ISDA® Safe, Efficient Markets

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MiFID – Article 59 – Position limits/ Position management

Council working group – Danish compromise

The appropriateness of applying position limits or position management rules to commodity derivatives markets is still under debate at Council level. Having considered the Danish compromise published on June 20th, 2012, ISDA would like to express the following views:

- On article 59-1: ISDA has strong reservations about the proposal that mandatory position limits should be part of a position management regime; ISDA believes that position limits should remain a last resort tool to be used in cases of market dislocation and should only be applied in such instances in the delivery month;

- On article 59-3: ISDA welcomes that level 2 measures will be developed to define the calibration of limits and the exemptions to their calculation but believes the regulatory technical standards should be developed by ESMA rather than delegated acts developed by the Commission given the leading role ESMA plays in implementing data collection at EU level and its technical expertise.

Article 59-1 – Position management including at least position limits

The Danish compromise published on 20 June 2012 proposes the followed wording for article 59-1 of MiFID:

> *"Member States shall ensure that **an operator of a trading venue** which trades commodity derivatives apply **position management, including at least position** limits, on **the size of a position in a commodity derivative** which **a person** can **have** over a specified period of time, to be imposed in order to:*
> *(a)~~support liquidity~~ [deleted].*
> *(b) prevent market abuse;*
> *(c) support orderly pricing and settlement conditions."*

ISDA is concerned that although the position management regime is the by-default regime, the resulting arrangement will be less flexible than the Commission's proposal because position limits becomes a mandatory part of the position management regime.

In this context, ISDA reiterates its positions:

- Exchanges (Regulated Markets) and regulators need information on commodity derivatives positions to enable them to monitor the market (position information) and mechanisms sufficiently flexible to be tailored to the situation to allow them to intervene in the event of any abusive behaviour or market distortion (position management).
- The most effective approach consists 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 in the delivery month.

- A position management regime is far more effective than a position limits regime for the following reasons:
  - It allows dynamic monitoring of, and associated intervention with respect to, not only large positions but also *any* unusual positions with regard to the functioning of the market (positions under the limits may potentially jeopardise orderly market functioning as well as large positions); .
  - It allows exchanges and regulators to evaluate market participants' large positions to prevent market manipulation but in the absence of any evidence of such, enables participants to continue their legitimate activities with minimal impact on the wider market.
  - It demands close and dynamic monitoring and associated intervention by the exchanges and the regulator of and over the whole 'curve'.
  - The focus of position limits should be that they are a tool to manage orderly deliveries in the front month. As part of their overall tool kit, regulators would be able to impose positional delivery limits in exceptional circumstances.

ISDA has already expressed its views on the effectiveness of a well calibrated and harmonised position management regime:

- https://isda.sharefile.com/d/s7ccc7c0377a44c6b (Harmonised position management regime)
- https://isda.sharefile.com/d/sfb7dcdbc55e41328 (Position limits vs position management)

Article 59-3 – Calibration of limits and exemptions

The Danish compromise proposes the following wording of article 59-3:

> *"The Commission shall be empowered to adopt delegated acts in accordance with Article 94 to determine the limits* ***regarding the size of a position in a commodity derivative*** *which any person can* ***have*** *over a specified period of time in accordance with paragraph 1, as well as the conditions for exemptions.*
>
> *The limits shall take account of the conditions referred to in paragraph 1 and* ***the experiences with*** *the limits that have been* ***employed*** *by* ***trading venue operators****.*
>
> ***The limits shall be determined according to the following criteria:***
> ***(i) whether the financial instruments can be physically settled or are cash settled***
> ***(ii) the maturity of the commodity derivative contracts***
> ***(iii) the deliverable supply in the underlying commodity***
> ***(iv) the overall open interest in the respective commodity derivative contracts***
> ***(v) the overall open interest in other financial instruments with the same underlying commodity***
> ***(vi) the level of volatility in the relevant markets, including substitutable derivatives and the underlying commodity markets***
> ***(vii) the number and size of the market participants.***
>
> *The limits determined in the delegated acts shall take precedence over any measures imposed by competent authorities pursuant to Article* ***71(1)(p)*** *of this Directive* ***unless these measures are more restrictive, adopted in accordance with paragraph 4****."*

We note that the Danish compromise text follows the Commission's proposal in suggesting delegated acts be developed by the Commission.

ISDA would, however, rather support regulatory technical standards to be developed by ESMA. The effectiveness of the calculation of positions and, as a result, appropriate regulatory intervention, depends upon the accuracy and quality of the data collected by trade repositories and the coordination between trade repositories, exchanges and national regulators. Thus it seems natural that ESMA, which plays a leading role in data collection at EU level, has a leading role in defining such a calibration.

We consider that the criteria for the determination of limits should be developed by ESMA at level 2 within the following parameters:

- Limits shall apply only in the delivery month (whatever the maturity and the conditions for settlement of the contracts);
- Limits shall apply only to physically delivered contracts, i.e. to contracts where there is the risk of market squeezes through cornering the underlying deliverable supply; and
- In calculating any limit, netting between futures and OTC commodities derivative positions is essential.

Finally, ISDA would emphasise that regulators and trade repositories have an important role to play in ensuring a position control regime is effective as it is important to be mindlful of positions across different markets, trading venues and OTC to form a comprehensive view (see appendix for examples demonstrating that the regime must occur on a net basis across identical or closely related contracts and not on an isolated trading venue basis).

Contact: bgourisse@isda.org

Appendix – 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, 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[1]. 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.

[1] 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.