GFMA CWG Responses to the ESMA MiFID II/MiFIR Consultation and Discussion Papers

The GFMA Commodities Working Group (CWG) submitted on 1 August 2014 its responses to the ESMA MiFID II/MiFIR Consultation and Discussion Papers.

The responses focus on the following key priorities areas:

1. Scope – Definition of Financial Instruments

We believe there must be sufficient specificity regarding those physical contracts that 'must be physically settled' (which will include contracts entered into for operational netting purposes) and consequently excluded from MiFID II. We support retaining the existing guidance under Articles 38 and 39 of the MiFID implementing regulation, including the standardization and clearing criteria, the definition of "spot" and the reference to contracts 'expressly stated to be equivalent' to contracts traded on a trading venue.

(*Please see Annex 1*)

2. Ancillary Activities Exemption

We advocate a narrow definition of ancillary activities and broadly support the ESMA principles set out in the DP. The assessment of when the commodity business of an entity constitutes a minority of that entity's activities and can be exempted from the MiFID II regime, should be considered:

1) at a global level on the basis of the commodity activities of an entity taking into account both the business of its EU and non-EU group entities. In this context, we believe that the definition of 'group' should be aligned with the definition used in EMIR; and

2) using qualitative criteria (or a combination of qualitative and quantitative criteria). We appreciate that a quantitative approach (based on a significantly lower threshold than the proposed 50%) may be more objective, however believe that other factors should also be taken into account (e.g. market presence in the relevant activity compared with that undertaken by authorised entities; headcount for the relevant activity compared with headcount for the main activity of the entity).

(*Please see Annex 2*)

3. Position Limits Regime (Discussion Paper)

In light of the absence of a hedge exemption for financial entities, we focus on the following issues arising from the definition of the criteria/methodology to be used for the calculation of limits:

1) Netting: the availability of broad netting rules which allow market participants to net across identical or correlated contracts;

2) 'OTC economically equivalent contracts': the availability of a broad definition of the OTC contracts which are equivalent to those traded on a EU trading venue to allow broad netting (not be limited to MiFID financial instruments);

3) Deliverable Supply: the assessment of deliverable supply is especially important as limits will be expressed as a percentage of this value. Data from different sources should be considered for a complete and accurate picture of each market; and

4) Aggregation: appropriate criteria for aggregating a person's position in a group context. It should take into account a person's shareholding and be based on the principle of effective control.

(*Please see Annex 2*)

ANNEX 1 – RESPONSE TO THE CONSULTATION PAPER (LINK)

7. Commodity derivatives

7.1. Financial instruments definition - specifying Section C 6, 7 and 10 of Annex I of MiFID II

Q213: Do you agree with ESMA's approach on specifying contracts that "must" be physically settled and contracts that "can" be physically settled?

We agree that it is necessary to establish criteria to enable market participants to distinguish between contracts that "must" be physically settled and contracts that "can" be physically settled. The criteria for determining the contracts that "must" be physically settled will be relevant only for the purposes of the carve-out from section C(6) and the definition of "C(6) energy derivative contracts", while the criteria for contracts which "can" be physically settled will be more generally relevant for determining which contracts fall within sections C(6) and (7).

We would welcome confirmation from ESMA in its Technical Advice that contracts which are excluded from section C(6) should not also be required to be tested against the criteria in section C(7) and the related implementing regulation. We consider that it is clear from the text of MiFID II that only contracts "not otherwise mentioned in point 6 of this Section" should be considered under section C(7), so a contract which falls within the section C(6) carve-out should not be brought back within scope under section C(7).
As discussed further in our response to Q217, we consider that ESMA should continue to develop criteria to enable market participants to determine which contracts "must" be physically settled and which "can" be physically settled, rather than seeking to develop a list of concrete examples of types of contracts which "must" be physically settled. We consider that the application of criteria developed by ESMA would be an effective means of properly characterising a contract as "must be" or "can be" physically settled, but are concerned that characterising by reference to specific contracts set out in the regulations could inhibit the future development and evolution of contracts and contract documentation that is customary in these markets.

We provide our comments on ESMA's approach to specifying contracts that "must be" physically settled in our responses to Q215 and Q217. However, we note here that the Draft Technical Advice provides little in the way of equivalent guidance on the interpretation of "can be" physically settled. To address this, we would particularly welcome clarification from ESMA on the meaning of the comments under paragraph 17(ii)(d) of section 7 of the CP.

Q214: Which oil products in your view should be caught by the definition of C6 energy derivatives contracts and therefore be within the scope of the exemption? Please give reasons for your view stating, in particular, any practical repercussions of including or excluding products from the scope.

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Q215: Do you agree with ESMA's approach on specifying contracts that must be physically settled?

Paragraph 1 of the Draft Technical Advice (on page 282 of ESMA's CP) sets out criteria for determining contracts that must be physically settled. As drafted the provision appears to apply to physically settled contracts in all commodity asset classes, whereas ESMA's supporting analysis appears to be considering physically settled contracts in power, gas, coal and oil only (see paragraphs 8-9).

We recommend that paragraph 1 of the Draft Technical Advice be amended to clarify that this advice applies only for the purposes of further specifying wholesale energy products under Section C(6) and C(6) energy derivative contracts. For example:

> "1**. For the purposes of further specifying wholesale energy products under Section C(6) and C(6) energy derivative contracts**, contracts must be physically settled if […]"

We support the general principle of the proposed paragraph 1(i) of the Draft Technical Advice.

We support the general principle of the proposed paragraph 1(ii) of the Draft Technical Advice. However, it would be helpful if the language was consistent with that used in the Level 1 text. For example, "the contract may not be settled in cash at the option of any of the parties other than by reason of default or other termination event".

We do not support paragraph 1(iii) of the Draft Technical Advice. The existence of provisions which allow for the netting of physical delivery obligations between the parties (for example, operational netting, book-outs and circle-outs) do not change the fundamental nature of the legal obligations between the parties and should not prevent a contract from being characterised as "must be physically settled". It is important to note that provisions allowing for the netting of physical delivery obligations between parties are common in physically settled contracts in commodity asset classes other than power and gas.

We support ESMA's proposal that the existence of force majeure provisions should not prevent a contract from being characterised as "must be physically settled". Force majeure is a widely understood and widely used legal principle. The events of force majeure will be agreed by the parties in respect of the particular transaction and documented in the relevant agreement. Standard trading agreements also commonly include force majeure provisions.

We support ESMA's proposal that the existence of "other bona fide clauses rendering it impossible to perform the contract on a physical settlement basis" should not prevent a contract from being characterised as "must be physically settled". This is not a widely used legal principle and so some further guidance from ESMA will be required. We suggest default and other termination events should be considered at first instance.

See also our response to Q218 in which we state that a "bona fide inability to settle" may arise as a result of an event of default or other termination events specified in the relevant contract. It is important that any guidance regarding what would constitute a "bona fide inability to settle" should not exclude events of default specified in the relevant contract, as this could lead to a situation in which the parties to the contract are unable to settle physically, but the contract is not considered to be one which must be settled physically. We also reiterate that the examples we have provided are not intended to provide an exhaustive list, as the point of these clauses is to address unforeseen events and specifying an exhaustive list would defeat this point.

We understand that the list of delivery methods which would be considered to be physical delivery set out in paragraph 4(i) of the Draft Technical Advice is a non-exhaustive list and we agree that is an appropriate approach. However, we would welcome further consultation on any proposed definition of what is meant by "physically settled". There are many different ways in which physical settlement can be made, depending on the type of market. It will be critically important for these markets to ensure that any proposed definition of "physically settled" remains a non-exhaustive list (as currently proposed by ESMA), because if the list is an exhaustive list and any particular method of delivery is not included in the list (for any reason, including inadvertently) there is a risk that the contract will no longer be considered to be physically settled, and so must be considered to be cash settled. In addition, if the list were to be an exhaustive list any definition would need to be sufficiently flexible to envisage new products with new methods of physical settlement, to avoid an argument that new types of contracts should be automatically categorised as C(5) contracts where the relevant method of physical delivery is not included in the list.

In relation to paragraph 4(i) of the Draft Technical Advice, we would recommend clarifying that the advice applies to derivative contracts relating to commodities and replacing the references to "relevant goods" with "relevant commodities" (as "goods" is not a term defined under MiFID II and as all these provisions relate to commodity derivatives).

We would also propose revising paragraph 4(ii) so that it reflects a more generally applicable concept of the transfer of ownership rights in a commodity. Although the concept of title transfer is a primary focus in physical markets such as coal and oil, markets such as power and gas tend to focus more on delivery and acceptance obligations which occur at the delivery point. However, in all cases the result is a transfer of a right of an ownership nature. We would propose the following amendment:

> "~~delivery of a document giving rights~~ **transfer of a right** of an ownership nature to the relevant ~~goods~~ **commodity** or the relevant quantity of the ~~goods~~ **commodity** concerned (such as **by delivery of a document, e.g. a confirmation from the power or gas market operator,** a bill of lading or a warehouse warrant);"

We would also recommend including book entry as an example of another method of bringing about the transfer of rights of an ownership nature under paragraph 4(iii), as this is a common method of transfer of rights in relation to markets such as precious metals or uranium.

Q216: How do operational netting arrangements in power and gas markets work in practice? Please describe such arrangements in detail. In particular, please describe the type and timing of the actions taken by the various parties in the process, and the discretion over those actions that the parties have.

We believe that a detailed explanation of operational netting arrangements in power and gas markets is necessary and useful to the extent that there is explicit reference in the technical advice that such arrangements do meet the requirements for contracts that 'must be' physically settled as we suggest in response to Q215.

For reference, under Q215 we stated that we do not support paragraph 1(iii) of the Draft Technical Advice. The existence of provisions which allow for the netting of physical delivery obligations between the parties (for example, operational netting, book-outs and circle-outs) do not change the fundamental nature of the legal obligations between the parties and should not prevent a contract from being characterised as "must be physically settled". It is important to note that provisions allowing for the netting of physical delivery obligations between parties are common in physically settled contracts in commodity asset classes.

Physically settled transactions in gas or power involve the delivery of the underlying commodity and the change in the ownership of the commodity. These contracts include forward contracts (for delivery at some point in the future) and spot products (where delivery is within a shorter time period).

The operational arrangements for delivery in gas and power markets may produce an offset of physical deliveries, however no netting takes place between contracts or transactions that can be considered equivalent to cash settlement or offset of transactions: the obligation under each individual contract to physically deliver and transfer rights of title is legally binding and enforceable, excluded only under specific circumstances (e.g. force majeure, default of due payment or inadequate performance).

In gas and power physical markets, participants have to enter into contractual arrangements with system operators of transportation pipelines/transmission lines in order to become network/system users and being able to deliver to wholesale counterparties or retail consumers the energy produced or acquired. Network codes and the technical annexes are the main contractual and operational documents regulating the relationship between network/system users (or market participants) and the Transmission System Operators (TSOs).

Market participants may have direct access to energy production facilities (e.g. power plant) or may acquire energy from other market participants. The acquisition (and sales) of energy at wholesale level takes place through contractual agreements (e.g. EFET master agreements) which stipulate the obligation for the selling party to a transaction to physically deliver and transfer the rights of title in the respective commodity and the obligation of the buying party to accept such delivery and transfer of title.

A market participant buys and/or sell gas or power for delivery in a specific day or hour at a specific trading point several times with several counterparties over time before the actual delivery, depending on the portfolio of their commercial activities (e.g. production of energy, sales of energy) and a series of factors (e.g. weather forecast, price forecasts, availability of infrastructures etc.). In order to manage risks related to the availability of the underlying and price fluctuations, transactions may be entered into also many years ahead of the period of delivery. Therefore a certain amount of uncertainty about the final amount of energy required is implicit for all market participants in gas and power markets, and this activity is normal in the necessary course of business for physically settled transactions.

However, when approaching the delivery period, market participants are required to balance inputs and outputs in the energy network on a relevant period basis (e.g. hourly or daily), hence an obligation applies to submit nominations of inputs and outputs for each trading point where the market participant is active. Nominations must be entered into TSOs' systems within the deadlines defined in operational rules (e.g. 2 PM on the day before the 'delivery period' starts).

Such nominations include the inputs from energy infrastructures directly owned or possessed by a market participant and the energy acquired (or sold) over time through forward contracts traded in multiple ways.

Therefore in gas and power markets, delivery is performed by submitting the schedules of the injections into/withdrawals from the energy system and the transactions with other wholesale counterparties to the operator of the designated trading point. These nominations may be required for each contract and/or facility or aggregated (total inputs and outputs for a single market area).

TSOs or service providers, who are responsible for the management and operations of the physical transportation networks, process the information received and match the schedules submitted by each market participant to ensure that the instructions of sellers and buyers are consistent in order to take into account the flows required by each network user (or group of network users). Any inconsistency must be rectified before the delivery period occurs.

In case market participants have more than one trade of opposite 'sign' (buy and sell) between them at a particular trading point/area and for the same delivery period, schedules or nominations may be required to be submitted on a net basis for administrative convenience i.e. to avoid the need for the operator to aggregate and handle multiple nominations.

In the daily activity of submitting nominations/schedules to system operators all individual contracts traded either on platforms or bilaterally are physical for settlement purposes. In the period following the actual flows (a few days or months), the TSOs and service providers calculate the energy inputs and outputs attributable to each network user for each relevant period, and differences between the final nominations and the actual intakes/offtakes are charged at a specific 'balancing price'. The balancing price is usually structured in a way to incentivise network users to stay 'in balance' during each period. This ensures that inputs and outputs of the system are commercially and physically balanced.

In any case, such arrangements do not involve the netting of contracts or transactions in the sense that the term "netting" is used in financial markets. The offset of deliveries may be merely the result of the schedules submitted to system operators: the submission of nominations according to the operational rules provided by system operators is the way in which counterparties perform the obligation to settle physically their contracts. By contrast, contracts that are not for physical settlement do not require entering into contractual arrangements with system operators, do not require the need to register contracts with system operators, do not require the submission of schedules and are not subject to balancing rules. These are substantial differences.

Q217: Please provide concrete examples of contracts that must be physically settled for power, natural gas, coal and oil. Please describe the contracts in detail and identify on which platforms they are traded at the moment.

We consider that ESMA should continue to develop criteria to enable market participants to determine which contracts "must" by physically settled and which "can" be physically settled, rather than seeking to develop a list of concrete examples of types of contracts which "must" be physically settled. In developing these criteria regard should be given to industry practices.

