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The GFMA Commodities Working Group¹ provides the following comments and examples in connection with the concept of economically equivalent OTC contracts contained in draft RTS 21 published by ESMA on 28 September 2015.

Context

The EU position limits regime will apply to a firm's net position in any commodity derivatives traded on a venue and their 'economically equivalent OTC contracts'. Article 57(3) of MiFID II specifically states that "ESMA shall take into account experience regarding the position limits of investment firms or market operators operating a trading venue and of other jurisdictions".

The proposed Article 6 in RTS 21 defines equivalence as 'identical'², which is not consistent with the experience of European trading venues³, investment firms, or the CFTC which also identifies a methodology for determining economic equivalence. Moreover, ESMA's approach means not only the contractual specifications of the OTC contract must be the same as the venue traded contract, but also every term and condition (e.g. number of days for settlement) of the OTC contract must be identical to those of the venue traded contract. The result is a very narrow pool of OTC contracts (e.g. futures look-a-likes) being brought within scope of the position limits regime.

We consider that the effectiveness of the position limits regime depends on its ability to capture the true economic exposures of all market participants taking positions in commodity derivative contracts. This includes the financial intermediaries who intermediate commodity risk for consumer and producer clients and require the ability to effectively risk manage commodity exposure within the confines of the regime.

We therefore agree with the Commission that:

"The definition of EEOTC contracts should be altered so that contracts which yield similar economic exposure for position holders whilst not necessarily identical in contractual terms are considered in scope of the limit regime. In particular, ESMA should consider whether variations in lot sizes, delivery dates, locations or any remaining terms change the economic exposure of the position."⁴

Moreover and at a fundamental level, if the definition of EEOTC is not broadened, the stated purpose of the position limit regime will not be achieved. As also noted by the Commission in its letter:

"... the narrow definition of EEOTC proposed could allow for easy circumvention of the regime using OTC contracts, which would have similar economic exposures, by simply changing a minor

¹The Global Financial Markets Association (GFMA) brings together three of the world's leading financial trade associations to address the increasingly important global regulatory agenda and to promote coordinated advocacy efforts. The Association for Financial Markets in Europe (AFME) in London and Brussels, the Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington are, respectively, the European, Asian and North American members of GFMA. For more information, visit <http://www.gfma.org>. GFMA is registered on the EU Transparency Register, registration number 898223513605-51.

² Excluding post trade risk management arrangements.

³ European trading venues allow a much wider range of instruments to be 'netted' against applicable position limits.

⁴ Letter from European Commission to ESMA, http://ec.europa.eu/finance/securities/isd/mifid2/index_en.htm.

parameter of the exchange traded contract. This result hinders the objective pursued by the position limits' mechanism devised by Article 57 with respect to commodity derivatives.”

Where the price paid by the end user for a commodity derivative is affected by a number of contracts, the position limit regime should apply on an accumulative basis across those related contracts. Without this broad definition, and instead with limits on individual contracts, firms could establish large unchecked exposures across a number of related contracts. These large exposures will ultimately impact the real economy companies who could end up paying more for such commodity derivatives.

End users (e.g. manufacturers, airlines, refiners) rely on financial institutions to provide hedging instruments for the end user to manage commodity price risk for their physical commodity consumption and/or production. Financial institutions are able to offer risk management services to real economy clients as these institutions are commonly able to manage their own risk by offsetting their exposure with more liquid exchange traded contracts. We believe that a narrow definition of “economically equivalent” will significantly limit an institution’s ability to operate within the prescribed limit regime which may lead to market disruption with a reduction of liquidity and could be particularly harmful to these real economy companies.

We note that the impact of broadening the definition of economically equivalent also has the following effects:

- it expands the scope of the regime to capture these instruments; and
- it also requires the recognition of these instruments for part of the calculation of deliverable supply and/or open interest when setting the relevant position limit.

We understand and acknowledge that ESMA has indicated that it is legally constrained from expanding the definition of EEOTC contracts beyond MiFID financial instruments. However, within that parameter, it is important that any definition of EEOTC recognizes similar economic exposures so that the scope of the regime is sufficiently wide to capture position holders’ true positions.

Examples

Included in the Attachment are some examples of OTC hedging instruments producers and consumers may request from financial intermediaries, together with the potential venue traded instrument that the intermediary may use to manage its own risk. We have further discussed below the principles underlying the inclusion of these types of OTC instruments as EEOTC.

In order to capture the true position or the market risk associated with a given contract, ESMA should consider the mechanism that establishes the price of the trading venue contract⁵, as well the aggregated delta of economically equivalent contracts. For example, we propose that ESMA consider the price formula used in the OTC derivative; so that OTC contracts that reference the same contract code or price assessment or exercise into an equivalent OTC contract in the case of options/swaptions, should be considered as “EEOTC contracts”. Accordingly:

- an OTC swap that references Brent 1st line futures settlement is EEOTC to ICE Brent Future, because the OTC swap settles directly in line with the price set on the futures contract;

⁵ The definition of “trading venue” under MiFID II includes regulated markets, MTFs and OTFs.

- an OTC swap that references ICE 16:30 assessment of Brent 1st line futures is EEOTC to ICE Brent Future, because the OTC swap directly refers to the contract code for ICE Brent Future;
- an OTC American option on ICE Brent Futures which exercises into ICE Brent Futures directly is EEOTC to ICE Brent Futures;
- an OTC swaption on the ICE Brent Index which exercises into an OTC swap, which in turn settles directly in line with the price set on ICE Brent Futures contract, is EEOTC to ICE Brent Futures.

