Public consultation on the review of the MiFID II/MiFIR regulatory framework

GFMA response – 18.05.20

I. Commodity markets[8]

As part of the effort to foster more **commodity derivatives trading denominated in euros**, rules on pre-trade transparency and on position limits could be recalibrated (to establish for instance higher levels of open interest before the limit is triggered) to facilitate nascent euro-denominated commodity derivatives contracts. For example, Level 1 could contain a specific requirement that a nascent market must benefit from more relaxed (higher) limits before a positon has to be closed. Another option would be to allow for trades negotiated over the counter (i.e. not on a trading venue) to be brought to an electronic exchange in order to gradually familiarise commodity traders with the beneficial features of "on venue" electronic trading.

ESMA has already conducted a consultation on position limits and position management. The report will be presented to the Commission at the end of Q1 2020. From a previous ESMA call for evidence, the commodity markets regime seems to have not had an impact on market abuse regulation, orderly pricing or settlement conditions. ESMA stresses that the associated position reporting data, combined with other data sources such as transaction reporting allows competent authorities to better identify, and sanction, market manipulation. Furthermore, the Commission has identified in its Staff Working Document on strengthening the International Role of the Euro that "There is potential to further increase the share of euro-denominated transactions in energy commodities, in particular in the sector of natural gas".

The most significant topic seems the current position limit regime for illiquid and nascent commodity markets. The position limit regime is thought to work well for liquid markets. However, illiquid and nascent markets are not sufficiently accommodated. ESMA also questioned whether there should be a position limit exemption for financial counterparties under mandatory liquidity provision obligations. ESMA would also like to foster convergence in the implementation of position management controls.

Another aspect mentioned in the Commission consultation on the international role of the euro is a more finely calibrated system of pre-trade transparency applicable to commodity derivatives. Such a system would lead to a swifter transition of these markets from the currently prevalent OTC trading to electronic platforms.

[5] The review clause in Article 90 paragraph (1)(f) of MiFID II is covered by this section.

Question 69. Please specify to what extent you agree with the statements below regarding the experience with the implementation of the position limit framework and pre-trade transparency?

	1 (disagree)	2 (rather not agree)	3 (neutral)	4 (rather agree)	5 (fully agree)	N. A.
The EU intervention been successful in achieving or progressing towards improving the functioning and transparency of commodity markets and address excessive commodity price volatility.		x				
The MiFID II/MiFIR costs and benefits with regard to commodity markets are balanced (in particular regarding the regulatory burden).		x				
The different components of the framework operate well together to achieve the improvement of the functioning and transparency of commodity markets and address excessive commodity price volatility.			x			
The improvement of the functioning and transparency of commodity markets and address excessive commodity price volatility correspond with the needs and problems in EU financial markets.			x			
The position limit framework and pre-trade transparency regime for commodity markets has provided EU added value.		x				

Question 69.1 Please provide both quantitative and qualitative elements to explain your answer and provide to the extent possible an estimation of the benefits and costs. Where possible, please provide figures broken down by categories such as IT, organisational arrangements, HR etc.

GFMA members are broadly supportive of the underlying aims of the position limits framework and pre-trade transparency regime and we welcome work undertaken by the Commission to improve the stability and integrity European commodity markets. However, in our view, there are adjustments that could be made in order to appropriately calibrate the existing regulatory framework to EU markets which will serve to enhance the competitiveness and performance of EU commodity markets. In particular, GFMA members recommend that the Commission seeks to address two key issues:

1) Clarifying the definition of commodity derivative and the resulting scope of position limit framework
2) Addressing the lack of flexibility of the position limits regime for new and illiquid contracts

Quantitative elements for question 69.1:

GFMA is not responding to this question.

Benefits	
Costs	

Qualitative elements for question 69.1:

The intention of the position limits regime, as stated in RTS 21, is to support “orderly pricing and settlement arrangements, developing new commodity derivatives and enabling commodity derivatives to continue to support the functioning of commercial activities in the underlying commodity market”. GFMA members support these objectives and have implemented costly position management and reporting systems to ensure compliance with their requirements under Article 57 and Article 58 of MiFID II. However, there remain issues with the regime which should be addressed in order to ensure the improved functioning of the position limits framework.

GFMA recommends that the Commission provides clarification of the definition of commodity derivatives as set out under Article 2(1)(30) of MiFIR. Market stakeholders have struggled with the fact the current definition draws securitised derivatives into scope as well as certain derivatives which do not have an underlying physical commodity. This issue was addressed by ESMA in updates of its Q&As on commodity derivatives topics in December 2016 and March 2018, however there remains uncertainty over these contracts.

GFMA members agree with ESMA’s view set out in its consultation paper (CP) on position limits and position management that “the position limit framework fails to recognise the unique characteristics of securitised derivatives compared to other commodity derivatives and therefore does not appear to be an appropriate tool for preventing market abuse and ensuring orderly pricing and settlement conditions in those instruments”. It is worth noting that securitised derivatives are already covered by MAR and that, in the context of commodities, they have no physical underlying and therefore cannot have an effect on physical commodity markets. GFMA also agrees with ESMA’s conclusion that the standard features of the position limit framework (e.g. open interest, deliverable supply, lots, spot/other months and delivery date) do not apply to securitised derivatives. Finally, GFMA agree with ESMA’s view that most securitised derivatives are ultimately held by a large number of retail investors, which does not raise the same risk of either abuse of a dominant position or to orderly pricing and settlement conditions as for ordinary commodity derivative contracts.