For your information, we provide below a non-exhaustive list of the types of master agreements/industry standard agreements currently used in the market to trade power, natural gas, coal and oil for physical settlement:

- (i) EFET General Agreement;
- (ii) ISDA Master Agreement (1992/2002) with physical trading annexes (GTMA Transactions; NBP; ZBT);
- (iii) Grid Trade Master Agreement 2004 (GTMA);
- (iv) Trading Terms & Conditions Short Term Flat NBP 1997 (NBP 1997);
- (v) Zeebrugge Hub Natural Gas Trading Terms & Conditions (ZBT 2004);
- (vi) Zeebrugge Beach Natural Gas Trading Terms & Conditions (ZBT 2012);
- (vii) Standard Terms and Conditions for Sale and Purchase of Natural Gas for UK Short Term Deliveries at the Beach (Beach 2000);
- (viii) Standard Coal Trading Agreement (SCoTA);
- (ix) BP General Terms and Conditions for the Sales and Purchases of Crude Oil/Petroleum Products.

However, we should note that coal is also commonly traded under terms prepared by specific market counterparties and subsequently negotiated on a bilateral basis as between with trading counterparts. This means that coal terms can vary from trade to trade and as between trading counterparts. Oil is commonly traded under terms issued by the oil majors, for example the BP General Terms and Conditions referred to above.

For reference, under Q215 we stated that we do not support paragraph 1(iii) of the Draft Technical Advice. The existence of provisions which allow for the netting of physical delivery obligations between the parties (for example, operational netting, book-outs and circle-outs) do not change the fundamental nature of the legal obligations between the parties (i.e. to physically deliver and accept delivery) and should not prevent a contract from being characterised as "must be physically settled". It is important to note that provisions allowing for the netting of physical delivery obligations between parties are common in physically settled contracts in commodity asset classes.

By way of example, the EFET General Agreements for gas provide that, where the parties mutually agree to scheduling their receipts and deliveries on a net or offset basis and it is possible to do so at the relevant delivery point, then each party will have fulfilled its obligations to physically deliver the contract quantity for each individual contract entered into with the other party if it schedules to the network operator the aggregate net result of all contract quantities being bought and sold under all relevant individual contracts.
The EFET Gas Master also requires parties to confirm that at the time of entering into the relevant contract such individual contract will result in physical delivery and that scheduling on a net or offset basis is for administrative convenience only. Scheduling on a net or offset basis is market convention in these markets and is contemplated under master agreements such as the EFET Agreements. These obligations expressly apply to each individual transaction for the purchase and sale of the relevant commodity entered into under the EFET Agreements.

In order to fulfil such obligation of delivery the counterparties to a transaction are required to have a contractual relationship with operators of transmission systems or transportation networks and/or service providers responsible for the management and operations of the nomination platforms. Delivery is performed by submitting the schedules of the transactions on a net or offset basis (as described above) to the operator of the designated delivery point.

Under the EFET Agreements the obligation under each individual transaction entered into under the agreement to physically deliver and transfer rights of title and risk in the relevant commodity is legally binding and enforceable. A contracting party is only released from such obligation in case of force majeure (delivery may also not occur in the case of a counterparty default, e.g., as a result of failure to make a due payment or delivery or inadequate performance assurance or credit support document, giving rise to early termination). A transaction can be terminated early by a non-defaulting party in such circumstances, but contracting parties will have obligations as a result of that default or termination (e.g. an obligation to pay an early termination amount).

There is no 'cash out' or 'book out' option in power and gas trading whereby either party can at its option elect to pay or receive cash settlement in lieu of delivery of the commodity. Payment or receipt of cash to the other party in lieu of physical delivery can happen only under power and gas trades in case of default or termination of the contract as described above, or in some cases for a non-material failure to deliver or accept (power) or in case of under delivery, under acceptance, over delivery or over acceptance (natural gas), in which case liquidated damages would be payable for that particular delivery, or by separate subsequent agreement of the parties.

We also note that, while the EFET Agreements do not permit a party to elect cash settlement in lieu of delivery or receipt, individual transactions entered into under these master agreements can be subject to operational netting arrangements, which we discuss in more detail in our response to Q216 and which we do not consider would prevent a contract from being characterised as "must be physically settled".

In addition to the examples of contracts for power and gas transactions described above, we set out below examples of methods of physical settlement in relation to coal that is physically settled, including:

(i) FOB (Free on Board) – title/risk pass on loading, payment is affected after completion of loading and receipt of documents (Bill of Lading, Certificate of Analysis etc.)
(ii) CIF (Cost, Insurance and Freight) - title/risk pass on loading, payment is affected after completion of loading and receipt of documents (Bill of Lading, Certificate of Analysis etc.)
(iii) CFR (Cost and Freight) – same as CIF
(iv) DAT (Delivered at Terminal) – title/risk pass on arrival at discharge port, payment is affected after completion of discharge and receipt of documents (Draft Survey, Certificate of Analysis etc.)
(v) DAP (Delivered at Place) – same as DAT but includes further delivery possibly by barge or train
(vi) EXW (Ex Works) – title/risk pass when tonnage is made available to buyer, initial payment is affected following completion of buyer lifting cargo or at the end of the month of delivery if not lifted during contract month, final payment is affected upon completion of loading and receipt of documents (barge/train lifting docs, Certificate of Analysis, Invoice)
(vii) DES (Delivered ex Ship) – was removed from previous Incoterms version (replaced by DAT) but still traded regularly.

There are other types of delivery but these are less commonly traded in coal (if at all). All of the above are subject to contract terms.

SCoTA is the industry recognised contract for a number of products with the most actively traded being DES ARA, FOB Richards Bay, FOB Newcastle and to a lesser extent FOB Colombia. Transactions under the SCoTA are from time to time cash settled in lieu of delivery, but as with the EFET Agreements cash settlement is not an option provided by the SCoTA but would be separately negotiated by the parties subsequent to their entering into the original transaction and in specific circumstances (i.e., where all parties in a relevant chain agree to cash settle). ESMA's Technical Advice should distinguish this situation from a situation where the relevant contract would fall within section C(5) as a contract which may be settled in cash at the option of one of the parties.

- Bookouts – where a party has a long and short position with the same client, the parties may agree to offset physical obligations and net settle the difference between contract prices for the volume bought and sold (however, again this would be subject to mutual consent in specific circumstances by the parties subsequent to their entering into the original transaction).
- Circle outs / close-outs – same as a bookout but with more than 2 parties involved and the value is settled as the following example:
    - Party A sells 50,000mt FOB Richards Bay to Party B at $80.00 in August 14
    - Party B sells 50,000mt FOB Richards Bay to Party C at $85.00 in August 14
    - Party C sells 50,000mt FOB Richards Bay to Party A at $90.00 in August 14
    - The Parties agree that there is a circle and to offset the physical obligations from each other and to settle the contract prices against API4 for August 14
    - API4 for August 14 outturns at $82.00, therefore:
        - Party A pays Party B $100,000 (50,000 * minus $2 pmt)
        - Party C pays Party B $150,000 (50,000 * $3 pmt)
        - Party A pays Party C $400,000 (50,000 * $8 pmt)

Q218: How do you understand and how would you describe the concepts of "force majeure" and "other bona fide inability to settle" in this context?

Although the meaning of "force majeure" may differ in light of the relevant governing law and the express provisions of the relevant contract, force majeure is essentially the means by which parties allocate the risk of unforeseen events which adversely affect their ability to perform contractual obligations. In this context, the concept of force majeure can be intended as an occurrence beyond the reasonable control of one of the parties which it could not reasonably have avoided or overcome which was not foreseeable at the time that the contract was entered into, and which hinders, delays or prevents performance of obligations according to the contract terms. In case of gas and power markets this may include failure of communication or IT systems of the relevant network or system operator or an unplanned outage. The party affected by force majeure is generally under a duty to attempt to resolve the force majeure event. In certain circumstances, no breach or default is deemed to have occurred and the counterparty claiming the force majeure is released from the contractual obligations for the period of time that force majeure prevents its performance. The consequences of the force majeure event will depend on the nature and terms of the contract, but they typically include suspension of performance, a reduction or cancellation of obligations or the cancellation of the contract if the force majeure event continues beyond an agreed period.

Other bona fide inabilities may include failure to pay or inadequate performance assurance or credit support document or cases of early termination due to specific circumstances such as the insolvency of a counterparty, but also other events that do not entail a fault of one of the parties to perform according to its obligations (e.g. a change in law preventing a counterparty from transacting in the relevant asset class or jurisdiction).

It is important that any guidance regarding what would constitute a "bona fide inability to settle" should not exclude events of default specified in the relevant contract, as this could lead to a situation in which the parties to the contract are unable to settle physically (e.g. as a result of the insolvency of one party), but the contract is not considered to be one which must be settled physically.

The examples provided above should be intended only as illustrative and not exhaustive or conclusive because the main purpose of such concepts is that they can be sufficiently broad to accommodate unforeseen events. Any attempt to define such cases in a granular way for all commodities would lead to additional legal uncertainty because the operational arrangements and practices in commodity markets differ extensively.

Q219: Do you agree that Article 38 of Regulation (EC) No 1287/2006 has worked well in practice and elements of it should be preserved? If not, which elements in your view require amendments?

We agree that Article 38 of the MIFID Implementing Directive has worked well in practice to date. We acknowledge that this provision will require revision to take account of the changes to the scope of financial instruments under MIFID II, particularly the introduction of the OTF trading venue.

However, we strongly disagree with the proposed changes to (i) the trading criterion under Article 38(1) (see our response to Q224, which sets out our opinion that deleting "expressly stated to be" from the equivalence test actually reduces the objectivity of the test rather than increasing it as ESMA intends) and to (ii) the clearing criterion (see our response to Q222, which sets out our opinion that deleting the clearing criterion is likely to have the effect of removing contracts from the scope of EMIR, as the definition of "derivative" under EMIR is based on that under MiFID II. EMIR on its own does not bring additional contracts within scope of the clearing obligation unless they are already within scope of MiFID II).

We would strongly encourage ESMA not to finalise its Technical Advice on the definition of financial instruments in advance of final policy proposals on the position limits regime and ancillary activities exemption. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

We support ESMA's clarification in paragraph 22 of section 7 that the criteria for determining whether or not a contract has the characteristics of other derivative instruments should be applied cumulatively and would welcome a similar statement in the final Technical Advice.

Q220: Do you agree that the definition of spot contract in paragraph 2 of Article 38 of Regulation (EC) 1287/2006 is still valid and should become part of the future implementing measures for MiFID II? If not, what changes would you propose?

We agree that the definition of "spot" is still valid and that it should become part of the future implementing measures for MiFID II.

While the flexibility of the definition gives rise to the possibility of differing interpretations in different Member States, we consider that it would be more appropriate to address any differences through guidance rather than by amending the definition in the legislation. Commodity markets are very diverse and seeking to define in legislation what would be a "spot" contract for every market, every type of underlying and every type of contract is likely to result in a definition which is inflexible and would not be able to respond to changes in the structure and practice of the markets or to be updated promptly to reflect changing market conditions.

For example, we are aware that in some cases market participants adopt different interpretations of "trading days" (e.g. banking days in the jurisdiction of the underlying commodity market, or banking days in the jurisdiction of the parties to the contract). It would be helpful for ESMA to clarify this issue in guidance to facilitate a consistent approach to implementation across the market.

We would also welcome confirmation from ESMA that the definition of "spot" provided in the context of section C(7) is generally applicable in relation to sections C(5) – C(10) and that spot contracts are not derivative financial instruments regardless of the underlying (as indicated in paragraph 29 of Section 7 of the Consultation Paper).

Q221: Do you agree that the definition of a contract for commercial purposes in paragraph 4 of Article 38 of Regulation (EC) 1287/2006 is still valid and should become part of the future implementing measures for MiFID II? If not, what changes would you propose? What other contracts, in your view, should be listed among those to be considered for commercial purposes?

The definition of a contract for commercial purposes is still valid. We would not propose any changes to the definition.

Q222: Do you agree that the future Delegated Act should not refer to clearing as a condition for determining whether an instrument qualifies as a commodity derivative under Section C 7 of Annex I?

No, we do not agree.

ESMA states in the CP that "in simplified terms, EMIR says that commodity derivatives as defined in MiFID I have to be cleared if certain conditions are fulfilled. If MiFID II were to then continue defining commodity derivatives as instruments which are (already) cleared, […] this would establish a circularity between the two pieces of legislation". However, we do not consider that this would establish a circularity. The starting point for determining the scope of EMIR is the definition of "financial instrument" under MiFID. If a contract is not a derivative under MiFID, it will not be within the scope of EMIR.

The clearing obligation under EMIR does not require all derivative contracts to be cleared, but rather provides that certain derivative contracts which are already admitted to clearing may be required to be cleared. In order to become subject to the clearing obligation, these contracts need to be "derivatives" as defined in EMIR (i.e., financial instruments under sections C(4) – (10) MiFID).

Removing the reference to clearing as a condition for determining whether or not an instrument qualifies as a commodity derivative under section C(7) may mean that some contracts which are cleared will no longer qualify as derivatives. If these cleared contracts no longer qualify as derivatives, they will no longer be within scope of EMIR and could not become subject to mandatory clearing.

We consider that the reference to clearing by a clearing house or having arrangements for payment or provision of margin add clarity to the scope of section C(7) and would not create circularity.

Q223: Do you agree that standardisation of a contract as expressed in Article 38(1) Letter c of Regulation (EC) No 1287/2006 remains an important indicator for classifying financial instruments and therefore should be maintained?

We agree that standardisation of a contract remains an important indicator and that it should be maintained. However, standardisation is not the only relevant indicator and it is important that standardisation continues to be considered together with the other factors set out in Article 38 of Regulation (EC) 1287/2006.

Standardisation of contract terms is common feature of market development. Efforts to enhance standardisation should be favoured because the use of standard terms reduces legal uncertainty and supports liquidity in the relevant markets.

Q224: Do you agree with the proposal to maintain the alternatives for trading contracts in Article 38(1)(a) of Regulation (EC) No 1287/2006 taking into account the emergence of the OTF as a MiFID trading venue in the future Delegated Act?

We strongly disagree with the proposed change to the third limb of the trading criterion from "*expressly stated to be equivalent to*" to "*equivalent to*".

We do not consider that the proposed test achieves ESMA's stated aim of a more objective test. Rather it introduces a subjective test under which the parties may adopt different positions on whether a contract is "equivalent". Any difference in regulatory treatment of a contract by the parties will result in significant practical compliance difficulties in the wider regime for regulation of derivatives (e.g. EMIR portfolio reconciliation and compression, reporting, clearing and collateral obligations).

The current test has worked well to date. The requirement for a contract to be "*expressly stated to be equivalent to*" a contract traded on a regulated market provides clarity for all market participants, as it is possible to establish whether or not this criterion is met by looking at the terms of the contract. The LME Look Alike Contract is a good example of a contract which is expressly stated to be equivalent to a contract traded on a regulated market (i.e. LME).

It is also unclear how ESMA's proposed "*equivalent to*" test would interact with the "economically equivalent" test under the position limits regime. This is a key concern given the inter-relationship between the scope of financial instruments and the position limits regime.