We also note that there is a direct link between some over the counter contracts and contracts cleared through regulated markets. For example, an OTC swap referencing the Platts daily assessment price for JET CIF NWE Cargoes can be cleared through ICE and therefore should be considered as economically equivalent to the relevant ICE cleared swap contracts.

Moreover, position limits should be applied by aggregating the delta of economically equivalent contracts. There is already precedent for this approach in the CFTC position limits rules which takes the delta of an option against the position limit as opposed to the number of contracts of the option itself. It also aggregates across multiple contracts into futures equivalents. Positions in different lot size units require risk based aggregation. See the schedule from CFTC, <https://www.cmegroup.com/rulebook/files/position-limits-nymex.xlsx>. The schedule shows various levels of aggregation, including column 'O' which specifies risk disaggregation of each contract into long and short leg when appropriate along with delta for conversion purposes. For example:

- a 1000 lot long call option on ICE Brent Futures with a 50% delta risk is equivalent to 500 lots of those Brent Futures contracts on a risk based aggregation (using the existing CFTC aggregation principle);
- a long OTC Jet NWE CIF Cargoes swap vs ICE Gasoil 1st line swap has a delta of long 100% Jet NWE CIF Cargoes swap and short 100% ICE Gasoil 1st line swap which are aggregated against other contracts referencing Jet NWE CIF Cargoes assessment in Platts and ICE Gasoil futures limits.

Additionally, we consider that in order for the position limits regime to reflect the true economic exposure of market participants, EEOTC should include an OTC derivative based on an underlying commodity, the characteristics of which are substantially related to the characteristics of a corresponding commodity underlying the commodity derivative traded on a trading venue. We would suggest that an OTC derivative shall be considered substantially related to the commodity derivative traded on a trading venue if:

- that commodity derivative traded on a trading venue contract is entered into by the market participant as economically appropriate to reduce the risks of the potential change in value of the underlying commodity of the OTC derivative; and
- that there is a reasonable relationship between the spot prices of the underlying commodity of the OTC contract and either the spot prices of the underlying commodity of the trading venue contract or the prices for the trading venue contract.

By way of example, intermediaries will hedge Jet Fuel price exposure with ICE Gasoil futures due to there being no liquid market for Jet Fuel swaps. ICE Gasoil futures have sufficient liquidity and correlation to Jet Fuel prices to mitigate a significant proportion of the intermediaries Jet Fuel price exposure.



We believe that these principles can be clearly enunciated and will also resolve a large number of issues with the practical implementation of the position limits rules. Should ESMA accept these principles, we consider that any unintended consequences to end users (e.g. manufacturers, airlines, refiners) who rely on financial institutions to provide hedging instruments for the end user to manage commodity price risk for their physical commodity consumption and/or production will be mitigated.

Encl.

Attachment

Below are some examples of OTC hedging instruments producers and consumers may request from financial intermediaries, together with the potential venue traded instrument that the intermediary may use to manage its own risk.

A. Energy

Client type	OTC instrument	Tenor	Potential venue traded instrument
Producer			
European Exploration & Production company	Brent OTC Swap ⁶	Cal 17	Dec16 Brent Future + Jun17 Brent Future + Dec17 Brent Future
European Exploration & Production company	Brent OTC Swap	Cal 20	Dec18 Future + Dec19 Future (maturity mismatch due to liquidity)
Refiner	Diesel OTC Swap	Cal 17	Dec16 Gasoil Future + June 17+ Dec 17+ Cal 17 ULSD CIF NWE Diesel Swap (vs gasoil) – all ICE Cleared
	Diesel OTC Swap	Cal 20	Dec18 Brent Future
Consumer			
Road Hauler	European Diesel 10 ppm NWE OTC Swap	Cal 17	Cal 17 ICE Gasoil Futures
Spanish Utilities	1% Fuel oil CIF MED OTC Swap ⁷	Cal 17	Cal 17 3.5% Fuel oil FOB Rotterdam Swap, ICE Cleared
Airline	Jet Fuel CIF NWE ⁸ Swap	Cal 17	Dec 16 Gasoil + June 17 Gasoil + Dec 17 Gasoil + Cal 17 Jet Swap (vs Gasoil) – all ICE Cleared
Airline	Jet Fuel CIF NWE Swap	Cal 18	Dec17 Gasoil Future + Dec18 Gasoil Future
Airline	Jet Fuel CIF NWE Swap	Cal 26	Dec18 Brent Future

⁶This is a cash settled Brent OTC swap referencing the spot month for each Brent contract month for the calendar year 2017. The rationale for this hedging instrument is that the producer remains in the spot month and therefore prior to expiration of the relevant spot month, the position will be rolled to the next spot month until expiry.

⁷Based on Platts quotes.

⁸Based on Platts quotes.

We would also draw your attention to the following presentation, particularly at page 14, which provides further illustration:

https://www.theice.com/publicdocs/futures/Jet_Fuel_Hedging_and_Trading_at_ICE.pdf

B. Metals

Client	OTC instrument	Tenor	Potential traded venue instrument
Producer⁹			
Large Metals and Mining companies or Private Equity companies buying a mine	ALM Swap	Cal 17	Mar 17 ALM Future+ Jun17 ALM Future + Sep 17 ALM Future + Dec 17 ALM Future
Consumer¹⁰			
Can companies, Car Manufacturers, or Appliance Makers	ALM Swap	Cal 17	Mar 17 ALM Future+ Jun17 ALM Future + Sep 17 ALM Future + Dec 17 ALM Future

⁹ Producers could be in ALM, CPL, LED, NIK or ZIN.

¹⁰ Consumers could be in ALM, CPL, LED, NIK or ZIN.