**5 July 2019**

**Response to the ESMA Call for Evidence on Position Limits under MiFID II**

https://www.esma.europa.eu/press-news/esma-news/esma-launches-call-evidence-position-limits-in-commodity-derivatives

| *#* | *ESMA Question* | *Response* |
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| | Introductory comments | FIA, ISDA and GFMA very much appreciate ESMA's engagement with the industry at this early stage of the MiFID II / MiFIR review process.<br><br>The MiFID II commodity derivatives position limits regime is an entirely new regime in the EU and has no equivalent in other jurisdictions. For this reason, it was a long and difficult implementation exercise and it is still early to see whether the application of limits have effectively met the objectives behind the legislation.<br><br>FIA and ISDA members therefore consider that ESMA and policy makers, in their review, should concentrate on a few features rather than a comprehensive re-writing of the regime.<br><br>Market participants have identified three main areas of focus:<br><br>- the ***application of limits to new and illiquid contracts***, where exchanges, dealers and end-users have raised concerns that the existing limits, even with the flexibility granted under ESMA RTS 21, are a hurdle to the development of markets for new contracts. This response includes specific examples to support the view that the regime applied to new and illiquid contracts should be amended;<br><br>- the ***scope of contracts covered by limits***. The definition of financial instruments – and of commodity derivatives – has led to extensive discussions as to whether some securities or some derivatives with no underlying physical commodity should be subject to position limits just because |

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| | | the cross references between MiFID and MiFIR suggest that they are 'commodity derivatives'. Market participants support the objectives of the legislation and particularly the prevention of excessive speculation on underlying commodities such as food commodities. However, they would welcome the idea raised by ESMA of limiting the regime to a *'set of important, critical derivatives contracts';*<br><br>- *the* ***scope of the hedging exemption****.* Whilst the position limits regime includes exemptions for market participants pursuing hedging activity, the MiFID II definition of *hedging* as set out in RTS 21 is clear that only non-financial entities can engage in such activity, thereby rendering the exemption unavailable to investment banks or commodity trading houses that are MiFID II authorised, which both play a vital role in providing smaller commercial players with access to commodity derivatives markets. |
| 1 | In your view, what impact, if any, did the introduction of position limits have on the availability and liquidity of commodity derivative markets? What are in your views the main factors driving this development, e.g. the mere existence of a position limit and position reporting regime, some specific characteristics of the position limit regime or the level at which position limits are set? Please elaborate by differentiating per commodity asset class or contract where relevant and provide evidence to support your assessment. | FIA, ISDA and GFMA members believe that the MiFID II position limits regime has so far been able to function for a number of well-developed benchmark contracts.<br><br>These highly developed markets are characterised by a large number of different types of active trading firms and an overall substantial amount of open interest.<br><br>However, for the development of new products and further growth of the existing illiquid commodity derivative markets, the position limits regime has proven to be a barrier. Fast growing markets in particular have suffered from (1) an increasingly restrictive limit as open interest increases and (2) inflexible treatment in terms of their categorization under the position limits framework.<br><br>ISDA, FIA and GFMA members have also noted (3) inaccurate reflection of the underlying physical markets**.**<br><br>**(1) Increasingly restrictive standardized limit**<br><br>Contracts classed as 'illiquid' under the position limits framework receive a standardized limit of 2,500 lots and thereby effectively get a highly restrictive limit (resembling a baseline limit of 25 percent of open interest) when open interest increases close to 10,000 lots. In consequence, market participants are forced |

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| | | to decrease their positions and the open interest returns to a lower level thereby sealing the illiquid status of the product.<br><br>And whilst in theory, in line with the ESMA Q&A on 'commodity derivatives', National Competent Authorities ("NCAs") can use different derogations for illiquid markets which have an open interest between 5,000 and 10,000 lots, these remain difficult to apply in practice and are often not sufficient to mitigate the negative impact of disproportionately low position limits.<br><br>Any increase of the limit under the available derogation will need to be substantial in order to provide sufficient relief to market participants close to the limits and prevent restricting trading activity in fast growing markets. An increase of a given position limit by for example 500 lots will only have a very limited impact, effectively allowing market participants close to the limit to trade additional lots equivalent to four Calendar or eight Season contracts.<br><br>Once the limit is reached participants withdraw from the market, often switching to another trading venue outside of the MiFID II regime, thereby leaving the regulator no time to adjust the limit upwards. Furthermore, in relation to newly launched contracts, it is not unusual that only one participant sits on the buy or sell side of the market. In such cases, even a fifty percent limit is not sufficient to allow the market to mature.<br><br>**(2) Inflexible categorization of markets and recalibration of position limits**<br><br>In order to provide for a workable regime for growth markets, NCAs need to be able to process near instant updates to the categorisation of markets and readjust the applicable limits as open interest in a market increases. This is especially true for markets that experience strong increases in open interest in a short period of time. Markets with initially relatively low levels of open interest can develop into liquid markets in a matter of weeks or months. In order for a limit not to impede the development of fast-growing markets: |