We understand that limiting the tests in paragraph 7(ii) of the Draft Technical Advice to, "*as far as contracts within the scope of C6 of Annex I Directive are concerned*" is intended to ensure that wholesale energy products traded on an OTF that must be physically settled which are carved out of C6 should not then be considered under C7. If so, we agree with this principle but would prefer that the issue to be dealt with in a separate specific paragraph in the Technical Advice to avoid any unintended consequences in interpretation of this provision going forward. See also our response to Q225.

Q225: Do you agree that the existing provision in Article 38(3) of Regulation (EC) No 1287/2006 for determining whether derivative contracts within the scope of Section C(10) of Annex I should be classified as financial instruments should be updated as necessary but overall be maintained? If not, which elements in your view require amendments?

We agree that the existing provision in Article 38(3) should be maintained as it currently stands, except that it should be updated as necessary to reflect the introduction of OTFs as a new category of trading venue.

We also recommend that ESMA reconsider paragraph 11(ii)(c) of the Draft Technical Advice.

We understand that specifying contracts that are traded on an OTF "if the contract is within the scope of C6 of Annex I" is intended to ensure that wholesale energy products traded on an OTF that must be physically settled which are carved out of C6 should not then be considered under C10. If so, we agree with this principle but would prefer that the issue to be dealt with in a specific paragraph in the Technical Advice. The current drafting appears to operate so that any derivative with a C10 underlying traded on an OTF will be excluded from C10 as it cannot, by definition, be within scope of C6. This does not appear to be the policy intention.

Q226: Do you agree that the list of contracts in Article 39 of Regulation (EC) No 1287/2006 should be maintained? If not, which type of contracts should be added or which ones should be deleted?

Intentionally left blank.

Q227: What is your view with regard to adding as an additional type of derivative contract those relating to actuarial statistics?

Intentionally left blank.

Q228: What do you understand by the terms "reason of default or other termination event" and how does this differ from "except in the case of force majeure, default or other bona fide inability to perform"?

The terms 'by reason of default or other termination event' should be understood differently from force majeure and a subset of the general case of bona fide inability to perform.

In this context the concept of force majeure should be intended as an occurrence beyond the reasonable control of one of the parties which it could not reasonably have avoided or overcome and which it makes impossible for one of the parties to perform according to the contract terms. *Default or termination events* may be specific cases of inability to perform of one of the counterparties, however other *inabilities to perform* may include also other cases like inadequate performance assurance or credit support documentation that determines the inability to perform the contract.

In any case we reiterate our view that these examples should be intended only as illustrative and not exhaustive or conclusive because the main purpose of such concepts is to remain sufficiently broad to accommodate unforeseen events. Any attempt to define these cases in a granular way for all commodities would lead to additional legal uncertainty.

7.2. Position reporting thresholds

Q229: Do you agree with the proposed threshold for the number of position holders? If not, please state your preferred thresholds and the reason why.

We broadly support ESMA's proposals, however it needs to be recognized that these proposals fit under a general position limit/reporting regime and therefore it is hard to assess all the implications at this stage. We would strongly encourage ESMA not to finalise its Technical Advice in advance of final policy proposals on the position limits/reporting regime. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

Q230: Do you agree with the proposed minimum threshold level for the open interest criteria for the publication of reports? If not, please state your preferred alternative for the definition of this threshold and explain the reasons why this would be more appropriate.

We broadly support ESMA's proposals, however it needs to be recognized that these proposals fit under a general position limit/reporting regime and therefore it is hard to assess all the implications at this stage. We would strongly encourage ESMA not to finalise its Technical Advice in advance of final policy proposals on the position limits/reporting regime. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

Q231: Do you agree with the proposed timeframes for publication once activity on a trading venue either reaches or no longer reaches the two thresholds?

We broadly support ESMA's proposals, however it needs to be recognized that these proposals fit under a general position limit/reporting regime and therefore it is hard to assess all the implications at this stage. We would strongly encourage ESMA not to finalise its Technical Advice in advance of final policy proposals on the position limits/reporting regime. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

7.3. Position management powers of ESMA

Q232: Do you agree that the listed factors and criteria allow ESMA to determine the existence of a threat to the stability of the (whole or part of the) financial system in the EU?

We broadly support ESMA's proposals, however it needs to be recognized that these proposals fit under a general position limit/reporting regime and therefore it is hard to assess all the implications at this stage. We would strongly encourage ESMA not to finalise its Technical Advice in advance of final policy proposals on the position limits and reporting regime. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

Moreover, we urge regulators to ensure flexibility if the criteria would practically prove ineffective in some situations.

Q233: What other factors and criteria should be taken into account?

It needs to be recognized that these proposals fit under a general position limit/reporting regime and therefore it is hard to assess this question at this stage. We would strongly encourage ESMA not to finalise its Technical Advice in advance of final policy proposals on the position limits and reporting regime. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

Q234: Do you agree with ESMA's definition of a market fulfilling its economic function?

It needs to be recognized that these proposals fit under a general position limit/reporting regime and therefore it is hard to assess this question at this stage. We would strongly encourage ESMA not to finalise its Technical Advice in advance of final policy proposals on the position limits and reporting regime. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

Q235: Do you agree that the listed factors and criteria allow ESMA to adequately determine the existence of a threat to the orderly functioning and integrity of financial markets or commodity derivative market so as to justify position management intervention by ESMA?

It needs to be recognized that these proposals fit under a general position limit/reporting regime and therefore it is hard to assess this question at this stage. We would strongly encourage ESMA not to finalise its Technical Advice in advance of final policy proposals on the position limits and reporting regime. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

Q236: What other factors and criteria should be taken into account?

It needs to be recognized that these proposals fit under a general position limit/reporting regime and therefore it is hard to assess this question at this stage. We would strongly encourage ESMA not to finalise its Technical Advice in advance of final policy proposals on the position limits and reporting regime. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

Q237: Do you consider that the above factors sufficiently take account of "the degree to which positions are used to hedge positions in physical commodities or commodity contracts and the degree to which prices in underlying markets are set by reference to the prices of commodity derivatives"? If not, what further factors would you propose?

It needs to be recognized that these proposals fit under a general position limit/reporting regime and therefore it is hard to assess this question at this stage. We would strongly encourage ESMA not to finalise its Technical Advice in advance of final policy proposals on the position limits and reporting regime. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

Q238: Do you agree that the listed factors and criteria allow ESMA to determine the appropriate reduction of a position or exposure entered into via a derivative?

We broadly support ESMA's proposals, however it needs to be recognized that these proposals fit under a general position limit/reporting regime and therefore it is hard to assess all the implications at this stage. We would strongly encourage ESMA not to finalise its Technical Advice in advance of final policy proposals on the position limits and reporting regime. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

Moreover, we urge regulators to ensure flexibility if the criteria would practically prove ineffective in some situations.

Q239: What other factors and criteria should be taken into account?

It needs to be recognized that these proposals fit under a general position limit/reporting regime and therefore it is hard to assess this question at this stage. We would strongly encourage ESMA not to finalise its Technical Advice in advance of final policy proposals on the position limits and reporting regime. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

Q240: Do you agree that some factors are more important than others in determining what an "appropriate reduction of a position" is within a given market? If yes, which are the most important factors for ESMA to consider?

It needs to be recognized that these proposals fit under a general position limit/reporting regime and therefore it is hard to assess this question at this stage. We would strongly encourage ESMA not to finalise its Technical Advice in advance of final policy proposals on the position limits and reporting regime. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

Q241: Do you agree that the listed factors and criteria allow ESMA to adequately determine the situations where a risk of regulatory arbitrage could arise from the exercise of position management powers by ESMA?

We broadly support ESMA's proposals, however it needs to be recognized that these proposals fit under a general position limit/reporting regime and therefore it is hard to assess all the implications at this stage. We would strongly encourage ESMA not to finalise its Technical Advice in advance of final policy proposals on the position limits and reporting regime. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

Moreover, we urge regulators to ensure flexibility if the criteria would practically prove ineffective in some situations.

Q242: What other criteria and factors should be taken into account?

It needs to be recognized that these proposals fit under a general position limit/reporting regime and therefore it is hard to assess this question at this stage. We would strongly encourage ESMA not to finalise its Technical Advice in advance of final policy proposals on the position limits and reporting regime. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

Q243: If regulatory arbitrage may arise from inconsistent approaches to interrelated markets, what is the best way of identifying such links and correlations?

It needs to be recognized that these proposals fit under a general position limit/reporting regime and therefore it is hard to assess this question at this stage. We would strongly encourage ESMA not to finalise its Technical Advice in advance of final policy proposals on the position limits and reporting regime. This is to ensure that the regime may be properly considered as a whole by market participants and regulators.

ANNEX 2 – RESPONSE TO THE DISCUSSION PAPER (LINK)

7. Commodity derivatives

7.1. Ancillary Activity

Q464: Do you see any difficulties in defining the term 'group' as proposed above?

We agree with ESMA's analysis regarding the definitions of "group", "parent undertaking" and "subsidiary" under MiFID II, and the conclusion that the term "group" comprises the parent undertaking and all its subsidiary undertakings, where subsidiary undertakings include undertakings controlled by a parent undertaking in accordance with Article 22 of Directive 2013/34/EU.

The circumstances in which a parent undertaking would be considered to have "control" under Article 22 of Directive 2013/34/EU are already used in other directives and there is already an understanding on how these terms should be interpreted, so we consider that it is appropriate to refer to these circumstances in the definition of "group" (and also that this is consistent with the definitions set out in MiFID II).

Q465: What are the advantages and disadvantages of the two alternative approaches mentioned above (taking into account non-EU activities versus taking into account only EU activities of a group)? Please provide reasons for your answer.

We consider that the term "group" should be interpreted as meaning the global group, including non-EU entities within the group, and that the consolidated financial statements of a parent undertaking is correctly identified by ESMA as being a key reference in defining how a "group" is constituted.

However, it is critical that the definition of "group" in MiFID II is consistent with the definition under EMIR to ensure that non-EU activities are captured and that there is consistency between the two regimes.

Recital 21 of MiFID II makes it clear that the group definition under MiFID II should be read consistently with that under EMIR, as otherwise consistency in the interpretation of "intra-group transactions" would not be possible (it would not be consistent to look at the activities of the EU subsidiaries only under MiFID II, while excluding transactions entered into with members of the broader consolidation group in accordance with the "intra-group transactions carve-out under EMIR). Recital 40 EMIR makes it clear that the definition of "group" under EMIR covers groups which are consolidated in accordance with non-EU consolidation requirements.

Q466: What are the main challenges in relation to both approaches and how could they be addressed?

As noted by ESMA, an EU-only approach has the potential for creating loopholes.

A possible disadvantage of the world-wide approach is the difficulty to assess the world-wide market size due to lack of available data.

Q467: Do you consider there are any difficulties concerning the suggested approach for assessing whether the ancillary activities constitute a minority of activities at group level? Do you consider that the proposed calculations appropriately factor in activity which is subject to the permitted exemptions under Article 2(4) MiFID II? If no, please explain why and provide an alternative proposal.

Although we appreciate that a quantitative approach may be more objective, we consider that the better approach would be to assess whether or not activities are "ancillary activities" by reference to a combination of qualitative and quantitative criteria. MiFID II clearly requires an approach based on more than just quantitative criteria. Article 2(4) states that the relevant criteria shall **take into account at least** whether an activity constitutes a minority of activities at group level, and goes on to state that the capital employed **shall in no case be sufficient** to demonstrate that the activity is ancillary to the main business of the group.

In addition, for activities to qualify as "ancillary activities" they should be truly ancillary to the main business (i.e., they should complement and provide necessary support to the main business). A business line which is merely incidental to or wholly unrelated to the main business of the group should not be considered to be "ancillary to the main business".

We consider that an approach based only on quantitative criteria is likely to lead to anomalous results. For example, in the context of a global group, 49% of the group's activities could constitute a significant business line relative to the main business of the group and may even give the group a dominant position in that business activity in some jurisdictions, but using only quantitative criteria such as the formulae proposed this business line would be considered to constitute ancillary activities.

However, if qualitative criteria are employed in combination with quantitative criteria then such qualitative tests could easily identify that the relevant business line is not "ancillary" and is in fact wholly unrelated to the main business.

However, if ESMA intends to apply quantitative criteria alongside qualitative criteria (or instead of qualitative criteria) we consider that a 50% threshold is too high. We discuss this further in our response to Q469.

Regarding the proposed calculations, we consider that the denominator should reflect the capital employed for the main activity at group level (calculated by deducting the capital employed for the sum of ancillary activities from the capital for the remaining activity as calculated in accordance with paragraph 24 of section 7 of the DP), as proposed by ESMA. We agree that the proposed calculations do appropriately factor in activity which is subject to the permitted exemptions under Article 2(4) MiFID II.

We do not consider that the denominator should reflect the capital for overall activity at group level, as this would not appropriately factor in activity which is subject to the permitted exemptions under Article 2(4) MiFID II.

Q468: Are there other approaches for assessing whether the ancillary activities constitute a minority of activities at group level that you would like to suggest? Please provide details and reasons.

As mentioned in our response to Q467, we consider that the better approach would be to assess whether or not activities are "ancillary activities" by reference to qualitative criteria (or by reference to a combination of qualitative and quantitative criteria). Examples of qualitative factors which ESMA could take into account compared to authorised entities and the entity’s main business, include:

- Market presence in the relevant activity;
- VaR used in the relevant activity;
- Compensation structure (e.g. do employees work to sales targets or receive bonuses based on level of business generated);
- Headcount;
- Whether or not the entity is a member of relevant exchanges or other trading venues.

Q469: How should “minority of activities” be defined? Should minority be less than 50% or less (50 - x)%? Please provide reasons.

As mentioned in our responses to Q467 and Q468, we consider that the better approach would be to assess whether or not activities are "ancillary activities" by reference to qualitative criteria (or by reference to a combination of qualitative and quantitative criteria). We appreciate that quantitative criteria can give a more objectively measureable result, but consider that where this test needs to be applied to a wide range of different businesses (in terms of their size, geographical scope and nature of their activities) it should not be a simple one-size fits all metric but will need to be more sophisticated.

However, if ESMA ultimately decides to apply quantitative criteria alongside qualitative criteria (or instead of qualitative criteria) we consider that a 50% threshold is too high and that "minority of activities" should be defined as a much lower percentage of a group's main business activity to ensure that any ancillary activities do fairly represent a minority of activities at group level. If the threshold is set at 50% or less we consider that this would still permit entities to carry on a significant amount of "MiFID business" without being subject to regulation.

If a 50% threshold was applied alongside other qualitative criteria this may reduce the risk of anomalous results somewhat. However, we still consider that while less than 50% may technically constitute a minority, it does not necessarily follow that a business line which makes up 49% of an entity's business should be considered to be an ancillary activity and could (relative to the main business of the group) constitute a significant amount of "MiFID business" which would be unregulated.

