Commodities – MiFID2

The GFMA Commodities Working Group[1] has major concerns arising from the proposed position limits and position reporting regimes, especially those relating to the scope and methodology of position limits and the obligation to report the ultimate 'end client' positions. We would note that given the status of proposals regarding these regimes, including their interdependencies, this paper should not be considered as exhaustive or conclusive of the issues. We anticipate that more will become apparent as we work towards implementation.

Position Limits Regime

Unlike the CFTC regime which has prioritised application to 28 specific contracts, the EU position limits regime will apply to a firm's net position in any commodity derivatives traded on trading venues and their 'economically equivalent OTC contracts'. Currently, the EU regime has no transitional arrangements. This breadth of scope will mean that a significant number of contracts (estimated to be in the hundreds) will be subject to position limits at the outset[2]. This will pose significant challenges for both market participants and regulators alike. Furthermore, unlike the US regime, the EU regime has no bona fide hedge exemption available to financial and other MiFID regulated entities.

Therefore, CWG believes it is vital that RTS 21[3] appropriately defines the criteria/methodology to be used for the calculation of limits, particularly:

- 'OTC economically equivalent contracts': the definition of OTC contracts which are economically equivalent to those traded on a EU trading venue should reflect the global nature of the markets and the interaction between the physical and the financial markets. The proposed Article 6 defines equivalence as 'identical', resulting in and a very narrow pool of OTC contracts and limited ability to offset OTC contracts with contracts traded on a trading venue.

  By way of example, Annex 1 Section C6 of MiFID2 contains an exemption for certain physically settled wholesale energy products that are traded on an OTF. This 'REMIT carve-out' means that certain gas and power wholesale contracts which are often viewed as largely fungible for risk management purposes, are not included as 'OTC economically equivalent contracts'. Therefore, there is no ability to offset these products against similar contracts traded on a regulated market or MTF. Accordingly, an ICE Futures Europe

[1]The 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] See Tracey McDermott speech of 4 February 2016: "we do not believe that it is necessary, as MiFID II requires, to have position limits for every single one of the hundreds of commodity derivatives contracts traded in Europe. Including the least significant. And I know there are concerns, frankly, that the practical details of position reporting were not adequately thought through in the negotiations on the framework legislation." https://www.fca.org.uk/news/independence-confidence-fairness

[3]Currently in draft form and published by ESMA in September 2015.

physically settled gas future will not be offset against a physically settled gas forward traded on an OTF[4].

We believe 'OTC economically equivalent contracts' should include OTC identical contracts, as well as OTC contracts sufficiently correlated, to venue traded contracts, regardless of whether a contract is a MiFID financial instrument or not. ESMA should outline the principles for determining sufficient correlation. We would welcome alignment of these principles with the CFTC's proposed approach to defining economic equivalence, which would permit economically equivalent contracts to be determined by the commodity reference price, ensuring that contracts with pricing mechanisms directly or indirectly linked to the price of the future can be netted.

- Netting: similarly, as position limits are imposed on the net position, we believe that the rules applying to that calculation should be flexible enough to allow market participants to net across identical and sufficiently correlated contracts, and not be limited to MiFID financial instruments. We understand that ESMA has indicated that it is constrained from allowing netting of non-MiFID financial instruments e.g. the wholesale gas and power transactions mentioned previously. This approach may result in hedging instruments which would otherwise be a MiFID financial instrument moving away from platforms/trading facilities, resulting in reduced transparency.

- Baseline calculation: deliverable supply should be used to calculate the baseline for 'spot month' position limits. Open interest (rather than deliverable supply) is generally used as the base line metric for the calculation of position limits for other 'non spot months', given non spot month contracts settle on a future date and (unlike spot month contracts) are not due for, or currently in, delivery. We note that the 'spot month' and market practice varies between markets and classes of commodities contracts. As a result, it will be important not to apply the definition of "spot month" used by one market across all markets or classes of commodities, but rather to develop a definition that works for all markets and classes of commodities. We would welcome a definition of "spot month" aligned with the US CFTC definition. This approach would have the advantage of supporting global consistency and also addressing contracts with infrequent expiry dates. Further, we recognize that there may be circumstances where open interest is not the most appropriate baseline. In such instances, NCAs should be given the option to apply the most appropriate base line metric, subject to ESMA approval.