| | | • the growth of open interest requires a timely reclassification of a market under the position limits regime (for example from 'illiquid' to 'less liquid') in order to allow the position limit to be adjusted to a workable level, before it becomes unnecessarily restrictive.<br>• the calculation of open interest in a market for the purpose of setting a position limit needs to adequately capture the period of growth of open interest. It is therefore essential that an appropriate methodology for calculating open interest is used. The usage of a randomly selected period with an inappropriate duration could furthermore result in relatively frequent requests to amend the established limits, as the newly set limit could be reached with only a limited amount of transactions in a fast-growing market.<br><br>In practice, it has proven to be very challenging for NCAs to reclassify markets and recalibrate the applicable limits in a manner that would prevent a negative impact on the development of fast-growing markets. ***Figure 1*** illustrates this negative impact on one of ICE's previously fast-growing markets when subjected to the MiFID II position limits regime. The material growth in open interest (area marked in yellow) started in the last month of Q4 2017, but this momentum has been severely impaired at the end of 2017 and in the first period of 2018 in anticipation of the introduction of the MiFID II position limits regime. Before any reclassification of this market and subsequent recalibration of the limit could occur, the damage to the development of this market has proven to be irrevocable. This negative effect on the development of commodity derivative markets described above is stereotypical for fast growing markets subjected to the MiFID II position limits regime. |
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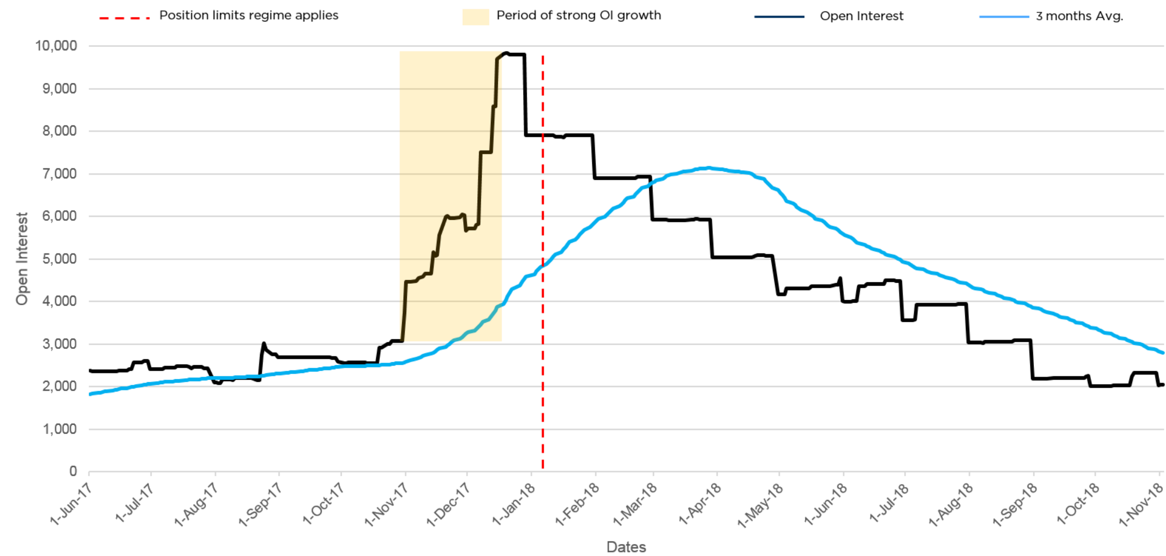


Figure 1. Impact of position limits regime on development of ICE Endex Italian PSV Gas Futures market.

**(3) Inaccurate reflection of the underlying physical markets**

Moreover, for some commodity derivatives, the characteristic of the underlying physical market is such that an effective hedge can only be achieved by trading a specific number of lots. Such a number cannot be traded without exceeding the limit. Yet, under the current MiFID II provisions, the limit cannot be raised without sufficient increase of the open interest.

For example, the recently launched *ICE Futures Europe TD20 West Africa to UK-Continent (Baltic) Future* has grown significantly over the past few months, reaching over six thousand lots of open interest. The contract is a Suezmax crude route, West Africa to UK Continent for tankers sized on average 130,000 MT

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| | | (DWT). The biggest positions exceeding 1.9k lots are held by MiFID II authorised investment firms or commodity traders not eligible for the hedging exemption. Further, their counterparties that are providing risk management services, are often financial institutions or investment firms that are not eligible for a hedging exemption under MiFID II.<br><br>Companies with Suezmax types of tanker fleets tend to hedge calendar years forward, fleet sizes up to 20 tankers and above.<br><br>To hedge a fleet of ten tankers on a year forward basis - the trade size will be (either as a single trade or done in a sequence of multiple smaller trades for the same calendar year tenor, keeping positions open throughout expiry):<br><br>**130 lots * 12months * 10 tankers = 15,600 lots** to hedge freight rates exposure for a single calendar year (i.e Cal 2019 trade)<br><br>The current position limits regime is not sufficiently flexible to adapt to fundamental regulatory or market changes. One example is the International Maritime Organization's regulation going live in 2020, which has been a significant factor behind longer-dated hedges as companies are seeking certainty and stability of "locked in" freight levels that are expected to become volatile as the new sulphur caps for bunker fuel will start affecting the cost of shipping from January 2020. With fast growing trading volumes in wet freight, companies are extending hedges down the curve, trading to cover Cal19 / Cal20 and even Cal21 tenors that we are now seeing in a VLCC TD3C route (Arab Gulf to China crude route).<br><br>Since the traders active in TD20 have indicated the business need to hedge multiple calendar years forward in TD20 routes, that would result in tripling trading volumes in the traded volume calculation scenario above, with potential volumes amounting to 46,800 lots.<br><br>However, the growth of the contract is restricted by the current *de minimis* position limit. Further development of this contract requires dynamic changes of the current limit from a fixed 2,500 lots level to a much higher limit based on the open interest. |