For example, in the context of a global group, 49% (or even a significantly lower figure, such as 20%) of the group's activities could constitute a significant business line and may even give the group a dominant position in that business in some jurisdictions.

In addition, if you look at the business lines operated by an entity, the relevant activity might be the largest single business line at 49% of the total business, while other business lines are individually far smaller even if taken together they comprise 51% of the total business.

If ESMA does decide to use quantitative criteria, we consider that a significantly lower threshold would be appropriate, in conjunction with other qualitative criteria. We would suggest a threshold in the region of 10 – 15%.

Q470: Do you have a view on whether economic or accounting capital should be used in order to define the elements triggering the exemption from authorisation under MiFID II, available under Article 2(1)(j)? Please provide reasons.

In order to provide a fully informed view on whether economic or accounting capital should be used, ESMA should provide more detailed information on what it means by accounting and economic capital.

We consider that ESMA should adopt an approach which does not only rely on a single metric in order to determine availability of the exemption. For example, ESMA could adopt an approach using accounting capital together with some economic capital metrics, measured against both the activity of the entity and that of the wider market such as:

- Headcount;
- Balance sheet usage / revenue / working capital employed;
- VaR used in the relevant activity;
- Compensation structure.

ESMA would need to establish a standard formula for calculating each of these metrics.

ESMA has indicated in the DP that where an accounting capital measure is not available, an economic capital measure should be used. If ESMA intends to take this approach (or to allow economic capital measures to be used), it would be useful to have a clear indication of what is meant by accounting and economic capital so that it is clear how these measures should be calculated, the specific heads of economic capital which ESMA considers to be relevant and measureable and instances when accounting capital may not be available. In order to avoid creating loopholes it should not be possible for entities to cherry-pick which approach they wish to use, based on the approach which gives them the best outcome.

Q471: If economic capital were to be used as a measure, what do you understand to be encompassed by this term?

As stated above, using economic capital as a measure would need further clarity from regulators as economic capital typically uses a variety of stress test methodology in its calculation and tends to be based on differing proprietary risk evaluation models and will vary across activities between the trading and non-trading parts of the business.

Q472: Do you agree with the above assessment that the data available in the TRs will enable entities to perform the necessary calculations?

We do not believe that Trade Repositories will contain the data to assess trading activity.

Q473: What difficulties do you consider entities may encounter in obtaining the information that is necessary to define the size of their own trading activity and the size of the overall market trading activity from TRs? How could the identified difficulties be addressed?

Firms assess their overall trading activity and reconcile their daily positions using their own internal risk and back office systems. It is not foreseen that firms will use TRs to assess or reconcile their trading activity. In addition TRs cannot provide a picture of overall EU and non-EU market activity given that under EMIR non-EU counterparties are not obliged to report their transactions.

Q474: What do you consider to be the difficulties in defining the volume of the transactions entered into to fulfil liquidity obligations?

The "requirement" to fulfil liquidity obligations should be a clearly stated and defined regulatory obligation, whether the obligation is satisfied directly against counterparties or through a trading venue.

Commercial liquidity arrangements between venues and their participants should be explicitly excluded by ESMA, as these arrangements are entered into voluntarily by participants in return for commercial benefits and not purely in order to satisfy a regulatory requirement.

Q475: How should the volume of the overall trading activity of the firm at group level and the volume of the transactions entered into in order to hedge physical activities be measured? (Number of contracts or nominal value? Period of time to be considered?)

We consider that since the hedging provision is intended to be considered in a way that is consistent with Regulation (EU) No 648/2012 (as mentioned in Recital 21 to MiFID II), the volume of transactions entered into to hedge commercial activities should be measured in the same way as under EMIR. This would mean that firms should look at the gross notional value of the relevant contracts.

Q476: Do you agree with the level of granularity of asset classes suggested in order to provide for relative comparison between market participants?

We are sympathetic to the argument that these asset classes should not be too granular given that by exceeding a threshold in one asset class, a firm would automatically trigger a MiFID II obligation in all asset classes. We note that in the Energy asset class it is much easier to exceed a trading threshold in gas than in oil, due to nominal contract size, even though volume of trading may be much smaller in gas.

However, we consider that grouping together a number of related asset classes may lead to arbitrary outcomes and may not fulfil the intention expressed by ESMA in paragraph 1 of section 7 of the DP, "to provide for a more narrow interpretation of allowed exempt activities thereby capturing within the scope of MiFID II a range of firms previously excluded".

Q477: What difficulties could there be regarding the aggregation of TR data in order to obtain information on the size of the overall market trading activity? How could these difficulties be addressed?

Given that only EU entities are subject to reporting derivative trades to a TR under EMIR, a large part of the commodity derivative market which is traded by non-EU entities bi-laterally and/or on markets external to the EU would not be reportable. Therefore there would be no way of incorporating these non-EU transactions into the overall market trading activity data held in European TRs.

In addition regulators need to be clear on what type of information they need to determine overall trading activity and for what purpose. If it is for systemic risk purposes, we suggest that position data is the correct data to show overall market share. This is problematic particularly for ETD trades under EMIR, as there is no obligation to report position data.

Q478: How should ESMA set the threshold above which persons fall within MiFID II's scope? At what percentage should the threshold be set? Please provide reasons for your response.

ESMA should assess the size of overall market trading activity in each relevant asset class, and set a threshold that is appropriate for that asset class. These thresholds should be kept under periodic review to ensure that they remain appropriate for the size of overall market trading activity in the relevant asset class. We consider that the threshold should be set at a relatively low level to ensure that activities exempt from regulation under MiFID are truly ancillary when compared to the main business of the group.

ESMA's comments in paragraph 38 of section 7 of the DP indicate that persons seeking to rely on this exemption may need to determine the size of overall trading activity in the different asset classes themselves. We consider that in order to ensure that all persons relying on the exemption are using the same approach to calculating the size of overall trading activity, ESMA should either publish detailed guidance on this calculation, or should publish indicative figures for overall trading activity which must be used in determining whether or not the exemption applies.

In particular, ESMA should consider leveraging the preliminary quantitative analysis (and any subsequent, more detailed analysis) that it has carried out in respect of the thresholds for assessing whether or not a firm should qualify as a systematic internaliser (discussed in section 3.3 of ESMA's CP), as well as the work that it has carried out in respect of position limits (discussed in section 7.2 of ESMA's DP).

ESMA should also ensure that when obtaining information from market participants it obtains information from unregulated market participants as well as from investment firms.

We note that in relation to establishing the size of relevant markets under the position limits regime ESMA has noted that this poses significant challenges. The same is also true for the definition of ancillary activities.

Q479: Are there other approaches for determining the size of the trading activity that you would like to suggest?

We suggest that position reports to be submitted under Art 58.1 could be a better measure for assessing trading activity than trade data reports from TRs. The only positions missing from such reports would be the pure bilateral trades (i.e. not traded on a RM, MTF or OTF).

Q480: Are there other elements apart from the need for ancillary activities to constitute a minority of activities and the comparison between the size of the trading activity and size of the overall market trading activity that ESMA should take into account when defining whether an activity is ancillary to the main business?

We agree that other qualitative elements should be taken into account when determining whether or not an activity is ancillary to the main business (see our responses to Q468 and Q470) and we support the view that ESMA should take into account how closely related a person's activities are to the main business. If the activity is integral to the main business it should not be regarded as ancillary (e.g., if a trading house is trading for its own account as its main business). Similarly, an activity should not be regarded as ancillary if it is determined to be merely incidental or secondary to a person's main business.

As set out in our response to Q468, qualitative elements that ESMA should take into account compared to authorised entities and the entity's main business include:

- Market presence in the relevant activity;
- VaR used in the relevant activity;
- Compensation structure (e.g. do employees work to sales targets or receive bonuses based on level of business generated);
- Headcount;
- Whether or not the entity is a member of relevant exchanges or other trading venues.

Q481: Do you see any difficulties with the interpretation of the hedging exemptions mentioned above under Article 2(4)(a) and (c) of MiFID II? How could potential difficulties be addressed?

In general we support the interpretation of the hedging exemptions under Article 2 (4) (a) and (c) of MiFID II and believe that Article 3 of EMIR is appropriate. However we suggest that full reference to the relevant definition of the hedging exemption as defined in EMIR is made in the Regulatory Technical Standards in MiFID II.

Q482: Do you agree with ESMA's proposal to take into account Article 10 of the Commission Delegated Regulation (EU) No 149/2013 supplementing EMIR in specifying the application of the hedging exemption under Article 2(4)(b) of MiFID II? How could any potential difficulties be addressed?

We support that Article 10 of the Commission Delegated Regulation (EU) No 149/2013 supplementing EMIR should be taken into account in relation to transactions objectively mitigating risks relating to commercial or treasury financing activity. However, the response to question 10(c) on portfolio hedging in the related ESMA Q&A states that there must be sufficient disaggregation in order to establish a clear link between the types of contracts entered into and the commercial or treasury activity of the group. Commercial firms use complex hedging instruments across many geographies, markets, products and time horizons to reduce firm wide risk on an overall aggregate basis. Consequently we believe that disaggregating portions of this overall risk reducing activity may result in increased risks and hedging costs resulting in higher pass-through costs to consumers.

We would draw attention to ESMA that regulators in other jurisdictions such as Canada have provided guidance that there will be situations where a commercial firm may qualify for the hedging exemption even where some of the trades in a portfolio could be interpreted as not being a hedge, as long as there is a reasonable commercial basis to conclude that such trades are included in the commercial firm's wider portfolio as part of its overall risk mitigation strategy.

Q483: Do you agree that the obligations to provide liquidity under Article 17(3) and Article 57(8)(d) of MiFID II should not be taken into account as an obligation triggering the hedging exemption mentioned above under Article 2(4)(c)?

We agree that the obligations to provide liquidity under Article 17(3) and Article 57(8)(d) should not be taken into account as an obligation which is carved out under Article 2(4)(c), for the reasons given by ESMA in the DP.

Q484: Could you provide any other specific examples of obligations of "transactions in commodity derivatives and emission allowances entered into to fulfil obligations to provide liquidity on a trading venue" which ESMA should take into account?

As set out in our response to Q474, the "requirement" to fulfil liquidity obligations should be a clearly stated and defined regulatory obligation, whether the obligation is satisfied directly against counterparties or through a trading venue.

Commercial liquidity arrangements between venues and their participants should be explicitly excluded by ESMA, as these arrangements are entered into voluntarily by participants in return for commercial benefits and not purely in order to satisfy a regulatory requirement.

As a result, ESMA should take into account requirements to provide liquidity imposed by national competent authorities, and should obtain information on the relevant requirements from those national competent authorities.

Q485: Should the (timeframe for) assessment be linked to audit processes?

Yes. This should be an annual review signed off by auditors. The burden and cost to comply should fall on those companies looking to make use of the exemptions.

Q486: How should seasonal variations be taken into account (for instance, if a firm puts on a maximum position at one point in the year and sells that down through the following twelve months should the calculation be taken at the maximum point or on average)?

Seasonal variations should be adequately captured if the calculation is made on an average trade basis, over a minimum period of 12 months.

ESMA should retain the right to re-assess this basis to address any spikes that might appear in particular businesses.

Q487: Which approach would be practical in relation to firms that may fall within the scope of MiFID in one year but qualify for exemption in another year?

We believe that firms should be assessed on a 3 year rolling average of their trading activity reported to regulators on an annual basis. We believe that trading activity data should be based on continual assessment throughout 12 months of the year and not based on a single snapshot at a given time. If a firm falls into MiFID II on this basis then a minimum 12 month transition period should be given to enable the firm to take the necessary operational steps to implement MiFID.

Q488: Do you see difficulties with regard to the two approaches suggested above?

We do not have a strong position on this point so long as the status of the relevant entity is clear to the market at any given time.

Q489: How could a possible interim approach be defined with regard to the suggestion mentioned above (i.e. annual notification but calculation on a three years rolling basis)?

We do not have a strong position on this point so long as the status of the relevant entity is clear to the market at any given time.

Q490: Do you agree that the competent authority to which the notification has to be made should be the one of the place of incorporation?

Yes, we agree that the competent authority in the place of incorporation of the entity invoking the (j) exemption should be notified should it be required. This is consistent with regulatory supervisory regimes already in place at a national level throughout the EU.

7.2. Position Limits

Q491: Do you agree with ESMA's proposal to link the definition of a risk-reducing trade under MiFID II to the definition applicable under EMIR? If you do not agree, what alternative definition do you believe is appropriate?

Regarding OTC contracts, we agree that hedges excluded from the position limits regime should remain consistent with hedges excluded from the clearing threshold under EMIR and, therefore, agree that the definition of risk reducing trade under MiFID II should be the same as under EMIR, i.e. article 10(3) of EMIR and article 10 of the EMIR regulatory technical standards (EU N° 149/2013).

We also think that, since position limits is a tool for maintaining orderly markets, the exemption should also cover trades on exchange and not just OTC. We note that the primary purpose of EMIR is risk mitigation and central clearing of OTC derivatives and that for this reason on-venue contracts are not covered. MIFID aims to apply to both on-venue and OTFC contracts.

Q492: Do you agree with ESMA's proposed definition of a non-financial entity? If you do not agree, what alternative definition do you believe is appropriate?

We agree that the definition of non-financial entity (NFE) under the MiFID II position limits regime should be aligned with the definition of non-financial counterparty (NFC) under article 2(9) of EMIR, which excludes entities which must obtain licence under existing European financial services legislation as set out in the definition of 'financial counterparty' under article 2(8) of EMIR (i.e. investment firms, credit institutions, insurance companies, UCITS and their asset management companies, AIFs and their management companies, pension funds).

However, we note with concern ESMA's proposal in paragraph 14 that MiFID II would use the existing comparable definition within EMIR of non-financial counterparty. The definition of NFE does not currently appear to consider application to third country entities. A third country credit institution with no presence in the EU will not be required to seek authorisation under the Banking Directive, and so under the current definition would qualify as a NFE. For the purpose of alignment with the EMIR NFC concept, the definition should be amended to cover entities established in the EU which are not required to seek authorisation under the relevant directives, and entities established outside the EU which would not have been required to seek authorization if they had been established in the EU.

We also note that if the definitions of economically equivalent OTC contracts and of netting are not sufficiently broad, an entity that may be required to be licensed under MiFID II (and which therefore would no longer be an NFE) will not be able to rely on the hedging exemption to the position limits regime and that this prohibition will materially limit its ability to manage the risks associated with its commercial activities effectively.

Q493: Should the regime for subsidiaries of a person other than entities that are wholly owned look to aggregate on the basis of a discrete percentage threshold or on a more subjective basis? What are the advantages and risks of either approach? Do you agree with the proposal that where the positions of an entity that is subject to substantial control by a person are aggregated, they are included in their entirety?