GFMA therefore recommends amending Article 2(1)(30) to exclude securitised derivatives from the scope of commodity derivatives and consequently the position limits regime.

In relation to new and illiquid contracts, GFMA considers that the scope of the position limits regime has been a challenge for market stakeholders as it has restricted the capacity for growth and development meaning that the varying needs of market participants have not been met through the use of EU contracts.

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/R 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 have expressed their support for ESMA’s proposal to amend Article 57 to mandate ESMA to develop specific Level 2 measures with regard to new commodity derivatives contracts, and in particular determine when position limits should start applying to those derivative contracts. However, GFMA would also support a reduction of the scope of the position limits regime to a limited set of significant or critical contracts. We note that this would align the EU position limits framework with the U.S. equivalent bringing added benefits with regard to the competitiveness of EU commodity derivatives markets.

1. Position limits for illiquid and nascent commodity markets

The lack of flexibility of the **position limit** framework for commodity hedging contracts (notably for new contracts covering natural gas and oil) is a constraint on the emergence euro-denominated commodity markets that allow hedging the increasing risk resulting from climate change. The current de minimis threshold of 2,500 lots for those contracts with a total combined open interest not exceeding 10,000 lots, is seen as too restrictive especially when the open interest in such contracts approaches the threshold of 10,000 lots.

Question 70. Can you provide examples of the materiality of the above mentioned problem?

GFMA is not responding to this question.

- Yes, I can provide 1 or more example(s)
- No, I cannot provide any example

Please provide example(s) of (nascent) contracts where the position limit regime has constrained the growth of the contract:

GFMA is not responding to this question.

Underlying cause of the constraint (A/B/C)*:

*Note: 1 The underlying cause of the constraint is due to (A) the position limit becoming too restrictive as open interest increases, (B) an incorrect categorisation under the position limits framework or (C) the underlying physical markets are not efficiently reflected.

Size of the OTC space the contract(s) is/are trying to enter (in €):

GFMA is not responding to this question.

Market share the nascent contract(s) is/are expected to gain (in %):

GFMA is not responding to this question.

Contract(s) is/are euro denominated?

GFMA is not responding to this question.

Question 71. Please indicate the scope you consider most appropriate for the position limit regime:

	1 (most appropriate)	2 (neutral)	3 (least appropriate)	N. A.
Current scope	◯	◯	x	◯
A designated list of 'critical' contracts similar to the US regime	x	◯	◯	◯
Other	x	◯	◯	◯

Please specify what other scope you consider most appropriate for the position limit regime:

GFMA is not responding to this question.

Question 71.1 Please explain your answer to question 71:

GFMA members believe that the scope of the position limits regime has been a challenge for market participants, particularly in relation to nascent or illiquid contracts which require the capacity for development and growth in order to meet the varying needs of market participants. GFMA recommends that the Commission and ESMA consider short term Level 2 measures (ESMA's Option 2 in its CP on position limits and position management) that can be undertaken to enhance the current regime before undertaking a fundamental review of the position limits framework which limits the scope of the regime to a list of critical contracts (ESMA's Option 1 in its CP on position limits and position management).

Although, GFMA would support a combination of the above options ESMA presented in its CP, we consider that the proposed changes to Level 2 (under Option 2) remain too restrictive. GFMA considers that the 12-month period prior to when position limits start to apply is too short and should instead be 24 months. Additionally, GFMA members recommend applying a 10,000 lot *de minimis* limit to contracts that have not exceeded 20,000 lots after 24 months.

Regarding Level 1 changes to the position limits framework, GFMA would also support a reduction of the scope of the position limits regime to a limited set of significant or critical contracts. The set of criteria to determine which contracts are deemed to be critical should consider:

- Contracts associated with deliverable supply
- Nature of the underlying commodity
- Size of the market
- Importance of the supply of the underlying commodity across the EU
- Existence of non-EU markets for the same commodity

We note that this would allow for the development of nascent and illiquid contracts whilst also aligning the EU position limits framework with the U.S. equivalent (enhancing the competitiveness of EU commodity derivatives markets).

Question 72. If you believe there is a need to change the scope along a designated list of 'critical' contracts similar to the US regime, please specify which of the following criteria could be used.

GFMA is not responding to this question.

For each of these criteria, please specify the appropriate threshold and how many contracts would be designated 'critical'.

- ☐ Open interest - Yes
- ☐ Type-variety of participants-Yes
- ☐ Other criterion - Yes
- ☐ There is no need to change the scope - No

Open interest:

Threshold for open interest:

GFMA is not responding to this question.

Number of affected contracts in the EU for open interest:

GFMA is not responding to this question.

