GFMA response to ESMA Consultation Paper on position limits and position management in commodity derivatives

Executive Summary

GFMA[1] welcomes the opportunity to respond to ESMA's Consultation Paper on its MiFID II review report which considers the impact of the application of position limits and position management on the liquidity, market abuse and orderly pricing and settlement conditions in commodity derivatives markets.

The position limits regime [applied?] is a new and unprecedented regime within the EU which has broadly achieved its original aims as set out in Article 57, MiFID II. GFMA is therefore supportive of ESMA's approach to focus on targeted changes designed to enhance the current regime as opposed to a comprehensive review.

ESMA's proposals are generally welcomed by GFMA members who highlight the importance of granting further flexibility within the position limits regime for new and illiquid contracts.

Additionally, GFMA also welcomes proposals to reconsider the scope of the position limits regime. However, whilst GFMA members are strongly supportive of a general review of the scope of the position limits regime our members further advocate that it is important to delineate between: (i) the impact of the regime on new and illiquid contracts; and (ii) the consideration of broader issues pertaining to overall scope, particularly, given the importance of these two fundamental (yet standalone) issues arising pursuant to a review of the position limits regime.

[1] 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 centres 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.

Questions

Part I

Q1 Which option (Option 1 or Option 2) do you support for dealing with competing contracts? Please explain why. If you support Option 1, do you have any suggestions for amending the definition of "same contract" in Article 5(1) of RTS 21? If you support another alternative, please explain which one and why.

GFMA members recognise ESMA concerns around what constitutes a "same commodity derivative" and agree that amendments to existing provisions are justified by the fact that no same commodity derivatives have yet been identified. Moreover, GFMA members support the creation of a level playing field between trading venues and are therefore mindful that smaller venues are unfairly hindered by tighter position limits being applied to what is fundamentally the same commodity derivative contract.

Regarding the options presented by ESMA, GFMA members believe that amendments to Level 1 (Option 2) would provide maximum clarity for market participants while also providing a clear mechanism by which competent authorities can agree upon the existence of same commodity derivatives.

GFMA would not support changes to Article 5(1) of RTS 21. Although the removal of the requirements that same commodity derivatives "form a single, fungible pool of open interest" would broaden the number of potential contracts in scope, there would be various issues in identifying all same commodity derivatives given that not all contracts will necessarily share "identical" characteristics. This being the case, GFMA members believe that changes to Level 1 to delete the reference to "same contract" represent an optimal solution

Q2 Do you agree that the C(6) carve-out creates an unlevel playing field across trading venues and should be reconsidered? If not, please explain why.

GFMA encourages ESMA to fully consider the regulatory impact of removing the C(6) carve-out before making a final recommendation. Such a decision would lead to the application of MAR, MiFID II, EMIR and the Benchmarks Regulation to previously scoped-out contracts. Importantly, it would mean that these contracts would be considered as financial instruments meaning that financial regulators (e.g. NCAs and ESMA) will need to regulate the physical energy market, effectively replacing ACER.

This change would place substantial requirements upon investment firms who would face significant changes in their systems and procedures relating to reporting under EMIR and MiFID II. Current C(6) products would be subject to several regimes under MiFID II including transaction reporting, pre and post trade transparency, [and] the commodity derivatives position reporting regime. GFMA would therefore emphasise that it is highly important to consider the implementation requirements placed upon market stakeholders ahead of introducing changes to the existing regulatory framework

Q3 Do you agree that the position limit framework should not apply to securitised derivatives? If not, please explain why.

Securitised derivatives based upon commodities are rightly identified within ESMA's Consultation Paper as having unique characteristics which makes the position limits regime an inappropriate tool for preventing market abuse and ensuring orderly pricing and settlement conditions in these instruments.

Within paras 94 to 98, ESMA provides detailed reasoning as to why securitised derivatives differ in their structure and function when compared to commodity derivatives meaning that the provisions of RTS 21 cannot be applied in the intended manner. Notably, the concepts of spot/other months, open interest, deliverable supply, delivery date and economically equivalent contracts are not applicable to securitised derivatives.

GFMA therefore supports ESMA's recommendation that securitised derivatives be removed from the scope of the position limits regime in Article 57 of MiFID II.

Q4 Which option do you support to address the negative impact of position limits on new and illiquid commodity derivatives: Option 1 or Option 2? Please explain why. If you support another alternative, please explain which one and why.

The scope of the MiFID II position limits regime has been a challenge for the industry, particularly because it has included new and illiquid contracts which require the capacity for development and growth in order to meet the varying needs of market participants.

The application of a restrictive standardised position limit of 2,500 lots to new or illiquid contracts means that market participants are forced [to] decrease any sizeable positions, reducing open interest and thereby creating a perpetual cycle where the contract will always remain illiquid. Once a limit is reached, market participants may withdraw from the market, often switching to another trading venue outside the MiFID II regime. National Competent Authorities are able to use different derogations for the purposes of illiquid contracts with an open interest between 5,000 and 10,000 lots, however this remains difficult to apply in practice and fails to mitigate the impact of disproportionately low position limits.