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| 2 | Have you identified other structural changes in commodity derivative markets or in the underlying markets since the introduction of the MiFID II position limit regime, such as changes in market participants? If so, please provide examples, and where available data, and differentiate per commodity derivative asset class where relevant. | FIA, ISDA and GFMA members have observed an increased difficulty for financial counterparties such as investment banks or MiFID II authorised commodity trading houses to efficiently serve their clients in commodity markets (for example, cocoa producers or oil refineries). This has been caused by inability of those financial counterparties to hedge risk through more structurally complex transactions than simply trading on a client's account.<br><br>Indeed, the position limits regime includes exemptions for market participants pursuing hedging activity. However, the MiFID II definition of hedging as set out in article 57.1 of MiFID and RTS 21 prescribes that only non-financial entities can engage in such activity, thereby rendering the exemption unavailable to investment banks or MiFID II authorised commodity trading houses which both play a vital role in providing smaller commercial players and non-financial entities with access to commodity derivatives markets. Therefore, the hedging exemption cannot be considered a universal solution to disproportionate position limits. We also note that the position limits regime in the U.S. to which ESMA refers in its call for evidence, contains a bona fide hedging exemption without restricting such exemption to non-financial entities.<br><br>An example of such situation is the so-called Refining Margin Hedge often used in oil markets, whereby an investment bank agrees with its client, a refiner, on a single price of a basket comprising various refined products. Once the refiner agrees the single price for the basket, the bank executes the offsetting trades in the futures market on its own account. |

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1. Banks' Client-Facing Trade (either directly/bilaterally or on an ICE Cleared basis)
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Even though within the context of such transaction the bank clearly performs a hedging activity, it would not be able to make use of the exemption envisaged under article 8 of MiFIR or article 57 of MiFID II. These challenges for investment firms can be reduced by allowing more flexibility for new and illiquid contracts, although challenges may remain for certain liquid contracts.
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<td>Do you consider that position limits contribute to the prevention of market abuse in commodity derivatives</td>
<td>Although article 57.1 (a) of MiFID II specifies that one of the objectives of the position limits regime is to prevent market abuse, because of its very nature, it can only prevent certain types of market abuse, such</td>
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| | markets? Please elaborate by differentiating per conduct, per commodity asset classes or contract where relevant and provide evidence to support your assessment when available. | as abusing a dominant position by cornering the market. The main regulatory tool to prevent and address all types of market abuse is the Market Abuse Regulation.<br><br>Trading venues have considerable experience in operating a position management system. Long before the application of MiFID II, they had developed a comprehensive, risk-based regime based on position, delivery and expiry limits with regards to commodity derivatives traded on their markets. These regimes are calibrated to prevent market abuse and ensure orderly delivery while allowing new products to be developed. Since January 2018, they have been operated by trading venues in parallel with position limits set by the relevant National Competent Authorities ("NCAs") under MiFID II.<br><br>In the opinion of FIA, ISDA and GFMA members, a properly calibrated position management regime can play an important role in preventing market abuse. However, the Associations do not consider the MiFID II position limits regime to have contributed to preventing market abuse in trading commodity derivatives on trading platforms. Rather, this has been achieved by the pre-existing position management regimes managed by trading venues as well as their market supervision and surveillance systems. |
| 4 | In your view, what impact do position limits have on the orderly pricing and orderly settlement of commodity derivative contracts? Please elaborate by differentiating per asset class or per contract where relevant and provide evidence to support your answer when available. | A properly calibrated position management regime can play an important role in ensuring orderly pricing and settlement of commodity derivate contracts. At the time of this call for evidence, MiFID II and the position limit rules have applied for 18 months only, which may not be sufficient to comprehensively assess the impact of the position limits regime on orderly pricing and orderly settlement, but at this stage, ISDA, FIA and GFMA members have not seen any major impact on pricing and settlement of the MiFID II position limits regime. Rather, these objectives had already been achieved by the pre-existing position management regimes managed by trading venues as well as their market oversight systems (including compliance, supervision and surveillance). |
| 5 | More generally, and beyond the specific items identified above, what would be your overall assessment of the impact of position limits on EU commodity derivatives markets since the application of MiFID II? | The MiFID II position limits regime has so far been able to function for a number of well-developed benchmark contracts. These highly developed markets are characterised by a large number of different types of active trading firms and an overall substantial amount of open interest. However, for the development of new products and further growth of the existing illiquid commodity derivative markets, the position limits regime has proven to be a barrier. Fast growing markets in particular have suffered from (1) an increasingly restrictive limit as open interest increases and (2) inflexible treatment in terms of their |