In principle, we agree that the notion of control should be the basis of the proposed regime for aggregation of group positions and support the view that provided controlled undertakings can demonstrate through objective criteria that they operate independently from their parent company, they should be able to disaggregate.

On disaggregation, we particularly agree with the statement of ESMA that aggregation with fellow subsidiaries of a mutual parent or ultimate holding company should not be required.

We also call for the development of other exemptions from aggregation for: (1) certain limited partners, shareholders or other commodity pool participants; (2) accounts held by investment firms, brokers, and similar market intermediaries; (3) accounts carried by an independent account controller; (4) positions held in connection with underwriting activity or a broker-dealer acquired in the normal course of business; and (5) information sharing where prohibited by law or regulation.

In the draft RTS dated 20 March 2014 under the revised Transparency Directive (2013/50/EU amending 2004/109/EC) - for the purpose of shareholdings calculation notably through derivatives - ESMA proposes that the parent undertaking of an entity wishing to benefit from the exemption in relation to holdings sets a list of the effectively controlled entities with their competent authorities and a statement that these controlled entities do not receive any direct or indirect instructions from the parent undertaking in the exercise of the voting rights. In addition, we understand that the exemption applies to non-EU groups and non-EU controlled undertakings where it can be demonstrated that the relevant undertaking's market making and trading activities as well as its asset management activities meet the independence criteria on an on-going basis as set out in the draft RTS under the Transparency Directive.

Although the purpose of the Transparency Directive is different from the MiFID position limits regime (exercise of voting rights versus positions on commodities), we believe that the definitions of the aggregation of positions at a group level should be aligned. We however do not support that any ownership percentage between 50% and 100% automatically involves aggregation of positions between the parent undertaking and the subsidiary without any consideration to independence in investment strategies or trading businesses.

Q494: Should the regime apply to the positions held by unconnected persons where they are acting together with a common purpose (for example, "concert party" arrangements where different market participants collude to act for common purpose)?

In principle, we support rules aiming at tracking 'concert parties'.

We note that the Level 1 text sets out in article 57(12) of MiFID II that ESMA is required to draft RTS only in respect of limited circumstances. Specifically with respect to aggregation, it is required to draft "*the methods to determine when positions of a person are to be aggregated within a group*".

As this notion of 'concert parties' is not referenced in article 57(12), ESMA may not be able to introduce level 2 measures on this point. In any case, if ESMA was to introduce such rules, we would support alignment with principles that were enforced under the legislative texts that already use this concept. We also believe that "*the circumstances where it is appropriate to aggregate positions even for unconnected persons where they are tied together in a common purpose*" (page 409 of the Discussion paper, Paragraph 20) must be proved by the competent authority in charge of enforcing the position limits regime.

Q495: Do you agree with the approach to link the definition of economically equivalent OTC contract, for the purpose of position limits, with the definitions used in other parts of MiFID II? If you do not agree, what alternative definition do you believe is appropriate?

Position limits apply to commodity derivatives contracts covered by the MiFID II definition of financial instruments (as stated in article 57 as well as recitals 127, 130 and 131).

However to accurately reflect the net risk-exposure of market participants, underlying physical positions, including non-derivative contracts, should be taken into account.

With this in mind, we highlight the following points:

- ESMA should set a list of EU listed contracts subject to the limits in order to bring legal certainty to the scope of the position limits regime.

- It is essential that written contracts from different locations should have the same notion of equivalence to ensure that the commodity risk exposures are accurately reflected. Since position limits will apply to net positions, netting must be allowed also between underlying physical (non-derivative) contracts and the on-venue contract subject to the position limits.

- ESMA should not impose an artificial restriction on the ability to net cash-settled and physically-settled non-derivative contracts if the contracts are economically equivalent. The level 1 text accurately sets that the economic equivalence is in the heart of the calculation of a position and not a legal equivalence. The purpose of level 1, clearly stated in article 57.1 (a), is to 'prevent market abuse' and 'support orderly pricing and settlement conditions'. These objectives go with a definition of netting that reflects the reality of these global markets.

- The industry strongly supports a mechanism that is sufficiently broad and legally clear (i.e. measurable). In this respect we believe that the first approach is not sufficiently broad because the criteria are cumulative. We also think that the implementation in the European Union of the second approach would need to be tailored to meet a much broader pool of contracts rather than the list of 28 contracts but potentially to all on-venue contracts. But we believe that the second approach offers a more practicable set of equivalence criteria by setting out the specific types of contracts which could be considered to be equivalent and that this type of approach would facilitate implementation. We suggest that ESMA considers defining qualitative criteria (which may be the same for certain commodities) per asset class, i.e. a) Oil, b) Gas and power, c) Metals, d) Agriculture.

- We note with concern that ESMA's comments in the Discussion Paper indicate that it intends to interpret economically equivalent OTC contracts as meaning only MiFID financial instruments. In order to ensure a workable netting regime, market participants should be allowed to net against the underlying physical positions, including contracts that are not commodity derivatives (e.g., certain REMIT instruments and other physical contracts, e.g. coal and oil, or spot contracts). This greater pooling of positions and the provision of netting to allow bona fide hedges to be offset against physically settled transactions would therefore facilitate the accurate presentation of commodity risk levels.

- In addition, a wider definition along the lines noted above is consistent with how the market hedges physical transactions which generally do not qualify as MiFID financial instruments (for example, (i) physically delivered metal forwards and options not traded on an MTF, not being for commercial purposes or having characteristics of other derivative financial instruments are hedged with LME futures; (ii) wholesale energy products subject to the REMIT carve out are hedged with power futures on European power exchanges; and (iii) OTC physically settled Loco London good delivery gold can be hedged with COMEX (non-EU venue) futures).

- Also, we encourage ESMA to consider the need for "proxy hedging" when considering economically equivalent OTC contracts. Proxy hedging occurs when a risk related to a particular product is managed by hedging with a different product. For example, a participant may choose to hedge jet fuel exposure with ICE Europe Gas Oil Futures Contracts, since this ICE futures contract is both a key price determinant in European jet fuel markets and a highly liquid risk management tool. For the market to function as efficiently as possible and for all participants to have the ability to continue to offer, and benefit from, price risk management services, the position limit regime should allow for netting between proxy hedging contracts as economically equivalent contracts.

  We recognise that there are challenges in defining proxy hedging contracts and in this regard refer ESMA to the CME Group rules and guidance on Exchange for Related Position (EFRP) transactions. EFRP's are used by market participants to establish, move or liquidate exchange positions by executing the exchange product versus an OTC contract. There are several types of EFRPs, including an Exchange of Futures for Physical (EFP), which is defined as, "*the simultaneous execution of an Exchange futures contract and a corresponding physical transaction or a forward contract on a physical transaction*." In determining what may qualify for the physical component of the EFP the CME Group provides the following in its guidance (see link provided):

  "The related position component of the EFRP must involve the product underlying the Exchange contract or a by-product, related product or OTC derivative instrument that is reasonably correlated to the corresponding Exchange instrument.
  The related position component of an EFRP may not be a futures contract or an option on a futures contract.
  Where the risk characteristics and/or maturities of the related position differ from the instrument underlying the Exchange contract, the parties to the EFRP may be required to demonstrate the correlation between the products and the methodology used in equating the futures to the related position. In all cases, the related position transaction must be comparable with respect to quantity, value or risk exposure of the corresponding Exchange contract."

  http://www.cmegroup.com/tools-information/lookups/advisories/market-regulation/files/RA1311-5.pdf

  The CME Group rules and guidance highlight both the need for proxy hedging capabilities and a general level of accepted market practice. ESMA requests suggested amendments to the second approach to determining economically equivalent OTC contracts (see Q497). We suggest that the CME Group rules and guidance on EFP transactions could be considered as the basis of an additional proxy hedging criterion for economically equivalent OTC contracts under the second approach.

Q496: Do you agree that even where a contract is, or may be, cash-settled it is appropriate to base its equivalence on the substitutability of the underlying physical commodity that it is referenced to? If you do not agree, what alternative measures of equivalence could be used?

We generally agree that it would be appropriate to base equivalence on the substitutability of the underlying commodity for such contracts. This is consistent with the legislative text in MiFID II which calls for a determination of *economic* equivalence. We emphasise that there must be genuine *economic* substitutability, i.e. fungibility, between cash-settled and physical-delivery contracts. Netting across cash-settled and physical delivery contracts is critical as segregating cash settled and physically delivered contracts could fragment the market and could push liquidity towards fewer markets.

Q497: Do you believe that the definition of "economically equivalent" that is used by the CFTC is appropriate for the purpose of defining the contracts that are not traded on a trading venue for the position limits regime of MiFID II? Give reasons to support your views as well as any suggested amendments or additions to this definition.

See our response to question 495:

“Position limits apply to commodity derivatives contracts covered by the MiFID II definition of financial instruments (as stated in article 57 as well as recitals 127, 130 and 131).

However to accurately reflect the net risk-exposure of market participants, underlying physical positions, including non-derivative contracts, should be taken into account.

With this in mind, we highlight the following points:

- ESMA should set a list of EU listed contracts subject to the limits in order to bring legal certainty to the scope of the position limits regime.

- It is essential that written contracts from different location should have the same notion of equivalence to ensure that the commodity risk exposures are accurately reflected. Since position limits will apply to net positions, netting must be allowed also between underlying physical (non-derivative) contracts and the on-venue contract subject to the position limits.

- ESMA should not impose an artificial restriction on the ability to net cash-settled and physically-settled non-derivative contracts if the contracts are economically equivalent. The level 1 text accurately sets that the economic equivalence is in the heart of the calculation of a position and not a legal equivalence. The purpose of level 1, clearly stated in article 57.1 (a), is to ‘prevent market abuse’ and ‘support orderly pricing and settlement conditions’. These objectives go with a definition of netting that reflects the reality of these global markets.

- The industry strongly supports a mechanism that is sufficiently broad and legally clear (i.e. measurable). In this respect we believe that the first approach is not sufficiently broad because the criteria are cumulative. We also think that the implementation in the European Union of the second approach would need to be tailored to meet a much broader pool of contracts rather than the list of 28 contracts but potentially to all on-venue contracts. But we believe that the second approach offers a more practicable set of equivalence criteria by setting out the specific types of contracts which could be considered to be equivalent and that this type of approach would facilitate implementation. We suggest that ESMA considers defining qualitative criteria (which may be the same for certain commodities) per asset class, i.e. a) Oil, b) Gas and power, c) Metals, d) Agriculture.

- We note from ESMA’s comments in the Discussion Paper that it intends to interpret economically equivalent OTC contracts as meaning only MiFID financial instruments. In order to ensure a workable netting regime, market participants should be allowed to net against the underlying physical positions, including contracts that are not commodity derivatives (e.g., certain REMIT instruments and other physical contracts, e.g. coal and oil, or spot contracts). This greater pooling of positions and the provision of netting to allow bona fide hedges to be offset against physically settled transactions would therefore facilitate the accurate presentation of commodity risk levels.

- In addition, a wider definition along the lines noted above is consistent with how the market hedges physical transactions which generally do not qualify as MiFID financial instruments (for example, (i) physically delivered metal forwards and options not traded on an MTF, not being for commercial purposes or having characteristics of other derivative financial instruments are hedged with LME futures; (ii) wholesale energy products subject to the REMIT carve out are hedged with power futures on European power exchanges; and (iii) OTC physically settled Loco London good delivery gold can be hedged with COMEX (non-EU venue) futures).

- Also, we encourage ESMA to consider the need for “proxy hedging” when considering economically equivalent OTC contracts. Proxy hedging occurs when a risk related to a particular product is managed by hedging with a different product. For example, a participant may choose to hedge jet fuel exposure with ICE Europe Gas Oil Futures Contracts, since this ICE futures contract is both a key price determinant in European jet fuel markets and a highly liquid risk management tool. For the market to function as efficiently as possible and for all participants to have the ability to continue to offer, and benefit from, price risk management services, the position limit regime should allow for netting between proxy hedging contracts as economically equivalent contracts.

We recognise that there are challenges in defining proxy hedging contracts and in this regard refer ESMA to the CME Group rules and guidance on Exchange for Related Position (EFRP) transactions. EFRP's are used by market participants to establish, move or liquidate exchange positions by executing the exchange product versus an OTC contract. There are several types of EFRPs, including an Exchange of Futures for Physical (EFP), which is defined as, "*the simultaneous execution of an Exchange futures contract and a corresponding physical transaction or a forward contract on a physical transaction*." In determining what may qualify for the physical component of the EFP the CME Group provides the following in its guidance (see link provided):

"The related position component of the EFRP must involve the product underlying the Exchange contract or a by-product, related product or OTC derivative instrument that is reasonably correlated to the corresponding Exchange instrument.
The related position component of an EFRP may not be a futures contract or an option on a futures contract.
Where the risk characteristics and/or maturities of the related position differ from the instrument underlying the Exchange contract, the parties to the EFRP may be required to demonstrate the correlation between the products and the methodology used in equating the futures to the related position. In all cases, the related position transaction must be comparable with respect to quantity, value or risk exposure of the corresponding Exchange contract."

http://www.cmegroup.com/tools-information/lookups/advisories/market-regulation/files/RA1311-5.pdf

The CME Group rules and guidance highlight both the need for proxy hedging capabilities and a general level of accepted market practice. ESMA requests suggested amendments to the second approach to determining economically equivalent OTC contracts (see Q497). We suggest that the CME Group rules and guidance on EFP transactions could be considered as the basis of an additional proxy hedging criterion for economically equivalent OTC contracts under the second approach.

In addition, we would like to highlight that the CME Group rules and guidance highlight both the need for proxy hedging capabilities and a general level of accepted market practice. In response to ESMA's request for amendments to the second approach to determining economically equivalent OTC contracts, we suggest that the CME Group rules and guidance on EFP transactions could be considered as the basis of an additional proxy hedging criterion for economically equivalent OTC contracts under the second approach.

We generally support this second approach as it is aligned more closely to the idea that limits should apply to the commodity risk levels and the economics of the underlying positions. It is also consistent with CFTC rules which will facilitate implementation for the many market participants that operate on both the EU and the US. We believe that the CFTC definition is appropriate for contracts that are not traded on a trading venue for the position limits regime of MiFID II, subject to ESMA recognising a wide definition of economically equivalent as highlighted in our response to question 495. Alignment of the two definitions would ensure global regulatory consistency in a global market. The definitions provide a logical sub-set of contracts to ensure that the resulting application of position limits would meet the European Parliament and Council's aims of preventing market abuse and supporting orderly pricing. A consistent approach across jurisdictions also greatly reduces the complexity of systems and controls required by global firms subject to both the CFTC and EU regimes.

We also reiterate that if ESMA's intention is to limit the definition of economically equivalent OTC contracts to MiFID II financial instruments, it is not clear whether broad netting (to accurately reflect commodity risk levels) can be achieved.