In light of these challenges, GFMA members would primarily support the adoption of Option 2, as described in paragraph 108 within ESMA's consultation. The optimisation of the position limits regime brings an opportunity to enhance the capacity of new commodity derivative contracts to develop and attract liquidity. A more focused approach to address this issue will bring meaningful change for market participants in an efficient manner.

Whilst GFMA members are strongly supportive of a general review of the scope of the position limits regime our member's further advocate that it is important to delineate between: (i) the impact of the regime on new and illiquid contracts; and (ii) the consideration of broader issues pertaining to overall scope, particularly, given the importance of these two fundamental (yet standalone) issues arising pursuant to a review of the position limits regime.

Accordingly, GFMA members discern that a more effectual approach would be: (i) the introduction of an immediate solution in respect of new/illiquid contracts as advocated pursuant to "Option 2" (para 108) of the Consultation Paper, (support for which is clearly iterated above) whilst also; (ii) undertaking a further broader concomitant exercise to separately consider and address fundamental issues and questions arising in respect of scope of the position limits regime.

Q5 If you support Option 1 and would suggest different or additional criteria to determine whether a contract qualifies as a critical contract, please explain which ones.

Please see GFMA's response to Question 4.

Should a broader scoping exercise be undertaken (in line with Option 1 set out within paras 101 to 107 of ESMA's Consultation Paper), GFMA members also consider that the following factors could be considered when determining whether a relevant commodity derivative contract is to be regarded as critical or not:

- Notional value to date
- Deliverable Supply
- Frequency of trade

Q6 Which open interest and participant threshold would you suggest for qualifying a commodity derivative as a critical one?

Please see GFMA's response to Question 4.

GFMA members consider that further clarity is required on the qualifying characteristics which will be used to determine whether a contract qualifies as a critical contract before any analysis, data and/or metrics can be provided in respect of these parameters.

Q7 Would you support a position limit exemption for financial counterparties under mandatory liquidity provision obligations? If not, please explain why.

GFMA members would support a position limit exemption for financial counterparties under mandatory liquidity provision obligations.

Q8 Would you support introducing a hedging exemption for financial counterparties along the lines described above? If not, please explain why.

GFMA members support a hedging exemption for financial counterparties (e.g. investment banks or MiFID II authorised commodity trading houses) when providing liquidity to smaller commercial players and non-financial entities in commodities markets. The current hedging exemption, as set out in Article 57(1) of MiFID II and RTS 21, applies only to non-financial entities meaning that no universal solution is provided for all market participants seeking to undertake hedging activity. GFMA notes that position limits regime in the U.S. (referred to within ESMA's consultation paper and call for evidence) contains a *bona fide* hedging exemption that is not restricted to non-financial entities.

An example showing how financial firms are negatively impacted by this restriction is the Refining Margin Hedge often used in oil markets, whereby an investment firm 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 investment firm executes 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
I	Brent 1st Line	1000
DBF	Dated Brent vs Brent 1st Line Future	1000
UCF	Urals Med vs Dated Brent CFD Future	1000
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
NEC	Naphtha CIF NWE Cargoes Future	11

2. **Bank's Offsetting Hedge in the Market for taking on the Refining Margin trade from the client:**

ICE Contract Code	ICE Contract Name	No of Lots
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

Figure 1 – Investment firm trading activity in a Refining Margin Hedge

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. GFMA also notes ESMA's comments that "most of the examples provided by stakeholders in support of a liquidity exemption for financial counterparties referred to the specific trading characteristics of new and illiquid commodity derivatives" and would point out that a number of the contracts used in this contract are highly liquid. Further challenges exist for other liquid contracts meaning that a disapplication of the position limits regime to new or illiquid contracts would not provide an adequate solution for financial counterparties undertaking hedging activity.

Q9 Do you agree with ESMA's proposals to amend Article 57(8)(b) of MiFID II and to introduce Level 2 measures on position management controls? If not, please explain why.

GFMA members are concerned by ESMA's proposal for an extension of trading venue powers under Article 57(8)(b) which would include "the power for a trading venue to obtain information from its members or participants on related positions entered by a person on other trading venues or OTC". This is a power adopted by certain regulated markets for a subset of commodity derivatives which are typically physically deliverable. GFMA considers that the current wording allows an appropriate degree of power for operators of trading venues to receive information on positions relating to assets, liabilities and positions on other trading venues. It is also worth noting that such powers can be applied by trading venues within their own rulebooks which already allows for an appropriate level of flexibility.

In relation to ESMA's suggestion that trading venues should be required to "to have measures in place to aggregate positions under common ownership and controls and, for each commodity derivative, to set pre-determined large position levels, or accountability levels", GFMA considers that the current approach allows for trading venues to include such powers in their own rulebooks in circumstances where it is deemed appropriate. Such measures are typically applied for commodity derivatives which can be physically delivered and may not be appropriate to all contracts in scope of the position limits regime.

Finally, GFMA members would welcome further clarity from ESMA on the specific intentions behind para 122 within ESMA's Consultation Paper, particularly on requirements for trading venues to "set, and implement, position limits for the period immediately preceding expiry for those contracts".