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| | | categorization under the position limits framework, and (3) inaccurate reflection of the underlying physical markets.<br><br>Please see the response to Q1, 13, 16 and 18 for further details. |
| 6 | Do you consider that position management controls have an impact on the liquidity of commodity derivatives markets? If so, please elaborate, differentiating per commodity derivative trading venues or contract where appropriate. | No comment. |
| 7 | Do you consider that position management controls adopted by commodity derivative trading venues have a role on the prevention of market abuse? If so, please elaborate, differentiating per commodity derivative trading venues or contract where appropriate. | No comment. |
| 8 | Do you consider that position management controls adopted by commodity derivative trading venues have a role on orderly pricing and settlement conditions? If so, please elaborate, differentiating per commodity derivative trading venues or contract where appropriate. | No comment. |
| 9 | If you are a commodity derivative trading venue, please explain how you | No comment. |

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| | have been exercising your position management controls since MiFID II application. In particular, how frequently did you ask further information on the size or purpose of a position, on beneficial owners or assets and liabilities in the underlying commodity under Article 57(1)(b) of MiFID II, require a person to terminate or reduce a position under Article 57(1)(c) of MiFID II, require a person to provide liquidity back into the market under Article 57(1)(d) of MiFID II or exercise any of your additional position management controls? | |
| 10 | Do you have any general comment on the position limit regime and associated position reporting introduced by MiFID II? | See Introductory comments |
| 11 | In your view, how will EU commodity derivatives markets be impacted by the UK leaving the EU? What consequences do you expect from Brexit on the commodity derivatives regime under MiFID II? | ISDA, FIA and GFMA members highlight that as far as the conditions under which the UK is leaving the EU are not certain, the impact on the position limits regime is difficult to assess. It is notably difficult to foresee whether some European contracts may become illiquid because the metrics used on an EU basis including UK figures would drop significantly.<br><br>However, market participants are concerned about a lack of equivalence for UK/EU trading venues under MiFID/MiFIR and EMIR. In the event of a no-deal Brexit, this could lead to a decrease in liquidity on UK trading venues as some firms may need to reduce their trading activities to remain below the clearing threshold. FIA, ISDA and GFMA have in the past advocated for trading venue equivalence and would like to |

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| | | reiterate the need for this. We refer to a letter co-signed by FIA, ISDA and AFME (GFMA's affiliate association) regarding the consequences of no-equivalence for trading venues[1].<br><br>ISDA, FIA and GFMA members note that there will be no regulatory arbitrage as the MiFID II position limits regime is fully implemented in the UK through national legislation. On the other hand, the MiFID II commodity regime was drafted based on the liquid UK commodity markets and ESMA may wish to consider if this regime is still fit for purpose for the EU if the UK leaves the EU market and with it many of the liquid commodity contracts (especially oil and metal contracts). Market participants are questioning whether the position limits regime may be too burdensome for less liquid EU markets and whether it should be reduced in scope to apply only to benchmark contracts as proposed by ESMA in Question 13. |
| 12 | Taking into consideration the intended purposes of position limits, do you consider that they deliver the same benefit across all commodity asset classes and across all types of commodity derivatives? Please explain. | The scope of the position limits regime has always been a challenge for the industry, because of the definition of "commodity derivatives" in Art. 4.1 (50) of MiFID II and 2.1 (30) MiFIR. The definition does not only refer to the instruments in annex 1 section C5, C6, C7 and C10 of MiFID II, but also to article 4.1 (44) and thus includes a wide range of transferable securities. As a result, many contracts that have no underlying commodity were potentially subject to position limits (e.g. inflation derivatives). ESMA published a series of helpful Q&As to clarify the conditions for the application of the position limits regime to certain contracts.<br><br>However, the level 1 and level 2 texts should clarify that the position limits regime only applies to contracts that have a commodity as an underlying. This would support the objective of the position limits regime to ensure the convergence between prices of derivatives in the delivery month and spot prices for the underlying commodity. |
| 13 | Would you see benefits in limiting the application of position limits to a more limited set of commodity derivatives? If so, to which ones and on which criteria? | The position limits regime under MiFID II is all encompassing and unprecedented in any other area in the world. ISDA, GFMA and FIA members noted that several EU contracts were moved outside of the EU after the application date of the position limits regime, although none of the historically major contracts. |

[1] https://fia.org/articles/fia-co-signs-letter-equivalence-trading-venues-under-emir-uk-and-mifir-uk%E2%80%99

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| | | ESMA refers to the recent US CFTC proposed position limits regime that would apply to only 9 agricultural contracts and that ESMA "*is of the view that there could be merits in limiting the application of MiFID II position limits to a more* [than under current EU framework] *limited set of important, critical derivatives contracts*".<br><br>ISDA, FIA and GFMA members have always supported the objectives behind the position limits regime and particularly the prevention of disorderly markets that may affect the spot prices of underlying commodities to the detriment of end-users and consumers, especially when it comes to food commodities.<br>ISDA, FIA and GFMA members nevertheless note that the scope, as designed under MiFID II, is not always appropriate (see our response to Questions 1 and 12).<br><br>ISDA, FIA and GFMA continue to support the objectives of the legislation and together with our members are available to assist with designing a regime that effectively prevents excessive speculation on underlying commodities, particularly food commodities, whilst allowing market growth and for the EU to remain competitive in a global commodities market.<br><br>The idea of limiting the regime to a *'set of important, critical derivatives contracts'* should indeed be seriously considered and ISDA, FIA and GFMA members would urge ESMA and regulators to consult the industry on the criteria that would be used for the classification of such '*important, critical derivatives contracts*', nature of the underlying commodity, size of the markets and importance for the supply of the underlying commodity across the EU, and the existence of non-EU markets for the same commodity may be important criteria in this respect.<br><br>ISDA, FIA and GFMA members consider that such a refocusing of the regime may be achieved by granting the NCAs greater flexibility in setting the limits, including not setting limits at all on less important, new, illiquid and non-critical derivative contracts, rather than by modifying article 57 of MiFID II. |
| 14 | More specifically, are you facing any issue with the application of position | We refer to our response to Question 12. |

