Reply Form to the Consultation Paper

MiFID II review report on position limits and position management
Draft Technical Advice on weekly position reports

5 November 2019

Responding to this paper

ESMA invites comments on all matters in this paper and in particular on the specific questions summarised in Annex 1. Comments are most helpful if they:

- respond to the question stated;
- indicate the specific question to which the comment relates;
- contain a clear rationale; and
- describe any alternatives ESMA should consider.

ESMA will consider all comments received by **8 January 2020.**

All contributions should be submitted online at www.esma.europa.eu under the heading 'Your input - Consultations'. Please follow the instructions given in the document 'Reply form for the consultation paper on "MiFID II review report on position limits and position management and draft technical advice on weekly position reports' also published on the ESMA website.

Instructions

In order to facilitate analysis of responses to the Consultation paper, respondents are requested to follow the below steps when preparing and submitting their response:

1. Insert your responses to the questions in the Consultation paper in the present response form.

2. Please do not remove tags of the type <ESMA_QUESTION_WPR_1>. Your response to each question has to be framed by the two tags corresponding to the question.

3. If you do not wish to respond to a given question, please do not delete it but simply leave the text "TYPE YOUR TEXT HERE" between the tags.

4. When you have drafted your response, name your response form according to the following convention: ESMA_WPR_nameofrespondent_RESPONSEFORM. For example, for a respondent named ABCD, the response form would be entitled ESMA_WPR_ABCD_RESPONSEFORM.

5. Upload the form containing your responses, in Word format, to ESMA's website (www.esma.europa.eu under the heading "Your input – Open consultations" → "Call for Evidence on Position limits and position management in commodities derivatives").

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading Legal Notice.

Who should read this paper

All interested stakeholders are invited to respond to this consultation paper. This consultation paper is primarily of interest to trading venues, investment firms and non-financial counterparties trading in commodity derivatives, but responses are also sought from any other market participant including trade associations, industry bodies and investors.

General information about respondent

Name of the company / organisation	European Federation of Energy Traders (EFET)
Activity	Non-financial counterparty
Are you representing an association?	☒
Country/Region	Europe

Introduction

Please make your introductory comments below, if any

<ESMA_COMMENT_WPR_1>

EFET welcomes the overall improvements proposed by ESMA in the consultation paper to render the current MIFID position limit regime more fit for purpose. We appreciate that ESMA is considering the feedback provided by market participants in the 2019 Call for Evidence and acknowledging that some elements of the current regime are excessively burdensome, hamper the development of new and illiquid contracts and do not contribute to the intended objectives.

As argued in our response to the 2019 Call for Evidence, EFET believes that the position limit regime has been working reasonably well for well-developed, liquid contracts, whereas we urge a review of its scope to reduce it to a limited set of critical contracts as proposed by ESMA under section 5.2.2. Such a reduction of scope would align the regime with the US approach of the CFTC and hence, ensure a level playing field between US and EU trading venues. It would also address several of the shortcomings of the current regime, namely the definition of 'same contracts,' the application of hedging exemptions and the negative impact on the development of new and illiquid contracts.

Although EFET supports a reduction of scope as the best way to increase the efficiency of the position limit regime, we understand that ESMA may consider gradual improvements to be more appropriate - first tackling its main shortcomings and reviewing the scope of the regime only in a second phase. Considering this, our feedback on the other alternatives consulted is to be considered a second-best option.

<ESMA_COMMENT_WPR_1>

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.

<ESMA_QUESTION_WPR_1>
EFET believes that the current definition of “same contract” is too narrow and may hinder competition between trading venues offering equivalent contracts. We therefore welcome ESMA’s proposals in this area.
While we consider both Option 1 and Option 2 as an improvement of the current regime, our preference is for Option 2. Under such an approach, the limits for each contract remain separate and continue to be set by the respective NCAs, which is a simpler alternative to implement and monitor than the establishment and monitoring of a joint limit. Allowing the NCA of the less liquid trading venue(s) to set the other months’ limit at 25% of the open interest of the most liquid market will be an effective mechanism to promote a level playing field between trading venues, enhancing the development of the less liquid trading venues, whilst still allowing NCAs to adjust limits based on the characteristics of the market. It will also provide an adequate choice to market participants.
<ESMA_QUESTION_WPR_1>

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.