- 'Spot Month' definition: "spot month" should be defined in accordance with the specifics of the relevant venue contract not as a calendar period.

- Illiquid and/or new contracts: in addition to the proposed derogation in Article 15 of the draft RTS, if NCAs consider that a contract's traded volume or the number of market participants trading in that contract is below a size which could impact orderly pricing and settlement conditions, NCAs should be given the option to apply minimum thresholds based on that contract's traded volume below which limits may be established at levels up to 100%, subject to ESMA approval.

[4]As discussed below, it should also be noted that as these contracts are not MiFID financial instruments they cannot be included in the calculation of a net position under the proposed methodology.

- Aggregation: position limits will apply to all transactions entered into by an entity and its subsidiaries. Appropriate criteria for aggregating an entity's position in a group context are needed. These should take into account relevant shareholdings and be based on the principle of effective control. ESMA should outline the principles for determining effective control. Disaggregation should be allowable based on independence of decision, including independently managed businesses to which legal mandatory information barriers apply. Moreover, where a parent company does not hold positions subject to position limits, it should not be mandatorily included in the aggregation.

  We note the recent comments made by FCA in its response to the Commission's "Better Regulation" call regarding aggregation[5]:

  " ... the aggregation of all positions held by entities within a group ignores whether such positions are subject to single control and is out of line with the approach taken in other major jurisdictions ... We would suggest that the MiFID II policy goals could be achieved in a less costly way if ... positions are only required to be aggregated across companies within a group where they are subject to common control".

- Scope of commodity derivatives: we are concerned that the scope of commodity derivatives[6] will raise significant issues in the context of applying the proposed regime. For example, the inclusion of inflation rates in C10 potentially could mean that if a contract is listed on an OTF, the regime may apply, with unintended consequences to market development and liquidity. We would also note that in the event a contract is listed on a platform before the MiFID2 implementation date (particularly on what will become an 'OTF'), separate data dependency issues and challenges exist for both for NCAs and market participants in terms their respective preparedness (e.g. the one year period for NCAs to gather data in order to set limits).

  Again, in this context, we note the FCA's comments regarding the challenges posed by the inclusion of securitised derivatives (being essentially retail in nature), in the definition of commodity derivatives and its suggestion that transferable securities are excluded.[7]

Position Reporting Regime

We would also like to take this opportunity to raise key concerns regarding the position reporting regime under MiFID2.

The regime requires financial and other MiFID regulated entities trading in commodity derivatives to report to relevant NCAs, their own positions, as well as those of clients 'until the end client is reached'.

There are significant technical and legal/confidentiality constraints (e.g. potential conflicts with national and non-EU data protection legislation), which will make it practically impossible for an individual firm to identify the complete chain of clients 'until the end client is reached'. There may be jurisdictions in which release of the information is illegal regardless of client consent, or

[5]FCA's response to Commission's "Better Regulation" call at http://fca.org.uk/your-fca/documents/eu-regulatory-framework-call-for-evidence, page 24.

[6] We also note that the scope of certain derivative contracts in Annex 1 Section C is subject to further specification via delegated legislation, yet to be published by the Commission.

[7] Refer footnote 5 above.

client's client agreements with explicit confidentiality provisions prohibiting the 'upstream' flow of position information.

ESMA and NCAs should recognise that regulated entities will conduct sufficient due diligence to identify what they believe to be the end client, which may include receiving representations for their direct clients that they are the beneficial owners of the relevant positions. This should be sufficient to satisfy the 'end client' requirement however its effectiveness as a possible way for regulated entities to obtain comfort will depend entirely on clients' appetite to provide these representations.