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| | limits to securitised derivatives? If so, please elaborate. | |
| 15 | Do you consider that there would be merits in reviewing the definition of EEOTC contracts? If so, please explain the changes you would suggest. | ISDA, FIA and GFMA members support the current definition of EEOTC and see no merit in reconsidering it. Current systems and monitoring processes are based on the current definition and redefining the scope of EEOTC contracts will require further implementation and system changes without providing a recognisable benefit. |
| 16 | In your view, would there be a need to review the MiFID II position limit exemptions? If so, please elaborate and explain which changes would be desirable. | 1) No quantitative limit for NFCs<br><br>Non-financial firms (NFCs) can apply for a hedging exemption from position limits for defined commodity contracts traded on trading venues. We believe that firms should be granted a hedging exemption without the imposition of a quantitative limit to this exemption, in other words, all hedging activity in a contract for which an exemption has been granted by an NCA should be exempt. However, some NCAs impose quantitative limits to the hedging exemption, which causes unnecessary implementation burden, because NFCs must then apply for a new exemption every time they breach the set limit if they have a larger hedging need, for example because of their increased power production. This quantitative limitation is not necessary as NCAs can monitor the use of the hedge exemption on the basis of the data they receive under the position reporting regime. FIA, ISDA and GFMA thus urge ESMA to harmonise the application of the hedging exemption across all NCAs.<br><br>2) Further considerations: hedging exemption for investment firms<br><br>Whilst the position limits regime includes exemptions for market participants pursuing hedging activity, the MiFID II definition of *hedging* as set out in RTS 21 is clear that only non-financial entities can engage in such activity. As a result, the exemption is unavailable to investment firms (investment banks, commodity trading houses, including financial entities belonging to an industrial group and acting on behalf of non-financial entities of that group), which play a vital role in providing smaller commercial players with access to commodity derivatives markets. |

For that reason, the hedging exemption cannot be considered a universal solution for disproportionate position limits.

An example of such situation is the so-called *Refining Margin Hedge* often used in oil markets, whereby an investment bank agrees with its client, a refiner, on a single price of a basket comprising various refined products. Once the refiner agrees the single price for the basket, the bank executes the offsetting trades in the futures market on its own account.

1. **Banks' Client-Facing Trade (either directly/bilaterally or on an ICE Cleared basis)**

| ICE Contract Code | ICE Contract Name | No of Lots |
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| **I** | Brent 1st Line | 1000 |
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| **BAR** | Fuel Oil 3.5% FOB Rotterdam Barges Future | 31 |
| **ULA** | Low Sulphur Gasoil 1st Line Future | 540 |
| **JCN** | Jet CIF NWE Cargoes (Platts) Future | 13 |
| **AEO** | Argus Eurobob Oxy FOB Rotterdam Barges Future | 24 |
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2. **Bank's Offsetting Hedge in the Market for taking on the Refining Margin trade from the client:**

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| **B** | Brent Future | 1000 |
| **DBF** | Dated Brent vs Brent 1st Line Future | 1000 |
| **UCF** | Urals Med vs Dated Brent CFD Future | 1000 |
| **BOB** | Fuel Oil 3.5% FOB Rotterdam Barges vs Brent 1st Line Future | 31 |
| **G** | LS Gasoil Future | 670 |
| **ULJ** | Jet CIF NWE Cargoes (Platts) vs LS Gasoil 1st line Future | 13 |
| **EOB** | Argus Eurobob Oxy FOB Rotterdam Barges vs Brent 1st Line Future | 24 |
| **NOB** | Naphtha CIF NWE Cargoes vs Brent 1st Line Future | 11 |