<ESMA_QUESTION_WPR_2>
EFET strongly disagrees with the position expressed by ESMA on the impact of the C(6) carve-out and the proposal to reconsider the exclusion of physical wholesale energy products traded on an OTF from the definition of financial instruments.
First, in expressing this view, ESMA is ignoring the structural differences between physical commodity markets and financial derivative markets, as well as key specificities of the energy sector.

- Gas and electricity markets (unlike metal, agricultural and other energy commodities) are characterised by a robust dedicated regulation addressing market abuse and transparency as well as strong sectoral regulators (both at the national and European level) with sufficient powers, knowledge and capability to adequately supervise physical energy markets. There is no evidence to argue that financial regulators would be in a better position to supervise and regulate complex physical wholesale energy markets.
- Many sector-specific regulations have been adopted (the Third Energy Package, the Transparency Regulation, REMIT, etc.) with the aim to ensure wide supervision, integrity and transparency for wholesale energy products, regardless of the trading venue on which transactions are concluded. National energy regulators also regulate the economic returns and supervise the conduct of system operators that manage access to energy networks, including trading and scheduling arrangements for the delivery of gas or electricity transacted on wholesale markets. As such, we do not see any regulatory gap that the removal of the C(6) carve-out would fill.

- Transactions in energy markets are concluded in variety of ways: (i) bilaterally, through negotiation with an individual counterparty; (ii) through exchanges, where the exchange's clearing house is the central counterparty of all transactions; and (iii) with some support of brokers, using electronic solutions and/or more traditional voice support. The method chosen for trading depends on several factors, including the liquidity of the market, the number of market participants, the availability of an exchange and central clearing services, the standardisation of the products traded, the dissemination of standard contracts and the national regulatory environment. Although wholesale energy market participants also trade commodity derivatives on exchanges, most transactions are physically settled as they involve the delivery of the underlying gas or electricity by means of scheduling or nominating to the designated delivery point (e.g. gas hub or price area) because it is usually most suitable for the needs of market participants.
- As physical trading is the most popular form of trading gas and power, market participants use for this purpose the OTF platforms because contracts concluded over OTFs correspond best to their needs and exchange contracts are only suitable in certain circumstances and therefore trading on exchange is necessarily going to be lower in volume. Also, price transparency on OTFs is high and easily accessed by market participants, which is another reason why it is favoured by market participants.
- Wholesale energy trading takes place between professional counterparties and is aimed at managing each party's supply and demand. Physical forward transactions are necessary to hedge merchant risk related to physical deliveries of wholesale energy products and pose no threat to the well-functioning and stability of financial markets. They are essential to ensuring a secure, sustainable and competitive energy supply to end consumers.

  Classifying physically delivered wholesale energy products traded through OTF brokers will significantly impact the cost of hedging for industrial groups and directly impact their core physical industrial activities. It will result in higher power and gas prices on wholesale energy markets and consequently higher energy prices for end users. The exclusion of physically settled wholesale energy products traded on an OTF was an acknowledgement of these realities, which has not changed since the introduction of MiFID II.
- Removing the C(6) carve-out will also impact physically settled bilateral trading of wholesale energy products as those bilateral contracts that are similar to OTF traded contracts will become financial instruments under C(7). Bilateral trading under standard master agreements (such as the EFET Master Agreements) are a widely used instrument to supply large industrial users, so if these contracts become financial derivatives there will be a direct impact on the real economy, not only because industrial firms will have to comply with financial regulation (EMIR hedging documentation, clearing threshold calculation, MIFID ancillary activity test, yearly notifications, etc.) but most importantly because the cost of physical energy supplies and hedging services for industrial clients will increase, impacting their production costs and their overall competitive position.