Please explain why you consider that the open interest is a criterion that could be used:

GFMA is not responding to this question.

Type and variety of participants:

Threshold for the type and variety of participants:

GFMA is not responding to this question.

Number of affected contracts in the EU for the type and variety of participants:

GFMA is not responding to this question.

Please explain why you consider that the type and variety of participants is a criterion that could be used:

GFMA is not responding to this question.

Other criterion:

GFMA members believe that the set of criteria to determine which contracts are deemed to be critical should consider:

- Contracts with associated deliverable supply
- Nature of the underlying commodity
- Size of the market
- Importance of the supply of the underlying commodity across the EU
- Existence of non-EU markets for the same commodity

Please specify what other criterion could be used and explain your answer:

GFMA is not responding to this question.

Threshold for this other criterion:

GFMA is not responding to this question.

Number of affected contracts in the EU for this other criterion:

GFMA is not responding to this question.

Question 72.1 Please explain your answer to question 72:

GFMA members note that Article 57(1)(b) of MiFID II calls for the position limits regime to ensure, in particular, “convergence between prices of derivatives in the delivery month and spot prices for the underlying commodity”. It would therefore be in keeping with the underlying goal of the position limits regime to apply the framework to contracts where there is an associated deliverable supply.

In order to ensure that the position limits framework is appropriately limited and in order to bring associated benefits to nascent and illiquid contracts, GFMA would also support including the consideration of the nature of the underlying commodity, the size of the market, the importance of the supply of the underlying commodity across the EU and the existence of non-EU markets for the same commodity.

ESMA has questioned stakeholders on the actual impact of position management controls. Stakeholder views expressed to the ESMA consultation appear diverse, if not diverging. This may reflect significant dissimilarities in the way position management systems are understood and executed by trading venues. This suggests that further clarification on the roles and responsibilities by trading venues is needed.

Question 73. Do you agree that there is a need to foster convergence in how position management controls are implemented?

GFMA is not responding to this question.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don’t know / no opinion / not relevant

Question 73.1 Please explain your answer to question 73:

GFMA is not responding to this question.

Question 74. For which contracts would you consider a position limit exemption for a financial counterparty under mandatory liquidity provision obligations?

This exemption would mirror the exclusion of the related transactions from the ancillary activity test.

	Yes	No	N.A.
Nascent	X	○	○
Illiquid	X	○	○
Other	○	○	○

Question 74.1 Please explain your answer to question 74:

GFMA members believe that the scope of the position limits regime has been a challenge for market participants, particularly in relation to nascent or illiquid contracts which require the capacity for development and growth in order to meet the varying needs of market participants. The introduction of a position limit exemption for financial counterparties under mandatory liquidity provision obligations would benefit both nascent and illiquid contracts. GFMA members would therefore recommend that a position limit exemption for a financial counterparty under mandatory liquidity provision obligations is applied in a similar manner to the liquidity provision exemption set out in Article 2(4) in MiFID II.

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Question 75. For which counterparty do you consider a hedging exemption appropriate in relation to positions which are objectively measurable as reducing risks?

	Yes	No	N. A.
A financial counterparty belonging to a predominantly commercial group that hedges positions held by a non-financial entity belonging to the same group	x		
A financial counterparty	x		
Other			

Please specify for other which counterparties you consider a hedging exemption appropriate:

GFMA is not responding to this question.

Question 75.1 Please explain your answer to question 75:

GFMA members consider that liquidity providers would be better equipped to fulfil their role within EU commodity derivatives markets through the introduction of a hedging exemption for financial counterparties.

GFMA notes that broadening the application of the hedging exemption in this way would ensure closer alignment of the EU position limits regime and the US position limits regime which includes a bona fide hedging exemption which is not restricted to non-financial entities (enhancing the competitiveness of EU commodity derivatives markets).

2. Pre-trade transparency

MiFIR RTS 2 (Commission Delegated Regulation (EU) No 2017/583) sets out the large-in-scale (LIS) levels are based on notional values. In order to translate the notional value into a block threshold, exchanges have to convert the notional value to lots by dividing it by the price of a futures or options contract in a certain historical period.

Some stakeholders argue that the current provisions of RTS2 lead to low LIS thresholds for highly liquid instruments and high LIS thresholds for illiquid contracts. This situation makes it allegedly hard for trading venues to accommodate markets with significant price volatility. This hinders their potential to offer niche instruments or develop new and/or fast moving markets.

Question 76. Do you consider that pre-trade transparency for commodity derivatives functions well?

GFMA is not responding to this question.

- 1 - Disagree
- 2 - Rather not agree
- 3 - Neutral
- 4 - Rather agree
- 5 - Fully agree
- Don’t know / no opinion / not relevant

If you do not consider that pre-trade transparency for commodity derivatives functions well, please (1) provide examples of markets where the pre-trade transparency regime has constrained the offering of niche instruments or the development of new and/or fast moving markets, and (2) present possible solutions including, where possible, quantitative elements:

GFMA is not responding to this question.

Question 76.1 Please explain your answer to question 76:

GFMA is not responding to this question