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| | | Even though within the context of such transaction the bank clearly performs a hedging activity, it would not be able to make use of the exemption envisaged under article 8 of MiFIR or article 57 of MiFID II.<br><br>For example, ICE has extensive experience with operating a position management system based on hedging exemptions. Under its regime, it can grant such exemptions to any market participant, regardless of their legal status, provided that the hedging intention is adequately documented and demonstrated. This ensures that the genuine hedging activity is not restricted and allows commodity market participants to manage their risks efficiently.<br><br>ISDA, FIA and GFMA members propose that an analogous regime relying on genuine hedging intention is introduced within the context of MiFID II/MiFIR package. Currently, some hedging transactions are attributed to banks' net commodity position limits despite such transactions actually providing vital commodity derivative market access for smaller commercial participants and contributing to the orderly pricing and settlement conditions of commodity derivative markets in general. |
| 17 | Would you see merits in the approach described above and the additional flexibility provided to CAs for setting the spot month limit in cash settled contracts? Please explain. | We do not see the need for changes in the existing methodologies. Regulators are already given sufficient flexibility to set spot month limits as a percentage of deliverable supply, using the higher or lower percentage on the basis of a number of intervening factors.<br><br>We note that for power and gas, the significant difference between deliverable supply and open interest can be explained by the fact that trading is still happening predominantly bilaterally and is taking place on different exchanges. It is therefore normal that the open interest of exchange traded derivatives is relatively low compared to the underlying market. It is therefore also justified to adjust the position limit upwards from the baseline limit, if deliverable supply is significantly higher than the open interest, as facilitated by article 18 paragraph 3 of the Delegated Regulation (EU) 2017/591. Deliverable supply is the right parameter for both spot and other month contracts. The reason for this is that deliverable supply reflects the underlying market that can be squeezed, while open interest only reflects the share of a member's position in a given contract at a given exchange. |

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| | | However, FIA, ISDA and GFMA members agree that NCAs should have discretion to set limits based on open interest for both spot and other months for commodity derivative contracts in certain pre-defined cases. Such a solution would prevent negative unintended consequences of the position limits regime for certain commodity derivative contracts which serve as pricing benchmarks and risk-management proxies in the absence of direct hedging instruments. An example of such contract is the ICE Brent Crude Oil Futures which allows market participants to hedge exposures in other oil grades in a very liquid and thus efficient market. Another example can be the ICE Endex TTF Natural Gas Futures contract which is a proxy for managing risks related to trades in LNG market. The importance of the latter has grown substantially in recent months as Europe plays the role of balancing market. Overly restrictive position limits in TTF Futures limit its ability to become a truly global benchmark for natural gas.<br><br>However, we emphasise that setting limits for both spot and other months based on open interest should be **at the discretion of NCAs and by no means a rule in setting position limits**. It should be conditioned upon specific characteristics and functions of a commodity derivative contract in question. |
| 18 | Would you see benefits to review the approach for setting position limits for new and illiquid contracts? If so, what would you suggest? | For the development of new products and further growth of the existing illiquid commodity derivative markets, the position limits regime has proven to be a barrier. Fast growing markets in particular have suffered from (1) an increasingly restrictive limit as open interest increases and (2) inflexible treatment in terms of their categorization under the position limits framework.<br><br>ISDA, FIA and GFMA members have also noted (3) inaccurate reflection of the underlying physical markets**.**<br><br>**(1) Increasingly restrictive standardized limit**<br>Contracts classed as 'illiquid' under the position limits framework receive a standardized limit of 2,500 lots and thereby effectively get a highly restrictive limit (resembling a baseline limit of 25 percent of open interest) when open interest increases close to 10,000 lots. In consequence, market participants are forced to decrease their positions and the open interest returns to a lower level thereby sealing the illiquid status of the product.<br><br>And whilst in theory, in line with the ESMA Q&A on 'commodity derivatives', National Competent Authorities ("NCAs") can use different derogations for illiquid markets which have an open interest |