Secondly, removing the C(6) carve-out would have a series of knock-on effects under various regulations, leading to a severe impact on wholesale energy market functioning and an increase in costs for market participants.

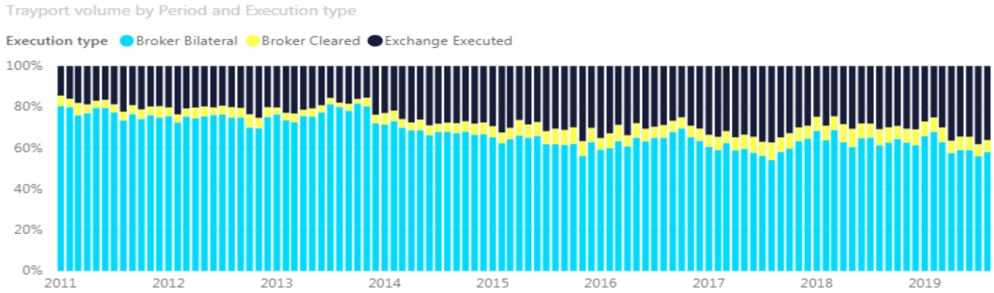
- The risk-reducing framework of non-financial counterparties under **EMIR** will be materially impacted. Financial derivative transactions can only be considered as risk reducing if they reduce a risk directly related to the commercial (non-financial) or treasury financing activities of a non-financial group. If a large share of the commercial activity of an industrial commodity dealer is classified as financial as a result of the review of the C(6) carve-out, most, if not all, current non-financial counterparties in the wholesale energy market will no longer be able to demonstrate the risk reducing nature of their hedges related to physical flows and will breach the EMIR clearing threshold. Breaching the EMIR clearing threshold triggers mandatory margining obligations and other more stringent risk mitigation measures (including daily mark-to-market). Not only will the core physical commercial activity of NFCs be impacted, but also these firms will no longer offer physical hedging services to their customers. On the other hand, requalifying such trades will not bring any additional transparency to the market, as all transactions in wholesale energy products are already reported to ACER under REMIT.

- The EMIR risk reducing definition is also used to determine which trades are "privileged" transactions for the Ancillary Activity Test under **MiFID** and hence will impact the capability of wholesale energy market participants to pass the test. Without a C(6) carve-out, trading entities of energy groups and other market participants may consequently have to turn into investment firms, which involves stricter organisation requirements, conduct of business rules and, most importantly, significant capital requirements. This will result in higher costs of doing business, which will be, at least partially, passed through to energy consumers across the economy. This increase in costs is not justified by the increased level of supervision, given the existence of the above-mentioned strong sectoral framework and the lack of systemic risk posed by commodity traders. In order to avoid the high costs of becoming an investment firm, some energy groups may reduce the amount of hedging they perform. Such reduced ability to manage their merchant risk will result in a higher premium charged to their customers. Alternatively, they may resort to hedging through bilateral OTC and non-standardised contracts, if available, resulting once again in higher costs that will be passed through.
- The scope of supervision of well-established energy regulators (NRAs and ACER) under **REMIT** will be put into question, resulting in disruption in the functioning and supervision of physical wholesale energy markets.