Q498: What arrangements could be put in place to support competent authorities identifying what OTC contracts are considered to be economically equivalent to listed contracts traded on a trading venue? ?

Once the definition of economically equivalent OTC contracts is set with sufficient width and certainty, then the implementation and supervision will be much easier. We therefore believe that the response to this question largely depends upon the definition of economically equivalent OTC contracts. We also believe that CCPs and trading venues will be essential in conveying the necessary data for determining economically equivalent positions to listed contracts. Competent authorities may consider publishing examples of what they consider to be economically equivalent OTC contracts by commodity asset class as this would facilitate consistent interpretation and implementation (based on qualitative criteria par asset class). The lists would not be exhaustive but would aim to provide guidance.

Q499: Do you agree with ESMA's proposal that the "same" derivative contract occurs where an identical contract is listed independently on two or more different trading venues? What other alternative definitions of "same" could be applied to commodity derivatives?

The intention of article 57(6) of MiFID II is to apply a single position limit across multiple trading venues where "the same" contract is traded. However, as a practical matter, we question if ESMA will be able to monitor and to resolve disputes with respect to position limits, in respect of trading venues located outside the EU. The example used in paragraph 35, page 412, of the discussion paper, is of the KOSPI 200 contract traded on Eurex and the Korea Exchange, is helpful however we do not see how the German regulator could impose its own position limits on the South Korean trading venue where there is no such regime.

We agree that the 'same' derivative contract is a subset of economically equivalent contract and that in addition to the criteria for recognising economically equivalent contracts, other elements have to be taken into account such as the settlement process.

We also strongly believe that the concept of 'same contract' is to be used only for the purpose of article 57(6) and shall not be used for the purpose of netting and calculation of net positions aggregated at a group level.

Q500: Do you agree with ESMA's proposals on aggregation and netting? How should ESMA address the practical obstacles to including within the assessment positions entered into OTC or on third country venues? Should ESMA adopt a model for pooling related contracts and should this extend to closely correlated contracts? How should equivalent contracts be converted into a similar metric to the exchange traded contract they are deemed equivalent to?

On aggregation of contracts (for aggregation at a group level, please see our response to question 493), we agree that same contracts and OTC economically equivalent contracts should be included within the calculation. When facilitating client trades where there is limited liquidity in the specific underlying contract, investment firms use hedging strategies across many geographies, markets, products and time horizons to manage their residual risk. The regime should allow for this approach.

On netting, we consider that the calculation of a market participant's position should be with respect to its net position on a portfolio basis for identical or correlated commodities (e.g. gasoil / oil, power / emissions) across different commodity markets and on third country venues (if considered significant for EU markets for example, COMEX or WTI) in order to accurately represent commodity risk levels.

Naturally, we would caution against any extra-territorial application of EU position limits to contracts on third country venues; this would not be supported by the level 1 text and, practically speaking, if implemented could lead to conflicting rules and requirements applying to the same position.

With respect to cross-commodity hedges, we recommend that ESMA reviews and takes into account the CFTC rules for cross-commodity hedges including quantitative (i.e. setting of correlation limits) and qualitative (i.e. commercial relationship between target commodity and commodity underlying the derivative contract) factors. We note, however, that ESMA should not impose a rigid quantitative test for determining what constitutes a permissible cross-commodity hedge e.g. a specific correlation requirement. While this may seem an attractive policy option it has major limitations due to the fact that many commodity markets do not have liquid exchange-traded derivatives that can be used as a hedge. In such cases, market participants must hedge their risk using related derivatives products even though these hedges are not perfect i.e. ICE's Brent Contract is used to hedge a significant number of energy commodities. A qualitative test that is based on specific facts and circumstances and defers to the reasonable judgment of market participants is most appropriate.

Q501: Do you agree with ESMA's approach to defining market size for physically settled contracts? Is it appropriate for cash settled contracts to set position limits without taking into account the underlying physical market?

Deliverable supply is the right metric for physically settled spot month contracts. For cash settled spot-month contracts, we believe that the metric should be the open interest.

We also believe that although they are expressed as percentage of open interest, limits on cash-settled spot month contracts should be as aligned as possible with limits applied to physically-settled spot month contracts.

In relation to the use of open interests for limits on physical and cash settled non-spot month contracts, as the MiFID II regime applies to a broader range of commodity derivatives than just futures and will include economically equivalent OTC contracts, it will be necessary to adjust the open interests (given is a futures related metric) to add the notional volumes of swaps relating to the relevant on-venue contract. It is also the case that certain commodities may not have a related futures contract and competent authorities will need to estimate the open interests based on notional amounts of swaps.

We also call ESMA to provide further detail on how they intend to determine the overall market size for securities contracts with a commodity underlying.

We highlight that there are significant implementation issues that need to be considered further. In particular: (i) the definition of deliverable supply/open interest and (ii) ensuring that the deliverable supply/open interest is based on reliable, accurate and current information. For example:
For ICE Europe Brent crude oil futures contract "...is a deliverable contract based on EFP delivery with an option to cash settle against the ICE Brent Index price for the last trading day of the futures contract. The Exchange shall publish a cash settlement price (the ICE Brent Index price) on the next trading day following the last trading day for the contract month"
This ICE Europe futures example highlights the difficulty in determining deliverable supply for a particular contract as effectively any crude oil can form the basis of an EFP transaction for the purposes of settling the ICE Europe Brent crude oil futures contract. This example also highlights the difficulty in sourcing reliable, accurate and current data to determine deliverable supply.

Also, the difference between commodities means that some are durable and can be stored indefinitely and some cannot; this means that for somes commodities as well as production deliverable supply should also include stock levels (i.e. surplus production stored from a prior period).

We note, even though question 501 does not address this issue, that in this section the discussion paper addresses the notification and approval of exemptions (paragraph 43, page 413). It is very unclear how such mechanism should work in practice without being burdensome and potentially disruptive of markets and hedging conditions. For the sake of effective and smooth implementation and supervision, we strongly support a notification process that works on the basis of assumption that the exemption is approved until and unless is explicitly rejected. In other words: market participants shall notify the competent authority before breaching the position limit; the notification should be based on a web service; the exemptions shall be considered as accepted by until and unless is explicitly rejected. Upon rejection, the market participant is required to reduce its positions in a reasonable timeframe. This solution would allow markets to continue to hedge their commercial exposure whilst mitigating the burden and potentially adverse consequences of the approval procedure.

Q502: Do you agree that it is preferable to set the position limit on a contract for a fixed (excluding exceptional circumstances) period rather than amending it on a real-time basis? What period do you believe is appropriate, considering in particular the factors of market evolution and operational efficiency?

We agree that amending the position limit on a real-time basis is not only unnecessarily but unfeasible and that setting it for a fixed (excluding exceptional circumstances) period is preferable. With regard to the period itself, we propose that position limits on a contract are fixed for an initial period of two years and with annual reviews thereafter with amendments to the limits only where necessary.

We also believe that spot month limits generally should not be determined at the time a contract month becomes the spot month. Determining a position limit for the spot month contract on the first day that such contract is available for trade is impractical as it would require notice of a limit to be provided when that contract has already commenced trading (open interest calculations are usually published after trading has begun each day) and when parties may already be holding positions that are in breach of that new position limit. Requiring parties to trade out of positions to comply with the new position limits may lead to artificial volatility and a disorderly market.
For instance, the LME have daily Prompt date contracts and thus have daily settlements. The LME already impose a pseudo position limit when the contract is coming up to prompt (settlement) in that it has a rule that stipulates that if the accumulated net long positions of a particular participant or member, two days before settlement, exceeds 50% of LME warranted stock, the long position holder(s) has to reduce the positions to below 50% of LME stock

at a pre-determined set premium (price). It is possible to have a forward position that adds up to more than 100% of LME warranted stock. It is then up to the position holder to manage his positions over the two day period before settlement to ensure it is holding less than 50% of LME stock. LME stock figures are published each day at 09:00 UK time. We believe this is the method enshrined in the LME Lending Guidance rules that LME has been operating since 1998 is an effective tool in ensuring orderly markets and in effect imposes a pseudo position limit on LME contracts that are physically settled on the exchange. An explanation of the Lending Guidance can be found here:
http://www.lme.com/~/media/Files/Notices/2011/2011_10/11_293_A286_R008_Explanation_of_Metal_Lending_Guidance.pdf

The implementation of a position limits regime will significantly affect the functioning of the commodity markets and for this reason an initial two year period is necessary to ensure that orderly trading conditions are maintained during the transition.

The measure of the deliverable supply for a period of time is challenging and ESMA and national regulators should rely on data gathered by exchanges and on existing database aiming to ensure transparency in physical markets. A one-size fits all approach such as the "three months expiry cycle" as proposed by ESMA may not fit the fundamentals of certain commodity markets.

We also highlight that data used for the purpose of defining the deliverable supply period per commodity type should span over a period of a minimum of three years and should have a granular view on a monthly basis. When calculating the deliverable supply period per commodity type, different factors must be included, among which, a basic taxonomy (i.e.: storable versus non-storable), weather, supply chain optimization level, demand and offer curve, geographical location-distance, seasonality, growth, and market concentration, as well as the trading cycles per each commodity market. As there would be differences across commodities and that some factors are outside of the control of either of the parties to the physically-settled contract, a +/- margin should be added to the averaged/estimated delivery supply period. This +/- margin could be set at no less than 15% of the overall delivery supply period.

Q503: Once the position limits regime is implemented, what period do you feel is appropriate to give sufficient notice to persons of the subsequent adjustment of position limits?

It may depend on the underlying commodity and on the liquidity of the affected physical and financial markets.

The period must be sufficient to ensure that the adjustment does not disrupt the market. Many commodity derivatives markets are by nature illiquid. If the period is too short, then the sudden adjustment that a major market participant might need to make could create stressed conditions in the concerned market.

We support that the notice/adjustment period should be at least half the time of the fixed period however if grandfathering is allowed then a 3 to 6 month adjustment period should be manageable.

Q504: Should positions based on contracts entered into before the revision of position limits be grandfathered and if so how?

Yes, we strongly support grandfathering of contracts entered into before the revision of position limits. The immediate application of new stringent rules can adversely impact illiquid markets. Many commodity derivatives markets are illiquid by nature and the immediate application of limits to existing contracts may increase the disruption of the markets and create the conditions for higher volatility and price spikes which is exactly what the position limits regime aims to prevent or mitigate.

We also believe that staged compliance could be implemented following revision of position limits to ensure that market disruption is minimised.

Q505: Do you agree with ESMA's proposals for the determination of a central or primary trading venue for the purpose of establishing position limits in the same derivative contracts? If you do not agree, what practical alternative method should be used?

Yes. We agree that the application of the rule should be limited to the same commodity derivatives contract that is traded on two or more trading venues within the EU.

We agree with the method proposed by ESMA to assess whether the contract is traded in significant volumes in another jurisdiction. We also agree that the measure of the largest volume of trading shall be based on the largest volume of open interests measured in the number of lots of the relevant contracts.

Lastly, we reiterate that the concept of 'same contract' is to be used only for the purpose of article 57(6) and shall not be used for the purpose of netting and calculation of net positions aggregated at a group level.

Q506: Should the level of "significant volume" be set at a different level to that proposed above? If yes, please explain what level should be applied, and how it may be determined on an ongoing basis?

No. We agree with the approach proposed by ESMA. We obviously recognise that the revision of the measure of the 'significant volume' should be subject to the same principles as the revision of the position limits itself.

(see our response to question 502:
We agree that amending the position limit on a real-time basis is not only unnecessarily but unfeasible and that setting it for a fixed (excluding exceptional circumstances) period is preferable. With regard to the period itself, we propose that position limits on a contract are fixed for an initial period of two years and with annual reviews thereafter with amendments to the limits only where necessary.

We also believe that spot month limits generally should not be determined at the time a contract month becomes the spot month. Determining a position limit for the spot month contract on the first day that such contract is available for trade is impractical as it would require notice of a limit to be provided when that contract has already commenced trading (open interest calculations are usually published after trading has begun each day) and when parties may already be holding positions that are in breach of that new position limit. Requiring parties to trade out of positions to comply with the new position limits may lead to artificial volatility and a disorderly market.
For instance, the LME have daily Prompt date contracts and thus have daily settlements. The LME already impose a pseudo position limit when the contract is coming up to prompt (settlement) in that it has a rule that stipulates that if the accumulated net long positions of a particular participant or member, two days before settlement, exceeds 50% of LME warranted stock, the long position holder(s) has to reduce the positions to below 50% of LME stock at a pre-determined set premium (price). It is possible to have a forward position that adds up to more than 100% of LME warranted stock. It is then up to the position holder to manage his positions over the two day period before settlement to ensure it is holding less than 50% of LME stock. LME stock figures are published each day at 09:00 UK time. We believe this is the method enshrined in the LME Lending Guidance rules that LME has been operating since 1998 is an effective tool in ensuring orderly markets and in effect imposes a pseudo position limit on LME contracts that are physically settled on the exchange. An explanation of the Lending Guidance can be found here:
http://www.lme.com/~/media/Files/Notices/2011/2011_10/11_293_A286_R008_Explanation_of_Metal_Lending_Guidance.pdf

The implementation of a position limits regime will significantly affect the functioning of the commodity markets and for this reason an initial two year period is necessary to ensure that orderly trading conditions are maintained during the transition.

The measure of the deliverable supply for a period of time is challenging and ESMA and national regulators should rely on data gathered by exchanges and on existing database aiming to ensure transparency in physical markets. A one-size fits all approach such as the "three months expiry cycle" as proposed by ESMA may not fit the fundamentals of certain commodity markets.

We also highlight that data used for the purpose of defining the deliverable supply period per commodity type should span over a period of a minimum of three years and should have a granular view on a monthly basis. When calculating the deliverable supply period per commodity type, different factors must be included, among which, a basic taxonomy (i.e.: storable versus non-storable), weather, supply chain optimization level, demand and offer curve, geographical location-distance, seasonality, growth, and market concentration, as well as the trading cycles per each commodity market. As there would be differences across commodities and that some factors are outside of the control of either of the parties to the physically-settled contract, a +/- margin should be added to the averaged/estimated delivery supply period. This +/- margin could be set at no less than 15% of the overall delivery supply period).

Q507: In using the maturity of commodity contracts as a factor, do you agree that competent authorities apply the methodology in a different way for the spot month and for the aggregate of all other months along the curve?

<ESMA_QUESTION_507>
We fully agree that competent authorities apply the methodology in a different way for the spot month and to all other months along the curve, considered in aggregate. We highlight that not all commodity markets follow the same vanilla date structure. For instance, the LME does not have a spot month, e.g. for the Primary Aluminium contract there exists daily prompt dates out to 3 months, weekly: 3 out to 6 months and then Monthly : 7 out to 123 months. (The 3rd Wednesday being the monthly prompt).