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between 5,000 and 10,000 lots, these remain difficult to apply in practice and are often not sufficient to mitigate the negative impact of disproportionately low position limits.
Any increase of the limit under the available derogation will need to be substantial in order to provide sufficient relief to market participants close to the limits and prevent restricting trading activity in fast growing markets. An increase of a given position limit by for example 500 lots will only have a very limited impact, effectively allowing market participants close to the limit to trade additional lots equivalent to four Calendar or eight Season contracts.
Once the limit is reached participants withdraw from the market, often switching to another trading venue outside of the MiFID II regime, thereby leaving the regulator no time to adjust the limit upwards. Furthermore, in relation to newly launched contracts, it is not unusual that only one participant sits on the buy or sell side of the market. In such cases, even a fifty percent limit is not sufficient to allow the market to mature.
(2) Inflexible categorization of markets and recalibration of position limits
In order to provide for a workable regime for growth markets, NCAs need to be able to process near instant updates to the categorisation of markets and readjust the applicable limits as open interests in a market increases. This is especially true for markets that experience strong increases in open interest in a short period of time. Markets with initially relatively low levels of open interest can develop into liquid markets in a matter of weeks or months. In order for a limit not to impede the development of fast-growing markets:
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<li>the growth of open interest requires a timely reclassification of a market under the position limits regime (for example from ‘illiquid’ to ‘less liquid’) in order to allow the position limit to be adjusted to a workable level, before it becomes unnecessarily restrictive.</li>
<li>the calculation of open interest in a market for the purpose of setting a position limit needs to adequately capture the period of growth of open interest. It is therefore essential that an appropriate methodology for calculating open interest is used. The usage of a randomly selected</li>
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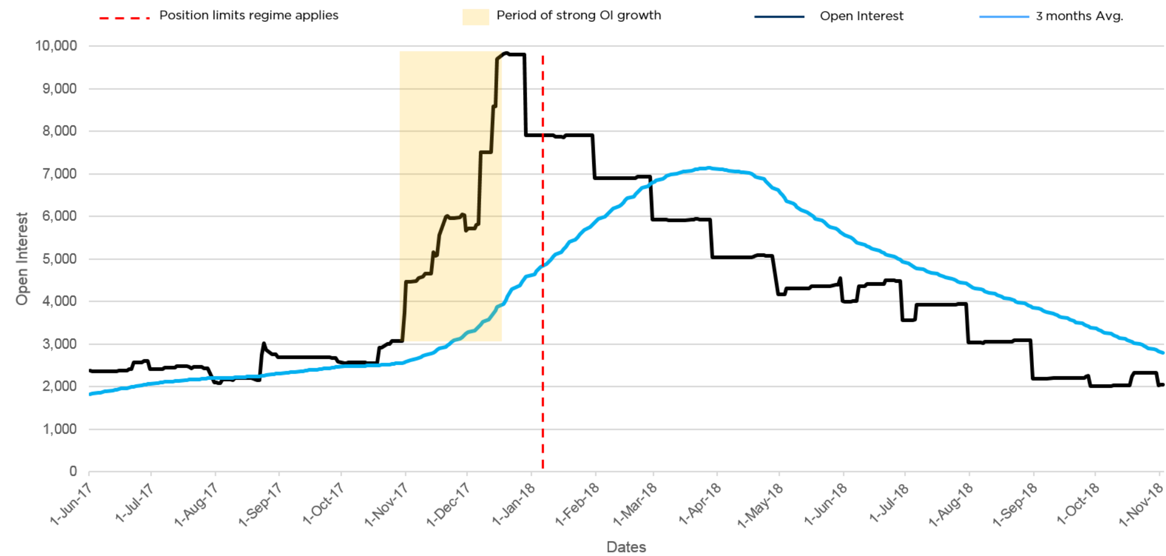
| | | period with an inappropriate duration could furthermore result in relatively frequent requests to amend the established limits, as the newly set limit could be reached with only a limited amount of transactions in a fast-growing market.<br><br>In practice, it has proven to be very challenging for NCAs to reclassify markets and recalibrate the applicable limits in a manner that would prevent a negative impact on the development of fast-growing markets. **Figure 1** illustrates this negative impact on one of ICE's previously fast-growing markets when subjected to the MiFID II position limits regime. The material growth in open interest (area marked in yellow) started in the last month of Q4 2017, but this momentum has been severely impaired at the end of 2017 and in the first period of 2018 in anticipation of the introduction of the MiFID II position limits regime. Before any reclassification of this market and subsequent recalibration of the limit could occur, the damage to the development of this market has proven to be irrevocable. This negative effect on the development of commodity derivative markets described above is stereotypical for fast growing markets subjected to the MiFID II position limits regime. |

| | | <br><br><br>Figure 1. Impact of position limits regime on development of ICE Endex Italian PSV Gas Futures market.<br><br>**(3) Inaccurate reflection of the underlying physical markets**<br><br>Moreover, for some commodity derivatives, the characteristic of the underlying physical market is such that an effective hedge can only be achieved by trading a specific number of lots. Such a number cannot be traded without exceeding the limit. Yet, under the current MiFID II provisions, the limit cannot be raised without sufficient increase of the open interest.<br><br>For example, the recently launched ICE Futures Europe TD20 West Africa to UK-Continent (Baltic) Future has grown significantly over the past few months, reaching over six thousand lots of open interest. The contract is a Suezmax crude route, West Africa to UK Continent for tankers sized on average 130,000 MT |
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| | | (DWT). The biggest positions exceeding 1.9k lots are held by MiFID II authorised investment firms or commodity traders not eligible for the hedging exemption. Further, their counterparties that are providing risk management services, are often financial institutions or investment firms that are not eligible for a hedging exemption under MiFID II.<br><br>Companies with Suezmax types of tanker fleets tend to hedge calendar years forward, fleet sizes up to 20 tankers and above.<br><br>To hedge a fleet of ten tankers on a year forward basis - the trade size will be (either as a single trade or done in a sequence of multiple smaller trades for the same Calendar Year tenor, keeping positions open throughout expiry):<br><br>**130 lots * 12months * 10 tankers = 15,600 lots** to hedge freight rates exposure for a single Calendar year (i.e Cal 2019 trade)<br><br>The current position limits regime is not sufficiently flexible to adapt to fundamental regulatory or market changes. One example is the International Maritime Organization's regulation going live in 2020, which has been a significant factor behind longer-dated hedges as companies are seeking certainty and stability of "locked in" freight levels that are expected to become volatile as the new sulphur caps for bunker fuel will start affecting the cost of shipping from January 2020. With fast growing trading volumes in wet freight, companies are extending hedges down the curve, trading to cover Cal19 / Cal20 and even Cal21 tenors that we are now seeing in a VLCC TD3C route (Arab Gulf to China crude route).<br><br>Since the traders active in TD20 have indicated the business need to hedge multiple calendar years forward in TD20 routes that would result in tripling trading volumes in the traded volume calculation scenario above, with potential volumes amounting to 46,800 lots.<br><br>However, the growth of the contract is restricted by the current de minimis position limit. Further development of this contract requires dynamic changes of the current limit from a fixed 2,500 lots level to a much higher limit based on the open interest. |