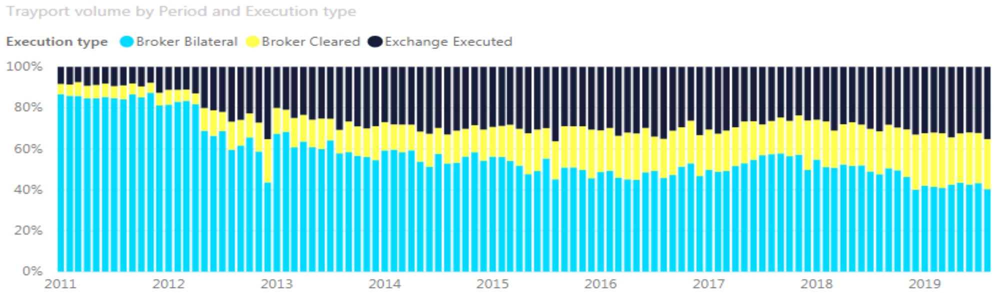
Third, ESMA's view is based on inaccurate premises and is not supported by data-driven evidence.

- The "shift of trading in physically-settled wholesale energy contracts from regulated markets and MTFs to OTFs" mentioned by ESMA on page 23 of the Consultation Paper has not taken place. The graphs below, based on publicly available data produced by Trayport (https://www.trayport.com/category/market-dynamics-report/), show that there has been no increase in the share of gas and electricity contracts executed bilaterally on brokerage platforms, which are mostly OTFs (light blue bars) vs. regulated markets and cleared venues (yellow and dark blue bars).

All gas:



All Power:



The data suggest there is no ground to claim that “the C(6) carve-out has proved a significant and successful incentive for market participants to move trading in REMIT contract to OTFs,” nor that it is a source of a “major competitive disadvantage for regulated markets and MTFs.” On the contrary, the market share of contracts executed on exchanges or cleared has increased in recent years, mainly as a consequence of the introduction of EMIR, and the limitation on open positions in OTC commodity derivatives and the incentive to move trading to cleared markets.

- No trading venue has been put at a competitive disadvantage as any interested party has had the opportunity to set up their own OTFs and a significant number of regulated market operators have indeed done so. Whether the OTFs they have established have been successful or not depends exclusively on the quality and competitiveness of their commercial offerings rather than on any supposed unfair advantage granted to other players. We also highlight that competition among trading venues, while desirable, should not be a primary objective of the MiFID II licensing and position limit regimes.

<ESMA_QUESTION_WPR_2>

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

<ESMA_QUESTION_WPR_3>
EFET members are not active in this market segment, so we do not have views on the topic.
<ESMA_QUESTION_WPR_3>

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.

<ESMA_QUESTION_WPR_4>

As mentioned in the introductory comments, EFET supports Option 1. Refocusing the scope of the position limit regime to a limited set of critical contracts is a more effective tool to address the negative impact of position limits on new and illiquid contracts and would deliver a much-needed simplification of the regime without significantly impacting its effectiveness in terms of market abuse prevention and market transparency.

As argued in our response to ESMA's Call for Evidence, EFET believes that a refocus of the framework is justified as price formation mainly occurs in benchmark products and only insofar it seems necessary and appropriate to reduce the potential threat of market manipulation. Finally, this would create a regulatory level-playing field between the EU and US commodity markets and protect the liquidity and competitiveness of EU commodity markets.

On the other hand, the increase of limits on illiquid contracts to 50% of the reference amount proposed in Option 2 would represent a slight improvement of the current situation but by no means a guarantee that the difficulties with new and illiquid will be overcome. Another shortcoming of Option 2 is related to the speed at which NCAs can adapt position limits in tune with evolving market liquidity. Since position limits are defined in absolute terms based on a percentage of the open interest identified by the NCA at a specific point in time, when the open interest of a contract increases rapidly market participants may be significantly constrained in the ability to trade such a contract until the limit is effectively reviewed.

<ESMA_QUESTION_WPR_4>

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.

<ESMA_QUESTION_WPR_5>

We agree with the criteria listed by ESMA to determine whether a contract would qualify as "critical." A combination of quantitative (liquidity, number of market participants) and qualitative (type of market participants, characteristics of underlying market) criteria is the preferable approach. Liquidity (measured in terms of either absolute open interest, open interest vs deliverable supply ratio, churn ratio or any other metric) should be used as the main variable.