Therefore we believe that ESMA should clarify how to interpret the definition of spot month when taking into account markets with daily prompts.

Q508: What factors do you believe should be applied to reflect the differences in the nature of trading activity between the spot month and the forward months?

Financial markets are structured to achieve price convergence between physical and financial commodity markets, and for futures markets to act as effective risk hedging venues for physical commodities. Settlement prices typically converge with physical market prices at expiry.

'Spot' or 'delivery' month limits restrict how many contracts a participant can hold in the period during which delivery of the physical commodity is to be made. This is where dominant market positions can have the most acute effect.

For instance, LME key metal contracts have daily prompt dates and daily settlement. Copper and Aluminium contracts go out to 10 years. A squeeze can only happen near the time of settlement when LME warrants have to be sourced in order to prepare for delivery. Further out the curve for contracts that are for further forward prompt dates have little impact on settlement and position limits are less relevant.

Further down the curve however, position limits may be less effective given reduced liquidity for long-dated contracts. If a market participant holds a large position further 'down the curve' markets have sufficient time to react. Therefore , in our view the main focus of the position limit regime should be on the spot month and to the extent that limits needs to be applied to other months they should sufficient to allow the normal functioning of the market and not unnecessarily restrict liquidity.

We also believe that it is important to take account of contract design and related specifications in addition to deliverable supply. Market distortions do not simply arise due to the size of the position built by a market participant in a particular commodity but also can arise due to the manner in which a contract is designed.

In certain cases, using deliverable supply alone as the single determining factor when setting a position limit for a commodity is insufficient as it is also necessary to take into account specific characteristics of that commodity, for example, logistical constraints i.e. ease with which the commodity can be delivered or extracted given contract delivery points.

Q509: Do you agree with ESMA's proposal for trading venues to provide data on the deliverable supply underlying their contracts? If you do not agree, what considerations should be given to determining the deliverable supply for a contract?

Yes, we fully agree that in the first instance the competent authority of the jurisdiction where a trading venue is located should obtain and use the data on deliverable supply that is maintained by that trading venue.

However, we consider that the competent authority should adjust the level of the deliverable supply as stated by the trading venue in order to reflect some other factors such as industry research or governmental statistics where it is difficult to get an accurate measure of the supply or for global markets. Also, for gas and power markets where system operators exist, the ENTSOs should be considered, either directly or through the intermediation of trading venues.

Further where a contract is a key benchmark and is used as a proxy hedge for other commodities e.g. ICE Gasoil contract is used to hedge jet derivatives, then the position limit regime should reflect this wider market.

This is because the exchange's view of deliverable supply will be focused on the specifics of its contract, whereas the MiFID position limit regime covers a wider universe.

We also fully support the G20 initiatives aiming to enhance the transparency in physical commodity markets (production and storage) though we highlight that on some commodities (precious metals and rare earths for instance) such a transparency does not yet exist, primarily because of the reluctance of some countries in a dominant position to publish relevant data on a regular basis.

Q510: In the light of the fact that some commodity markets are truly global, do you consider that open interest in similar or identical contracts in non-EEA jurisdictions should be taken into account? If so, how do you propose doing this, given that data from some trading venues may not be available on the same basis or in the same timeframe as that from other trading venues?

Yes, we believe that a harmonised regime globally for key economically-linked contracts both exchange traded and OTC is critically needed where the fundamentals of the underlying commodity markets are global. It would be a grave concern if a global commodity such as, for instance, gold, which is traded on different markets, to have different position limits depending on whether it falls within the CFTC regulation or the EU MiFID regime.

Coordination between relevant EU and non-EU competent authorities having access to regional or national trade repositories is essential to measure the overall size of the relevant commodity derivatives markets. In other words, open interest in similar or identical contracts in non-EU jurisdictions should be taken into account. Imposing limits that do not reflect the global nature of commodity markets would cause substantial fragmentation and would be detrimental to beneficial risk management activities.

Q511: In the absence of published or easily obtained information on volatility in derivative and physical commodity markets, in what ways should ESMA reflect this factor in its methodology? Are there any alternative measures that may be obtained by ESMA for use in the methodology?

We in general believe that volatility is not a relevant criterion for the purpose of the calculation methodology of limits and we do not clearly see at this time how ESMA proposes to incorporate volatility into position limit calculations.

Volatility is natural to markets and reflects the market adjusting to new information. If regulators believe that the effect is driven by some sort of abuse they have sufficient powers under MAR to take action. We do not believe that position limits prevent volatility. There is evidence that in some cases limits may even lead to increased volatility if they are inappropriately calibrated.

The presence of volatility in a market generally leads participants to seek risk management solutions and any restriction on participants' ability to do so through the use of position limits may prohibit participants from effectively managing their risks. Further, where limits are revised down at short notice in response to increasing volatility, this may further exacerbate volatility as participants are forced to close down positions to meet the new limits. Historically, regulated markets have used margin methodologies to manage volatility. Parties unable to maintain positions in volatile markets may have to reduce positions due to margin call, but there is no artificial constraint in their ability to participate.

We therefore request ESMA to undertake a further review of the impact of volatility before including any volatility based adjustment factor in the position limit methodology.

At the very least ESMA should clarify whether volatility in this particular context is intended to refer to price volatility or to the amount of the commodity available in the market.

We agree that the absence of accurate data on all physical markets makes it difficult to measure volatility of these markets. Given that volatility usually results from a lack of liquidity, we believe that position limits should be set high enough to take into account volatility of the physical markets and the consequences that volatility has on trading volumes e.g. fewer new market participants the higher the volatility.

Q512: Are there any other considerations related to the number and size of market participants that ESMA should consider in its methodology?

We agree with ESMA's views on the size and number of market participants and do not see any other consideration. We also support ESMA's statement on page 419, paragraph 77 of the discussion paper: "*Concentration of positions in a market will particularly be a factor in national gas and power markets, which may need to set limits to reflect the existence of 'national champions', depending on the extent of fragmentation of former state-owned incumbents and the terms of any market maker schemes operated by venues as necessary for proper market operation. This is accommodated in the use of separate factors for different asset classes, which can reflect the individual market structures*".

We also believe that where a product is traded by a small number of participants, ESMA should seek to understand the composition of market participants before determining the position limit. For example, a market with ten active participants may have two sellers and eight buyers, or just one risk management provider amongst nine participants seeking risk management services. In such markets, a single position limit may have a disproportionate impact on some of the participants.

Q513: Are there any other considerations related to the characteristics of the underlying commodity market that ESMA should consider in its methodology?

We agree with ESMA's views that the seasonal supply outages in the physical market, the perishability of deliverable materials and the capacity constraints (with regard to transportation and delivery) should be taken into account. We reiterate that the absence of accurate data on production and storage of some commodities should be reflected in the consideration related to the characteristics of the underlying commodity market.

Q514: For new contracts, what approach should ESMA take in establishing a regime that facilitates continued market evolution within the framework of Article 57?

Firstly, we recognise there will be difficulty in determining position limits for new contracts. We therefore encourage ESMA to consider mechanisms to ensure that the limits do not damage developing liquidity in the new contracts. Low liquidity is not only a characteristic of new contracts, but also of many more regional or specialised commodity products. Where very few market participants exist with respect to a contract, liquidity will naturally be limited. Any consideration and/or methodology adopted for new contracts should therefore be extended to existing illiquid contracts.

We believe that the best approach would be to take each new or illiquid contract separately and consider a reasonable multiple of the current transaction size after a defined period of trading, so approach 1.

We also think that, instead of position limits, ESMA should consider relying on the position management powers available to national regulators and trading venues. New contracts often are illiquid/ immature initially and may be used by a small number of market participants. In order to accommodate the demand of hedgers and develop a robust, established market, it may be necessary to permit a small number of market participants to represent a relatively large share of the (small) market. Concerns regarding market abuse can be adequately addressed through enhanced reporting and surveillance, as necessary.

Q515: The interpretation of the factors in the paragraphs above will be significant in applying ESMA's methodology; do you agree with ESMA's interpretation? If you do not agree with ESMA's interpretation, what aspects require amendment?

We broadly agree with ESMA's views on the various factors that should be taken into account in the calculation methodology. We however reiterate that volatility is probably not a relevant tool for this purpose.

Q516: Are there any other factors which should be included in the methodology for determining position limits? If so, state in which way (with reference to the proposed methodology explained below) they should be incorporated.

Where a liquid benchmark contract is used as a proxy or a generic hedge for a range of contracts, the position limits should be set at a level to allow this bona fide hedging activity to continue.

Q517: What do you consider to be the risks and/or the advantages of applying a different methodology for determining position limits for prompt reference contracts compared to the methodology used for the position limit on forward maturities?

We strongly believe that different methodologies should be applied for determining position limits for prompt reference contracts compared to position limits on forward maturities.

In terms of forward maturities an alternative methodology to imposing position limits is to instead require market participants to disclose their position upon coming within a certain range and then to explain the reason for having that position to the relevant NCA. This promotes greater transparency for the market and regulators while not artificially restricting liquidity in contracts that are not subject to logistical constraints associated with the delivery period (expiration).

We also note that the CFTC's proposed position limits regime differentiate spot and forward maturities as follows: Spot month limit levels are set at 25% of estimated deliverable supply (separately for physical-delivery and cash-settled Reference Contracts) determined by the exchange that lists the Core Referenced Futures Contract, unless CFTC chooses to rely on its own estimate – and may not be greater than 25% of such supply but not less than 1,000 lots for agricultural commodities and not less than 5,000 lots for energy / metal commodities. Each month (i.e. single month) and all-months-combined limits, which are set at the same level, are based on largest average annual open interest in Reference Contracts in the preceding two years (10% of open interest for first 25,000 contracts and 2.5% thereafter).

Q518: How should the position limits regime reflect the specific risks present in the run up to contract expiry?

The position limits regime could introduce "telescoping" limits to avoid market disruption. This would involve stating limits in the immediate period prior to contract expiry.

Q519: If a different methodology is set for the prompt reference contract, would it be appropriate to make an exception where a contract other than the prompt is the key benchmark used by the market?

We do not think that instances where a contract month other than prompt is primarily used as the "key benchmark contract" should cause particular problems. The key risk being addressed by limits is abusive squeezes occurring as the contract approaches expiry; spot month limits will ultimately apply to all contract maturities as they approach expiry, regardless of whether some months are more traded than others; ESMA is also anticipating applying back month limits, which would govern all contract maturities outside of the spot month, which could apply to the "key benchmark contract" when spot month limits are not currently in effect.

Q520: Do you agree that the baseline for the methodology of setting a position limit should be the deliverable supply? What concrete examples of issues do you foresee in obtaining or using the measure?

As stated in our response to question 501:
Deliverable supply is the right metric for physically settled spot month contracts. For cash settled spot-month contracts, we believe that the metric should be the open interest.

We also believe that although they are expressed as percentage of open interest, limits on cash-settled spot month contracts should be as aligned as possible with limits applied to physically-settled spot month contracts.

In relation to the use of open interests for limits on physical and cash settled non-spot month contracts, as the MiFID II regime applies to a broader range of commodity derivatives than just futures and will include economically equivalent OTC contracts, it will be necessary to adjust the open interests (given is a futures related metric) to add the notional volumes of swaps relating to the relevant on-venue contract. It is also the case that certain commodities may not have a related futures contract and competent authorities will need to estimate the open interests based on notional amounts of swaps.

We also call ESMA to provide further detail on how they intend to determine the overall market size for securities contracts with a commodity underlying.

Q521: If you consider that a more appropriate measure exists to form the baseline of the methodology, please explain the measure and why it is more appropriate. Consideration should be given to the reliability and availability of such a measure in order to provide certainty to market participants.

In determining its methodology for the setting of position limits for physically delivered contracts ESMA should consider not only the defining of deliverable supply, but equally importantly the capacity for determination of deliverable supply.

Whether a trading venue or other related body is identified as the responsible calculation party, the ability for any one body to determine deliverable supply is limited by the scope of information available. For example, for medium to long term supply calculations, industry and government sponsored organisations (such as the International Energy Agency or, for oil, the OPEC reports) may have well established processes for determining structural supply and demand data, but for shorter term calculations it would most likely be the market participants that would be the key data providers for deliverable supply calculation.

In recommending a trading venue be responsible for determination of deliverable supply it is critical to provide a framework that enables the venue to access all relevant data and participants. In considering a more suitable calculation agent ESMA must consider the same availability and transparency of data. In support of the trading venue being the calculation agent, the availability of trading data across that particular venue may enable it to direct its focus to those participants most active in the relevant product most immediately and more effectively.

It should be noted by ESMA that commodity markets can exhibit very rapid changes in supply and demand balances given the global nature of those markets (where product may move in and out of region frequently given supply/demand/pricing arbitrage, and production volumes in some commodities can change very rapidly). As a result the deliverable supply, particularly where a defined set of criteria is used to determine that supply, can change dramatically and very rapidly. Shorter term supply calculations could, and would likely, exhibit a level of volatility that can disrupt the efficient functioning of the market if this short term supply volatility is manifested in rapidly changing position limits based on deliverable supply.

Q522: Do you agree with this approach for the proposed methodology? If you do not agree, what alternative methodology do you propose, considering the full scope of the requirements of Article 57 MiFID II?

We support the expression of the limits as percentage of open interests (for cash-settled contracts and non-spot month physically-settled contracts,) or deliverable supply (for physically settled spot month contracts). We note that open interest will need to be adjusted to take into account the notional value of swaps given open interest for the relevant contract will be applied to OTC equivalents.

Q523: Do you have any views on the level at which the baseline (if relevant, for each different asset class) should be set, and the size of the adjustment numbers for each separate factor that ESMA must consider in the methodology defined by Article 57 MiFID II?

We think that position limits should be sufficiently high until the regulators are able to assess the data. Downwards adjustments may be made afterwards.

Also, we foresee significant issues with adjusting the absolute baseline figures on the basis of deliverable supply, volatility and number and size of market participants. In addition we do not understand the basis for ESMA's maximum adjustment calibration of 15% of the baseline figure nor is it clear how this will be applied i.e. if the total limit 25%=/-15% how will this be applied to the spot and other months.

Q524: Does the approach to asset classes have the right level of granularity to take into account market characteristics? Are the key characteristics the right ones to take into account? Are the conclusions by asset class appropriate?

The characteristics for each class outlined by ESMA relate to the relevant exchange contract not necessarily the OTC and physical markets and these differences will need to be recognised when applying a limit e.g. a monthly OTC metals contract to a daily LME regime. However, in general we think the granularity of the taxonomy is acceptable e.g. oil and oil products class should allow for the hedging of oil products without exchange contracts via ICE's Brent Contact.

Q525: What trading venues or jurisdictions should ESMA take into consideration in defining its position limits methodology? What particular aspects of these experiences should be included within ESMA's work?