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| | | **Solution:**<br><br>ESMA's proposal to limit the regime to a *'set of important, critical derivatives contracts'* should indeed be seriously considered and ISDA, FIA and GFMA members would urge ESMA and regulators to consult the industry on the criteria that would be used for the classification of such '*important, critical derivatives contracts*', nature of the underlying commodity, size of the markets and importance for the supply of the underlying commodity across the EU, and the existence of non-EU markets for the same commodity may be important criteria in this respect.<br><br>ISDA, FIA and GFMA members consider that such a refocusing of the regime may be achieved by granting the NCAs greater flexibility in setting the limits, including not setting limits at all on less important, new, illiquid and non-critical derivative contracts, rather than by modifying article 57 of MiFID II.<br><br>In the interim until such changes have been made to RTS 21, ISDA, FIA and GFMA members urge ESMA to consider the suspension of position limits on new and less liquid contracts at least for an interim period to allow them to develop. Within the context of MiFID II, this would mean that the limits for commodity derivatives contracts are suspended until their open interest exceeds 20,000 lots. Once they have exceeded this threshold, the suspension is removed, and the contract becomes subject to a bespoke limit set by the responsible NCA.<br><br>Such an approach would provide for the necessary flexibility allowing fast-growing markets to thrive and thus the development of new products is not restricted by disproportionately low position limits. Furthermore, it would be in line with the policy objective of MiFID II as expressed in its implementing RTS 21 which stipulates that:<br><br>"*Position limits should not create barriers to the development of new commodity derivatives and should not prevent less liquid sections of the commodity derivative markets from working adequately*". |

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| | | At the same time, such an amendment would better fulfil the overall policy objective of MiFID II to "*improve the functioning and transparency of commodity markets and address excessive commodity price volatility*". New and nascent products constitute a minor share of commodity markets. Such contracts are unlikely to influence price movements in the underlying physical commodity markets and thus do not negatively impact consumers. Furthermore, even in case of a limit suspension, these contracts would remain subject to internal position monitoring and management by the trading venue, market surveillance procedures aimed at preventing abuse as well as position reporting under MiFID II. |
| 19 | Would you see merits in a more forward-looking approach to the calculation of open interest used as a baseline for setting position limits? Please elaborate. | FIA, ISDA and GFMA members support the introduction of a forward-looking model whereby the position limit is calculated based on a form of extrapolation of the historical development of open interest in a certain market, as this approach would be better suited to accommodate for periods of strong market growth.<br><br>Under the existing model, a position limit is based on a percentage of the average amount of open interest of a certain historical period, which is usually a one, three, six or twelve month period depending on the characteristics of the commodity market. This backward-looking methodology inherently does not properly capture the potential future growth of a market and risks applying an over restrictive limit when a market experiences a period of strong growth. At a minimum and where appropriate, it should therefore be allowed to use the smallest possible period for the calculation of open interest levels (i.e. the average open interest of the most recent trading day) under the existing rules.<br><br>One example for this is the EEX Supramax Freight Future, for which there is a process in the market to update the existing index methodology from Supramax-6TC (STCM) to Supramax-10TC (SPTM). The process of transferring to a new index means that the market will switch trading over time from one product to the other. At the point in time where the market participants have switched over to the new index, they typically also want to transfer positions in the old to the new contract as this enables them to actively manage their open positions in a single contract. Without this transfer, positions in the old contract become 'stranded' and members are forced to hold them until expiry, as finding a counterparty prepared to trade the old contract becomes very difficult. However, this is currently prevented by the fact that the de minimis limit for the new contract is not sufficiently high to allow market participants to transfer their old position |

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|  |  | to the new contract. As a consequence, no action that would enable a position limit increase cannot be conducted as it would initially result in some market participants breaching limits. For these particular cases, the NCAs should be entitled to base the position limit of the new contract on the open interest of the old contract. |
| 20 | In your view, are there other specific areas where the methodology for calculating the position limits set out in RTS 21 should be reviewed? If so, what would you suggest, and why? | If Brexit leads to significant changes to the calculation of deliverable supply, then a full assessment of the methodology would be necessary. But at this stage, ISDA, FIA and GFMA members are not in a position to assess the impact of Brexit. |
| 21 | How useful do you consider the information on position management controls available on ESMA's website? | No comment on position management controls.<br><br>However, ISDA, FIA and GFMA members would urge ESMA to expand their list of position limits to not only include contracts for which ESMA has published an opinion but also limits proposed by NCAs for which an opinion is still outstanding (and marking them as such) to serve as golden source for liquid contract limits. |
| 22 | Do you consider that there is a need to review the list of minimum position management controls to be implemented by commodity derivatives trading venues under Article 57(8) of MiFID II? If so, please explain the changes you would suggest. | No comment. |

**About FIA**

FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C. FIA's membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from more than 48 countries as well as technology vendors, lawyers and other professionals serving the industry. www.fia.org.

**About ISDA**

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 900 member institutions from 70 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter @ISDA.

**About GFMA Commodities Working Group**

The Commodities Working Group of GFMA focuses on regulatory issues specific to banks operating in the financial and physical commodities markets. The CWG's work centers around the creation of a more level regulatory playing field for the commodity markets, advocating consistency and avoiding duplication among legislative measures.

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