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MiFID II Commodity derivatives position limits

Application to securitised commodity derivatives

- The Position Limits regime set out in article 57 of MiFID II (and further specified in RTS 21) applies to commodity derivatives traded on a trading venue and economically equivalent OTC contracts. The definition of 'commodity derivatives' in Art 4.1 (50) of MiFID II and Art 2.1 (30) MiFIR includes certain financial instruments listed in Annex I section C of MiFID II:
  - Cash settled commodity derivatives (Section C.5);
  - Physically settled commodity derivatives that are traded on a regulated market, MTF, or an OTF (Section C.6)[1];
  - Physically settled commodity derivatives not falling within Section C.6 (Section C.7);
  - Options, futures, swaps, forwards or other derivative contracts relating to climatic variables, freight rates, inflation rates or other official economic statistics (Section C.10).
- In addition, article 2.1(30) of MiFIR expressly includes securitised commodity derivatives by reference to article 4.1 (44) (c) of MiFID.

  As a result, the position limits regime appears to apply to securitised commodity derivatives.
- However, we consider that the inclusion of securitised commodity derivatives in the definition of 'commodity derivatives' contradicts the principle that transferable securities (Section C.1) are not derivatives (Sections C.4 - C.10) and therefore are not subject to the same legal regime as derivatives (e.g. transferable securities are subject to the Prospectus Directive whereas derivatives are not and derivatives are subject to EMIR whereas transferable securities are not. Exchange traded warrants, for instance, are not subject to EMIR obligations).

The Associations would then call on ESMA to clarify, *via* level 3 Q&As, that the Position Limits regime set out in article 57 of MiFID II (and consequently, the article 58 Position Reporting regime) is limited in scope as follows:

1 With the exception of wholesale energy products traded on OTFs that must be physically settled.

- **Transferable securities such as securitised commodity derivatives are not subject to the position limits regime.**

Justification of the non-application of the position limits regime to securitised commodity derivatives

Application of financial regulation to securitised derivatives has raised a number of legal questions in the past. For instance, it was debated whether warrants should be subject to the Prospectus Directive as transferable securities or to rules applicable to derivatives. In the end, warrants were considered transferable securities: they are subject to the Prospectus Directive but not to EMIR.

We raise a similar question about the application of position limits to securitised commodity derivatives.

Our understanding is that securitised commodity derivatives are transferable securities: the bank acts as an issuer, submits a prospectus under the Prospectus Directive and targets a large panel of investors including retail and wholesale investors. Unlike derivatives, securitised commodity derivatives are subject to custody and to notary functions administered by Central Securities Depositaries. Securitised commodity derivatives are not subject to EMIR.

This is supported by Section C.1, Annex I, MiFID II and the definition of transferable securities in article 4.1 (44) (c) of MiFID II:

> "'***transferable securities***' *means those classes of securities which are negotiable on the capital market, with the exception of instruments of payment, such as:*
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> *(a) shares in companies and other securities equivalent to shares in companies, partnerships or other entities, and depositary receipts in respect of shares;*
>
> *(b) bonds or other forms of securitised debt, including depositary receipts in respect of such securities;*
>
> *(c)* ***any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures***;".

We note that in its formal response to the call for evidence published by the European Commission on better regulation and the cumulative impact on EU legislation of the financial sector, the UK FCA stated that "*the MiFID II policy goals could be achieved in a less costly way if (…) instruments which are transferable securities are excluded from the definition of commodity derivatives (NB: in article 2.1 (30) of MiFIR).*"

We further note that indirectly the FCA points out a major inconsistency between article 2.1 (30) of MiFIR and article 4.1 (44) (c) of MiFID II: it is not possible that an instrument is both a security and a derivative. If they were both, how could the resulting clash between the application of EU Directives applicable to securities (notably, the Prospectus Directive) and rules applicable to derivatives (such as EMIR) be resolved?

This creates confusion between transferable securities and derivatives in MiFID II which is the cornerstone of the EU financial markets legislation and would have unexpected consequences that are difficult to assess. For example, one consequence will be that an issuer of a securitised commodity derivative will hold 100%

of the open interest for that contract. We note indeed that: a) this issuer will always be an investment firm or a credit institution which do not benefit from the hedging exemption and b) there is no market in EEOTC unlisted securities. Therefore, this issuer is unable to reduce its position holding 100% of the open interest in the relevant contract. We cannot see then how the position limits regime could apply as it would lead de facto to the prohibition of issuances of securitised commodity derivatives

For the purpose of the position limits regime set in article 57 of MiFID II we strongly believe that the scope should not include securitised commodity derivatives. We note that the design of the position limits regime and particularly the features of the calculation methodology set in ESMA RTS 21 cannot apply to securitised commodity derivatives: the concepts of deliverable supply or open interest are meaningless; the concepts of lots, delivery date, economically equivalent contracts (there cannot be any economically equivalent contract to a securitised derivative which by nature is a fungible security) are equally not applicable.

As noted above, position limits were intended to prevent market abuse and to support orderly pricing and settlement conditions. However, we note that in relation to securitised commodity derivatives, these instruments are already subject to the market abuse regime under Regulation (EU) No 596/2014 (MAR) and can only be admitted to trading on a regulated market in the EU if it is possible to have an orderly market in trading in these instruments (Art. 51.1 MiFID II). In addition, since there is no possibility of physical delivery or physical settlement in relation to these instruments, they are not capable of having the same impact on physical commodity markets as derivatives falling within sections C.5, C.6, C.7 and C.10, Annex I of MiFID II. As a result, we consider that it should not be necessary to apply commodity derivative position limits to these instruments as appropriate controls are already in place. Moreover, we note that if additional controls were required, both ESMA and competent authorities have the power to implement such controls (e.g., ESMA's temporary intervention powers under article 40 MiFIR).

We strongly believe that for the purpose of the position limits regime, the definition of 'commodity derivatives' should not be read as including securitised commodity derivatives as defined in article 4.1 (44) of MiFID.

We urge ESMA and regulators to consider that the MiFID position limits regime cannot apply to securitised commodity derivatives as they are transferable securities. A clarification in a future Q&A would be required.

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