In order to improve the stability of the position limit regime, we suggest that the relevant assessment is performed by NCAs and ESMA annually on the basis of a three-year rolling average of the relevant indicators.

<ESMA_QUESTION_WPR_5>

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

<ESMA_QUESTION_WPR_6>

EFET believes that thresholds should be defined after extensive stakeholder consultation to ensure that all relevant elements and views are taken into account. In particular, trading venues find themselves in a privileged vantage point, as they understand best the markets they operate and possess a vast amount of information about participants, orders and trades, so their views should be taken into special consideration.

<ESMA_QUESTION_WPR_6>

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

<ESMA_QUESTION_WPR_7>

EFET supports the introduction of a position limit exemption for positions entered in the framework of a mandatory liquidity provision arrangements. However, we believe that such an

exemption should be available to both financial and non-financial counterparties. We do not see any valid reason why the scope of the exemption should be limited to investment firms.
For the sake of consistency, the exemption should mirror the treatment of liquidity provision arrangements in the Ancillary Activity Exemption test, stipulated by Delegated Regulation 2017/592.
<ESMA_QUESTION_WPR_7>

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

<ESMA_QUESTION_WPR_8>
EFET supports the introduction of a position limit hedging exemption for financial counterparties belonging to a predominantly commercial group and agrees with ESMA that no blanket hedging exemption for all financial counterparties should be introduced.
The extension of the hedging exemption to new counterparties should also be an opportunity to review and harmonise the application process. As argued in our response to the Call for Evidence, we also believe that ESMA should promote greater coordination in the implementation of hedging exemptions across the EU, including a more harmonised application process for market participants. At present, some NCAs impose quantitative limits on hedging exemptions, unnecessarily increasing the administrative burden for market participants who face greater hedging needs (for instance, due to an increase in the production of the underlying commodity) and are consequently forced to file new applications. We believe that once the hedging needs have been demonstrated, market participants should be granted a hedging exemption without quantitative limits. The robustness of the regime and the supervisory capabilities of the NCAs would be unaffected as NCAs can continue to monitor the use of the exemption on the basis of the daily position reports.
<ESMA_QUESTION_WPR_8>

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.

<ESMA_QUESTION_WPR_9>
EFET believes that the current position management regimes exercised by exchanges are generally adequate. As argued in our response to the Call for Evidence, we continue to believe that trading venues are best placed to determine how to implement position management controls and when it is necessary to trigger them. We view trading venues as the primary gatekeepers of the position limit regime. In our view, trading venues should actively monitor positions and effectively communicate with position holder to ensure the robustness of the regime.
While a one-size-fits-all approach may be difficult to calibrate and may result in unintended consequences, we see merits in establishing a set of measures that would provide a minimum standard with which all trading venues must comply. We agree with ESMA that new Level 2 measures may be the most appropriate instrument to achieve this objective. Given the wide variety of market structures and specificities across different commodity derivative markets, such measures should not be overly prescriptive and should not constrain the ability of a trading venue to implement enhanced controls if deemed necessary.
<ESMA_QUESTION_WPR_9>

Part II

Q10 : Do you agree with the revised proposed minimum threshold level for the open interest criterion for the publication of weekly position reports? If not, please state your preferred alternative for the definition of this threshold and explain why.

<ESMA_QUESTION_WPR_10>
EFET agrees with the revised minimum threshold level proposed by ESMA for the publication of weekly position reports. The publication of more weekly position reports is welcome as long as the confidentiality of trading strategies and other key business decisions continues to be preserved.
<ESMA_QUESTION_WPR_10>

Q11 : Do you have any comment on the current number of position holders required for the publication of weekly position reports?

<ESMA_QUESTION_WPR_11>
EFET believes that the current number of 20 position holders required for the publication of weekly position reports could be reduced (to e.g. 10 position holders) without materially impacting the orderly pricing and orderly settlement of commodity derivative markets.
<ESMA_QUESTION_WPR_11>