ISDA® Safe, Efficient Markets

An Evening with Industry Experts and Public Authorities: What does MiFID II Mean for Commodity Market Participants?

June 14, 2017
Scott O'Malia Opening Remarks

Good afternoon, ladies and gentlemen. Welcome to our 'evening with industry participants' event on the MIFID II commodities rules. I'm delighted that so many of you – and so many high-profile and influential speakers – have taken the time to attend.

The fact that you've all chosen to give up your evening speaks volumes about the importance of MIFID II, and the fast-approaching implementation deadline. MIFID II and MIFIR will have a major impact right across the financial sector, but the changes they will bring to the commodity markets are among the most significant.

This matters. Commodity derivatives play a vital role in the economy. They allow agricultural companies to manage the risk of fluctuating crop and livestock prices, energy producers and distributors to manage changes in energy prices, and airlines to hedge the cost of fuel. Without them, companies and consumers would be more susceptible to price volatility, to uncertainty and to risk.

That's why it's important to get these rules right. In my remarks, I'd like to focus on the MIFID II position limits rules, and make the case for an evidence-based review of these requirements after implementation. The fact of the matter is that setting positions limits is very complex, and is especially so given the global nature of these markets.

The MIFID II position limits rules set a cap on the number of contracts in any single commodity that can be held, with the aim of cooling perceived speculation in commodity prices. Those limits are based on commodity derivatives traded on trading venues and economically equivalent OTC contracts.

As always, the devil is in the detail.

There are currently three key drivers that will impact the position limits rollout. First, the technical complexity of developing a methodology for calculating these position limits. In developing the rules, ESMA has had to tackle a number of knotty issues. What's the best metric to base the limits on? At what level should they be set, and should the same limits apply to every commodities contract subject to the position limits rule? What is an economically equivalent contract? This is made even more difficult by a lack of market data in some areas, notably in physical agriculture markets. And what if those contracts are traded overseas or on non-EU venues?

The second driver is the short time frame that has been provided to implement the rules. The European Parliament only approved the implementing standards in February this year, and the final text was published in the Official Journal in March. Market participants now have only six months to implement monitoring and reporting systems for every single type of commodity traded across their branches and subsidiaries, and ensure these systems link up with multiple trading venues.

This work is made all the more difficult by the fact that the rules will be rolled out for everyone at once – a ‘big bang’ implementation with no phase-in. The scope of the work is vast, and time is short.

The third driver is related to the global nature of these markets. This framework imposes local rules on a global market. There’s actually nothing else like it anywhere else in the world, certainly on this scale. Europe is so far the only jurisdiction to set a date for the implementation of commodity position limits. While the CFTC in the US re-proposed its own mandatory position limits for 28 core referenced contracts at the end of last year, it’s unclear when these rules will come into effect – if at all.

In being a first mover, it is important that liquidity is not driven away from EU commodity markets. That would be a disaster for those EU end users that rely on commodity derivatives to hedge their risk. A smaller liquidity pool means less choice, potentially higher prices, and greater difficulty trading in large size. The derivatives market works best when it is global – when participants can choose from the biggest pool of prices and counterparties possible.

At present, there are questions hanging over the extraterritorial impact of the position limits rules, which could have an impact on cross-border trading. For example, understanding how the aggregation requirements will work for EU contracts subject to limits that are also traded outside the EU by non-EU firms will be critical. It will also be important to assess whether this leads to trading activity moving to non-EU exchanges.

Review of the EU Position Limits

It’s obviously too early to say for sure what the impact will be. The truth is, we don’t know – the position limits methodology is untested and the data isn’t yet available. Given that uncertainty, and the potential consequences for end-user hedging if liquidity does start to evaporate, ISDA strongly recommends a review of the position limits regime post implementation.

That review should be conducted by the appropriate regulatory authorities, with input from ISDA and the industry, and should be completed two years after launch of the position limits regime. The review should focus on fact-based evidence – for example, data on pricing, bid-ask spreads, volumes and end-user access. It should look at the underlying metrics of the position limits regime, and consider whether these are still appropriate to current market conditions. We would ask regulators to commit to such a review to ensure any negative impacts will be spotted and addressed.

Despite the uncertainty about the ultimate impact on liquidity, the industry is pushing hard to meet the January deadline. ISDA has worked to help members comply by seeking and obtaining clarification on numerous aspects of the position limits requirements, including position reporting. This work will continue as the industry faces the inevitable kinks and wrinkles in compliance.

Once the compliance dust has settled, we can then move on to the crucial task of monitoring the effects of position limits in this market.

ISDA's MIFID II work isn't just limited to the position limits regime, of course. This is an expansive and complex body of regulation, and there are many other topics where ISDA and its members have been actively involved, including transparency and reporting, TOTV, the trading obligation and trading venues.

I'd like to spend a minute or two highlighting a couple of these topics.

First, 'traded on a trading venue', or TOTV. This is another complex topic, and will determine which trades will be subject to MIFID II pre- and post-trade transparency requirements and reporting obligations. ISDA has been advocating for clarity on what TOTV means for some time, and ESMA published an opinion on this issue in May that clarifies that derivatives will only be classed TOTV if they share reference data details with a derivative traded on a trading venue.

The TOTV concept is not ideal, and the approach is far from perfect. There are also several details that still need to be ironed out – for instance, how this ties in with use of the ISIN standard, which has been mandated as the trade identifier for certain requirements under MIFID II. But with only six months until implementation, we welcome the clarity from ESMA, and recognise it had to work within the confines of the level-one MIFID text. Over the coming months, we will continue to liaise with regulators to seek clarity on the remaining issues.

Turning to the trading obligation. ISDA is broadly supportive of the approach that ESMA suggested in a discussion paper last year, and a follow up consultation is expected within weeks. We look forward to receiving that and providing feedback on behalf of our members.

However, there are concerns that a trading obligation may be implemented in the EU before an equivalence decision is reached for EU and non-EU trading venues – in particular, those in the US. We think this would reinforce the fragmentation of derivatives markets that we've seen since the introduction of US SEF rules in October 2013, and would be damaging to cross-border flows.

ISDA conducted analysis on the MIFID II and SEF rules last year, and found the two rule sets are very similar in outcome. The framework for SEFs in the US and OTFs and MTFs in Europe both promote transparency and encourage trading on centralised platforms. They both have participation rules that prohibit abusive trading practices, maintain trade surveillance and detection systems, and maintain effective rule enforcement systems. They both establish transparent procedures for order execution, and they both ensure that trading venues conduct real-time monitoring to detect and prevent manipulation.

This analysis indicates there is a strong foundation for substituted compliance or equivalence between the CFTC and ESMA in this area, and we would encourage regulators to work towards a quick determination to avoid a detrimental impact on liquidity.

But now let's focus back on commodities, and the implications of MIFID II on this important market. I've sketched out our view on the position limits regime, but our first panel at 5.15pm will delve into some of the technical considerations in implementing this requirement.

Before I introduce our first keynote speaker, I'd like to once again thank all of our speakers for taking part. In implementing a regime as vast in scope as MIFID II, it's absolutely vital the industry has close dialogue with the regulatory authorities. And we're really spoiled in that regard today, with speakers from the EC, European Parliament, IOSCO, AMF, FCA and Bafin.

Thank you.