We believe that all venues should be taken into account. We think that in addition to consulting with the relevant trading venues, ESMA should continue working closely with the CFTC on harmonising their approaches.

The key consideration in defining the EU position limits methodology is harmonisation. We also strongly believe that alignment of position limits regimes will improve results and provide a powerful data set for regulators to develop accurate and more useful tools to achieve their objectives. Inconsistencies across regimes will make systems harder to build and implement across global trading businesses.

Q526: Do you agree that the RTS should accommodate the flexibility to express position limits in the units appropriate to the individual market? Are there any other alternative measures or mechanisms by which position limits could be expressed?

Expression of limits as percentage of open interest or deliverable supply is the most appropriate way. But as long as the measure of the physical underlying market is taken into consideration, flexibility may make sense in some limited cases

See our response to question 502:

We agree that amending the position limit on a real-time basis is not only unnecessarily but unfeasible and that setting it for a fixed (excluding exceptional circumstances) period is preferable. With regard to the period itself, we propose that position limits on a contract are fixed for an initial period of two years and with annual reviews thereafter with amendments to the limits only where necessary.

We also believe that spot month limits generally should not be determined at the time a contract month becomes the spot month. Determining a position limit for the spot month contract on the first day that such contract is available for trade is impractical as it would require notice of a limit to be provided when that contract has already commenced trading (open interest calculations are usually published after trading has begun each day) and when parties may already be holding positions that are in breach of that new position limit. Requiring parties to trade out of positions to comply with the new position limits may lead to artificial volatility and a disorderly market.
For instance, the LME have daily Prompt date contracts and thus have daily settlements. The LME already impose a pseudo position limit when the contract is coming up to prompt (settlement) in that it has a rule that stipulates that if the accumulated net long positions of a particular participant or member, two days before settlement, exceeds 50% of LME warranted stock, the long position holder(s) has to reduce the positions to below 50% of LME stock at a pre-determined set premium (price). It is possible to have a forward position that adds up to more than 100% of LME warranted stock. It is then up to the position holder to manage his positions over the two day period before settlement to ensure it is holding less than 50% of LME stock. LME stock figures are published each day at 09:00 UK time. We believe this is the method enshrined in the LME Lending Guidance rules that LME has been operating since 1998 is an effective tool in ensuring orderly markets and in effect imposes a pseudo position limit on LME contracts that are physically settled on the exchange. An explanation of the Lending Guidance can be found here:
http://www.lme.com/~/media/Files/Notices/2011/2011_10/11_293_A286_R008_Explanation_of_Metal_Lending_Guidance.pdf

The implementation of a position limits regime will significantly affect the functioning of the commodity markets and for this reason an initial two year period is necessary to ensure that orderly trading conditions are maintained during the transition.

The measure of the deliverable supply for a period of time is challenging and ESMA and national regulators should rely on data gathered by exchanges and on existing database aiming to ensure transparency in physical markets. A one-size fits all approach such as the "three months expiry cycle" as proposed by ESMA may not fit the fundamentals of certain commodity markets.

We also highlight that data used for the purpose of defining the deliverable supply period per commodity type should span over a period of a minimum of three years and should have a granular view on a monthly basis. When calculating the deliverable supply period per commodity type, different factors must be included, among which, a basic taxonomy (i.e.: storable versus non-storable), weather, supply chain optimization level, demand and offer curve, geographical location-distance, seasonality, growth, and market concentration, as well as the trading cycles per each commodity market. As there would be differences across commodities and that some factors are outside of the control of either of the parties to the physically-settled contract, a +/- margin should be added to the averaged/estimated delivery supply period. This +/- margin could be set at no less than 15% of the overall delivery supply period.

Q527: How should the methodology for setting limits take account of a daily contract structure, where this exists?

We believe that ESMA should defer to the relevant markets here. However, care needs to be taken not to 'jam' OTC/physical trades into inappropriate daily limits.

Q528: Do you agree that limits for option positions should be set on the basis of delta equivalent values? What processes should be put in place to avoid manipulation of the process?

Yes. During the lifetime of the option, in order to minimise risk, the hedge for the option will replicate the change in delta (as opposed to the absolute value of the option). Therefore, in setting limits for options position limits should track the option delta. Regarding anti-manipulation, calculation methodology can be subject to retrospective audit from the relevant national regulator, upon request. Also, in the event options are used to hedge futures it is critical that option deltas are able to be netted with futures positions delta in order to accurately reflect commodity risk levels.

Q529: Do you agree that the preferred methodology for the calculation of delta-equivalent futures positions is the use of the delta value that is published by trading venues? If you do not, please explain what methodology you prefer, and the reasons in favour of it?

As market participants will have different internal calculation methodology for calculating delta futures equivalent values, to ensure consistency with internal risk systems they should be allowed the flexibility to use their own calculations rather than those delta value published by trading venues (subject to being able to justify the calculation).

Q530: Do you agree that the description of the approach outlined above, combined with the publication of limits under Article 57(9), would fulfil the requirement to be transparent and non-discriminatory?

Yes, we fully agree with this approach.

Q531: What challenges are posed by transition and what areas of guidance should be provided on implementation? What transitional arrangements would be considered to be appropriate?

Unfortunately, the level 1 MiFID II text does not allow a phased-in approach. However, at a minimum, the grandfathering of existing positions at the time of implementation of the new regime, along with setting of "high limits" which can be calibrated over time, is required in order to avoid market disruption and mismatched hedging.

7.3. Position Reporting

Q532: Do you agree that, in the interest of efficient reporting, the data requirements for position reporting required by Article 58 should contain elements to enable competent authorities and ESMA to monitor effectively position limits? If you do not agree, what alternative approach do you propose for the collection of information in order to efficiently and with the minimum of duplication meet the requirements of Article 57?

We agree with ESMA's approach on the purpose of the position reporting requirements.

We particularly support the expressed will to standardise the data definitions and the format of the reporting information required by MiFID with other existing legislative texts to the greatest extent possible in order to reduce the quantity of duplicative reporting. In our view, wherever possible, we also think that ESMA should establish reporting requirements and data standards that are equivalent to, or at least compatible with, analogous requirements imposed (or proposed) by other jurisdictions. For instance, we believe that an appropriate comparison for regulators would be CFTC form 102 and 204, and the data required to be reported pursuant to Parts 15 through 20 of the CFTC's rules. In case the US and EU standards were not compatible, this would result in significant additional costs on the industry, and increase the risk of market disruption and fragmentation.

Lastly, we agree that the data fields included within position reports should include an indicator of whether a position is risk reducing for commercial purpose or not (and therefore eligible to the hedging exemption to position limits). However, we call for clarifications on the following points: a) do the requirements for members of trading venues to provide their clients' positions in on-venue contracts pertains only to that which the member holds on behalf of their client (rather than their counterparty's positions under principal transactions)?; b) if a market participant has to report positions all the way down to the "end client", how can this market participant establish whether or not the end client's position is a hedging position? c) Would the market participant be liable if the end client misinformed it (which would not be acceptable)?

Q533: Do you agree with ESMA's definition of a "position" for the purpose of Article 58? Do you agree that the same definition of position should be used for the purpose of Article 57? If you do not agree with either proposition, please provide details of a viable alternative definition.

Yes, we agree that the definition of 'position' under article 58 should be aligned with the definition under article 57 since the position reporting requirements aim to support the position limit regime. The position reporting requirements should therefore apply to contracts traded on a trading venue and economically equivalent OTC contracts. We also agree that the definition of position, alternatively called 'open interest', should embrace the net accumulation of buy and sell transactions in a particular commodity derivative, emission allowance or derivative on an emission allowance at a specific point in time.

Q534: Do you agree with ESMA's approach to the reporting of spread and other strategy trades? If you do not agree, what approach can be practically implemented for the definition and reporting of these trades?

Article 58 only requires that positions that are risk reducing transactions (i.e. netting applies to the calculation of the overall position of the market participant for the calculation of the limits but not to reporting) should be reported gross.

Any additional reporting is duplicative and unnecessary given that Investment Firms will already be reporting transactions. Looking at a gross position does not provide any regulatory useful information nor is it the way that exchanges current receive position reports. Those positions that are not used for the purposes of 'risk reducing' should be reported net.

Any requirement to report spread and other complex trades on a disaggregated basis should be consistent with the reporting requirements imposed by other jurisdictions. For example, in certain circumstances, market participants should be permitted to report positions based on a diversified commodity index on a consolidated basis (e.g. where the index is commonly known and the weightings of individual components are publically available).

Q535: Do you agree with ESMA's proposed approach to use reporting protocols used by other market and regulatory initiatives, in particular, those being considered for transaction reporting under MiFID II?

Yes, we agree with ESMA's approach to use reporting protocols used for other transactions reporting under MiFID II but not as stated above; position reporting should be on a net position basis.

Q536: Do you have any specific comments on the proposed identification of legal persons and/or natural persons? Do you consider there are any practical challenges to ESMA's proposals? If yes, please explain them and propose solutions to resolve them.

ESMA's proposal to use LEI, BIC, National code waterfall logic will mean existing EMIR reporting methodology can be leveraged minimising new builds and facilitating implementation.

Q537: What are your views on these three alternative approaches for reporting the positions of an end client where there are multiple parties involved in the transaction chain? Do you have a preferred solution from the three alternatives that are described?

We have two major concerns regarding the reporting of the positions of an end-client:

- The protection of client confidentiality, i.e. the end-client's identity is not disclosed to the intermediaries involved in the transaction chain;
- The simplicity and cost-neutrality of the reporting system, i.e. the approach should not involve complex data fields setting that would imply onerous implementation for market participants.

With these two concerns in mind, we feel that none of the three approaches are entirely satisfactory.

As we suggest in our response to Q538, one possible solution would be to adopt the CFTC approach where an investment firm will identify its client, and the relevant competent authority will require that client (or its underlying client) to provide the relevant report. This would allow competent authorities to receive the information they require without the intermediation of the investment firm, although there may be cases in which the client or its underlying client is unable to provide the necessary information.

However, regardless of the way in which ESMA seeks to obtain information on clients and their underlying clients, investment firms should not be prohibited from dealing with clients who are unable to provide the required information (either in relation to themselves or in relation to their underlying clients), as this is likely to result in significant barriers to market access for end clients.

Q538: What alternative structures or solutions are possible to meet the obligations under Article 58 to identify the positions of end clients? What are the advantages or disadvantages of these structures?

One possible solution would be to adopt the CFTC approach where an investment firm will identify its client, and the relevant competent authority will require that client (or its underlying client) to provide the relevant report. This would allow competent authorities to receive the information they require without the intermediation of the investment firm, although there may be cases in which the client or its underlying client is unable to provide the necessary information.

However, regardless of the way in which ESMA seeks to obtain information on clients and their underlying clients, investment firms should not be prohibited from dealing with clients who are unable to provide the required information (either in relation to themselves or in relation to their underlying clients), as this is likely to result in significant barriers to market access for end clients.

Q539: Do you agree with ESMA's proposal that only volumes traded on-exchange should be used to determine the central competent authority to which reports are made? If you do not agree, what alternative structure may be used to determine the destination of position reports?

We agree with ESMA's proposal that the determination of the central competent authority to which position reports are made should be decided solely by the volume of activity undertaken on exchanges but note that it does not take into account that the level of activity is likely to change from time to time, meaning that the relevant competent authority will also change. Firms may want some assurances that they will not be sanctioned for reporting to the wrong competent authority if there is a change.

ESMA may consider publishing a list of the relevant competent authorities, which firms could rely on for a period of time (e.g. one or two years) and which would be updated by ESMA. ESMA will also need to consider situations where a significant portion of the market is off exchange, i.e. OTC swap market.

Q540: Do you agree that position reporting requirements should seek to use reporting formats from other market or regulatory initiatives? If not mentioned above, what formats and initiatives should ESMA consider?

Yes, we agree that position reporting should seek to use reporting formats for other regulations and in particular those that are in place or being considered for EMIR trade reporting or for transaction reporting under MiFID.

We further recommend that any reporting requirements and data standards that are adopted be compatible with analogous requirements imposed by other jurisdictions. Differing data standards will require market participants to develop duplicative systems. This would be costly and inefficient. Moreover, inconsistent data standards increase the risk that regulators will receive and make policy decisions based on inconsistent market information. We therefore call, amongst other things, for consideration of the formats used for position reporting in other jurisdictions in order to facilitate both implementation and accuracy of reporting.

Q541: Do you agree that ESMA should require reference data from trading venues and investment firms on commodity derivatives, emission allowances, and derivatives thereof in order to increase the efficiency of trade reporting?

Yes, we agree that to support the position reporting of investment firms, trading venues should be required to provide reference data on on-venue and economically equivalent OTC contracts. We recognise the product identification under EMIR may not be granular enough in the specific context of position reporting of commodity derivatives for the purpose of position limits under MiFID II. We also recognise that product identification under EMIR does not incorporate the concept of linking position in on-venue contracts with 'economically equivalent OTC contracts'.

Q542: What is your view on the use of existing elements of the market infrastructure for position reporting of both on-venue and economically equivalent OTC contracts? If you have any comments on how firms and trading venues may efficiently create a reporting infrastructure, please give details in your explanation.

We believe that CCPs are best placed to report position data on OTC cleared trades, however currently some data fields such as the client identifier will be missing. Trading venues should be able to report positions either to NCAs or Trade Repositories for on-exchange contracts.

Q543: For what reasons may it be appropriate to require the reporting of option positions on a delta-equivalent basis? If an additional requirement to report delta-equivalent positions is established, how should the relevant delta value be determined?

Reporting of delta equivalent positions is established, and then consistent with question 529, the conversion to delta would need to be based on market participants' models and not be restricted by pre-defined numbers published by trading venues.

We do not think that the preferred methodology for calculation of delta-equivalent futures position should require use of the delta value published by trading venues. Instead we think participants should be able to use their own internal models / delta calculations to ensure consistency with internal records and risk systems (subject to being able to justify the calculation).

Q544: Does the proposed set of data fields capture all necessary information to meet the requirements of Article 58(1)(b) MiFID II? If not, do you have any proposals for amendments, deletions or additional data fields to add the list above?

Gap analysis should be conducted against existing reporting formats applicable to market participants. In particular, we recommend consideration of EMIR reporting formats and the CFTC's position reports, and new ownership and control reporting rules. This will ensure consistency and therefore reduction in differences in further formats.

Q545: Are there any other fields that should be included in the Commitment of Traders Report published each week by trading venues other than those shown above?

While recognising the need for the reporting fields to be specifically applicable to, and take account of, the idiosyncrasies of the European market framework and regulatory regime, both market participants and market infrastructures strongly support alignment with CFTC standards (including Commitment of Trader reports) wherever possible so as to promote consistency of reporting for all market participants with operations outside the EU (and, in particular, those active in the US).