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MiFID II Commodity derivatives position limits

Application to non-commodity contracts in Annex I section C.10

- The Position Limits regime set out in article 57 of MiFID II (and RTS 21) applies to commodity derivatives traded on a MiFID trading venue and their economically equivalent OTC contracts. The definition of 'commodity derivatives' in Art 4.1 (50) of MiFID II and Art 2.1 (30) MiFIR includes the following 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 Regulated Markets (RMs) or MTFs or OTFs (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 all derivatives contracts on underlyings referred to in Section C.10, i.e. climatic variables, freight rates or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash (...), as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in Section C of Annex I of MiFID.

Consequently, the position limits regime appears to apply to non-commodity contracts in Section C.10.

- However, certain provisions in MiFID, MiFIR and the Delegated Regulation of 25 April 2016, as set out in further detail below, suggest that the position limits regime is intended to apply only to contracts having a commodity as an underlying, and should therefore only apply to certain categories of contracts covered by section C.10.

Our view is that the article 2.1(30) MiFIR definition of 'commodity derivatives' should apply to cross-asset classes regimes of MiFID II (e.g. provision of investment services, conduct of business rules), but

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

should not apply to the position limits regime set out in article 57 of MiFID II, whose primary purpose is to address commodity markets.

We would therefore propose that ESMA clarifies, via level 3 Q&As, that the Position Limits regime set out in article 57 of MiFID II (and the article 58 Position Reporting regime) is limited in scope as follows:

- **Of the financial instruments falling within Section C.10 of Annex I, MiFID II, the only contracts which are subject to position limits are those contracts which relate to an underlying commodity which itself may be subject to a supply constraint (e.g. freight). Other contracts that do not relate to commodities (i.e., inflation, statistics, assets, rights, obligations and indices^[1] that are not related to commodities) are not subject to the position limits regime.**

Justification of non-application of MiFID II Position limits regime to non-commodity contracts in Annex I section C.10

The Position Limits regime was established for the purpose of limiting excessive speculation and preventing market abuse in commodity markets, particularly in agricultural commodity markets.

The stated intention has always been, since the G20 Pittsburgh summit, to ensure the convergence between commodity spot prices and commodity derivatives prices in the delivery month of the derivative contract.

This is reflected in the following texts:

- ♦ **MIFID II, recital 125:** *“The G20 summit in Pittsburgh on 25 September 2009 agreed to **improve the regulation, functioning and transparency of financial and commodity markets to address excessive commodity price volatility**. The Commission Communications of 28 October 2009 on ‘A Better Functioning Food Supply Chain in Europe’, and of 2 February 2011 on ‘Tackling the Challenges in Commodity Markets and Raw Materials’ outlined measures that fall to be taken in the context of the review of Directive 2004/39/EC. (...)”*
- ♦ **MiFID II, recital 127:** *“A harmonised position limits regime is needed to ensure greater coordination and consistency in the application of the G20 agreement, especially for contracts that are traded across the Union. Therefore, explicit powers should be granted to competent authorities to **establish limits, on the basis of a methodology determined by ESMA, on the positions any person can hold, at an aggregate group level, in a derivative contract in relation to a commodity at all times in order to prevent market abuse, including cornering the market, and to support orderly pricing and settlement conditions including the prevention of market distorting positions. Such limits should promote integrity of the market for the derivative and the underlying commodity without prejudice to price discovery on the market for the underlying commodity and should not apply to positions which objectively reduce risks directly relating to commercial activities in relation to the commodity. The distinction between spot contracts for commodities and commodity derivative contracts should also be clarified. In order to achieve the harmonised regime, it is also appropriate for ESMA to monitor the implementation of the position limits and for competent authorities to put***

^[1] We consider the reference to indices and measures in Section C.10, Annex I, MiFID II to be confusing since derivatives contracts relating to financial indices and financial measures are already covered by Annex I section C.4 which is expressly not subject to the position limits regime.

in place cooperation arrangements, including exchange of relevant data with each other and to enable the monitoring and enforcement of the limits.”

