tools being position limits.

W**e note that the Council is determined to opt in favour of mandatory position limits, with position management rules only being expressed as additional to such limits.**

We are keen to continue to engage in this debate in a constructive way and, as requested by several members of the MiFID Council working group, we hereby provide a set of proposals on how such limits, if adopted, should be calibrated and how appropriate exemptions to these limits should be designed to avoid market disruptions.

In this respect we think the level 1 text should:

- **State that limits apply only to the delivery (spot) month and for physically settled contracts**

- Recognise that the **limits are applied to net positions** that persons can enter into or hold over a specific period of time, taking account of the characteristics of the derivatives market, including liquidity, and the underlying market.

- **Recognise that the exemption to position limits rules should generally apply to transactions whose purpose is to hedge risks.**

1. Position limits apply only to the delivery (spot) month and for physically settled contracts

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

Delivery month limits restrict how many contracts a participant can hold in the period in which delivery of the physical commodity is to be made. Futures contracts are standardized by the exchange and all commodity futures contracts have several designated months during the year when commodities are delivered, so participants know in advance what the delivery month will be. Some commodities 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).

For futures markets to act as an effective hedging instrument for physical commodities they must converge with the physical market price at expiry. **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**.

Where markets are not physically settled, i.e. for cash settled contracts, the risk of market manipulation by squeezes should be reduced, since participants should be able to access cash to settle their obligations. As such, the application of position limits is unlikely to be appropriate in most cases.
In this regard, wenote that the position limits which have been applied by market operators and the CFTC in the United States predominantly have operated on physically settled contracts (e.g. CME/ NYMEX WTI Crude Futures, Unleaded Gasoline, Grain, Wheat etc.)

2. In calculating the size of their respective positions limits, market participants should be permitted to net OTC commodity derivatives and futures positions

We believe that **without the ability to net**, where appropriate, **it is impossible to reflect the true position that a market participant holds in the market**. In other words, **the calculation of a market participant's position should be its net position on a portfolio basis for identical or obviously related underlying commodities (e.g. gasoil/ oil)**.
This principle is provided 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.

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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.

An inability to net will also restrict the ability to effectively manage risk: a market participant holding a physical long position could be limited by how much of that physical long position can be hedged by a short futures position on a trading platform with position limits; this could result in market participants moving their trading activity to other markets (whether physical or financial positions) where position limits do not exist, reducing liquidity and transparency on exchanges and raising the costs of hedging for all market participants*, including end-users***.** In the annex we provide two examples demonstrating that the regime must occur on a net basis across contracts with the same underlying product.

Alternatively firms may concentrate their positions on to one venue so that they can net their positions within that venue only, thus resulting in concentration risk and reduced competition and again potentially raising the costs of hedging for all market participants*, including end-users***.**

3. Exemptions to position limits need to recognise the hedging purpose of transactions

Firms which trade in physical commodities need to be able to manage price risk: to effectively hedge this risk a firm may need to hedge its entire physical supply or demand and this could be in excess of any position limit set on a trading platform. **Therefore firms should be entitled to apply for exemptions from limits when they are hedging commercial risk. In addition, these exemptions need to be available to all market participants, whether financial or non-financial firms**.

We support ESMA's role in defining exemptions and highlights that attention shall be paid to the need of market participants to retain the ability to hedge their operating costs and manage their risks appropriately, including on a portfolio basis. In particular, we support the idea that positions that are objectively measurable as reducing risks directly related to the commercial activity or treasury financing activity of an entity, or group of entities, should be exempted from calculation against position limits. **This "hedging" exemption should be available to all entities that satisfy the relevant hedging criteria and contribute to effective commercial and credit risk management**

4. Position limits should be tailored to the specific characteristics of each contract, and to the commodity market; and should be regularly reviewed and adjusted

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*).

It is therefore critical to clearly assess the size, volume, liquidity, and trading activity of any markets in respect of which position limits are being considered through careful analysis of available data and where this does not already exist, by collation of such data, before setting appropriately calibrated limits. Arbitrary limits could unnecessarily and potentially harmfully limit liquidity and could lead to increased volatility, for example if traders have to unwind existing positions in a way that may in fact have a distortive effect on the market concerned. This would run directly contrary to the G20 objective, namely addressing excessive commodity price volatility.

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 and adjusted accordingly over time to avoid a cliff edge effect in terms of market liquidity. This is especially true in circumstances where factors relevant to the calculation of a market participant's trades against such limits may be dependant upon factors outside of their control.

5. Position limits need to be set by market operators in close cooperation with competent authorities (i.e. national regulators)

The choice of the appropriate calibration of limits should remain in the hands of the exchanges and venues, under the control of national regulators and with a reporting obligation to ESMA to gather information on existing regulatory regimes across the EU. It is critical to recognise the knowledge and expertise that market operators have in relation to the functioning and the characteristics of each market.

In practice when a market participant reaches or anticipates reaching a spot limit in the market, he should be able to request an exemption to hold a position above such limit from the market operator and in the course of such request he should provide all relevant information to the marker operator, including OTC and physical positions, to justify the granting of an exemption.

Should position limits be introduced, ongoing analysis is necessary to assess the impact and the appropriateness of the limits (in particular with regards to liquidity, pricing and settlement) and should be refined/ revised accordingly to address, accommodate and adjust to market conditions and requirements over time.

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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. the futures contract) is held in addition to a similar position in the other contract (e.g. 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. Holders of large positions would be forced to hold positions across multiple venues to 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. Conversely it would push some business to inferior and poorly performing venues, removing the incentive for them to improve their service.

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).

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[2]. 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.

2 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.