- ♦ **MiFID II, article 57.1:** *“The limits shall be set on the basis of all positions held by a person and those held on its behalf at an aggregate group level in order to:*

(a) prevent market abuse;

(b) support orderly pricing and settlement conditions, including preventing market distorting positions, and ensuring, in particular, convergence between prices of derivatives in the delivery month and spot prices for the underlying commodity, without prejudice to price discovery on the market for the underlying commodity.”

- ♦ European Commission’s **Delegated Regulation of 25 April 2016** supplementing MiFID II as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, **article 2.6:** *“ ‘commodity’ means any goods of a fungible nature that are capable of being delivered, including metals and their ores and alloys, agricultural products, and energy such as electricity”.*

We believe that the intention of the co-legislators has always been to tackle potential misconduct in the commodity space. However, there appears to be a fundamental inconsistency between the definition of “commodity” in the Delegated Regulation of 25 April 2016 and the definition of “commodity derivative” in article 2.1 (30) of MiFIR. We believe that Section C.10, Annex I, MiFID II, unlike sections C.5, C.6, and C.7, was not designed for the purpose of a specific regime devoted to commodities. This is further evidenced by the lack of reference to commodities in section C.10, whereas sections C.5, C.6 and C.7 expressly refer to commodities.

Section C.10 is drafted widely and could potentially include all derivatives contracts, irrespective of the underlying (with the exception of insurance contracts), that do not fit within sections C.1 to C.9 and C11, for instance real-estate contracts.

We note that whereas the position limits regime was designed for a very precise purpose (address potential misconduct and excessive speculation in the commodity space), Section C.10, Annex I, MiFID II was intended to capture financial instruments not otherwise caught by the other sub-sections of Section C, Annex I, MiFID II. If the position limits regime were read as applying to any financial instrument falling within Section C.10, this would mean that a market participant who creates a new category of contract (not related to commodities) would have to, without delay, comply with the position limits regime.

Expanding position limits to cover those asset classes, such as inflation derivatives or real-estate contracts for instance, will be very challenging to implement as Art. 57 of MiFID II and RTS 21 do not appear to have been drafted with those asset classes in mind: terms such as “lot size” and “delivery date”, for instance, are not used outside the commodity space.

Also, the very limited definition of economically equivalent contracts, which provides that differences in delivery dates may be disregarded for the purpose of determining equivalence but only if the dates diverge by less than one calendar day, would have unexpected consequences in the non-commodity space. For instance, the otherwise equivalent inflation swaps traded on a Monday and the following

Wednesday could not be netted and aggregated under the same position limit even though their economic exposure is near-identical.

Regarding inflation derivatives, we note that the Delegated Regulation of 14 July 2016 supplementing MiFIR with regard to regulatory technical standards on transparency requirements for trading venues and investment firms in respect of bonds, structured finance products, emission allowances and derivatives, sets the following classification in its Annex III (Liquidity assessment, LIS and SSTI thresholds for non-equity financial instruments):

- single-currency inflation swaps, futures and forwards on single-currency inflation swaps, multi-currency inflation swaps and futures and forwards on multi-currency inflation swaps are considered “Interest rate derivatives” under chapter 5 of the annex;
- commodity derivatives are covered by chapter 7 of the annex
- C.10 contracts are an independent category under chapter 10 of the annex.

We also note that this view is shared by the European Banking Authority, which in a Q&A dated July 2014, considered inflation products as interest rate products (see https://www.eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2014_841).

For the purpose of market transparency and despite the wording of article 2.1 (30) of MiFIR, the definition of commodity derivatives is *de facto* limited to instruments listed in Sections C.5, C.6 and C.7, Annex I, MiFID II, i.e. contracts having a commodity as an underlying.

We strongly maintain that the legislators did not intend to apply the position limits or position reporting regimes to contracts that are not related to commodities and that for the purpose of articles 57 and 58 of MiFID II, ESMA should clarify through Q&A that of the financial instruments falling within covered by Section C.10, Annex I, MiFID II the only contracts which are subject to position limits and position reporting are those contracts which relate to an underlying commodity which itself may be subject to a potential supply constraint (e.g. freight). Other contracts that do not relate to commodities (i.e. inflation, statistics, assets, rights, obligations and indices that are not related to commodities) are not subject to the position limits and position reporting regimes.

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