European Securities and Markets Authority

Reply Form to the Call for Evidence

Position limits and position management in commodity derivatives

24 May 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 **5 July 2019.**

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 call for evidence on position limits and position management controls in commodity derivatives' also published on the ESMA website.

Instructions

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

1. Insert your responses to the questions in the Call for Evidence in the present response form.
2. Please do not remove tags of the type <ESMA_QUESTION_PLPM_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_PLPM_nameofrespondent_RESPONSEFORM. For example, for a respondent named ABCD, the response form would be entitled ESMA_PLPM_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_PLPM_1>

The European Federation of Energy Traders (EFET) promotes and facilitates European energy trading in open, transparent, sustainable and liquid wholesale markets, unhindered by national borders or other undue obstacles. We currently represent more than 100 energy trading companies, active in over 28 European countries. For more information, visit our website at www.efet.org.

<ESMA_COMMENT_PLPM_1>

Questions

Q1 : 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.

<ESMA_QUESTION_PLPM_1>
EFET members have not identified any major impact on liquidity. The introduction of position limits has not disrupted commodity markets in a major way. However, the introduction of position limits has increased uncertainty in commodity derivative markets and occasionally discouraged market participants from entering into positions. One example of this is the introduction of position limits on the electricity price area differential (EPAD) contracts in the Nordic electricity market. Whilst it is helpful that the Nordic EPADs are treated as one market, the position limit has contributed to the decision of one of the two market makers in this contract to cease its activities.

In general, the lack of clear rules regarding calculation methodologies and the possibility of unexpected changes to the rules increases the risks for market participants and may reduce liquidity or move liquidity to non-EU trading venues.

<ESMA_QUESTION_PLPM_1>

Q2 : 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.

<ESMA_QUESTION_PLPM_2>
EFET members have not identified any structural changes in commodity derivative markets following the introduction of position limits except from the transfer of about 250 contracts from the UK-based trading venue ICE Futures Europe to ICE Futures US. The underlying of these contracts were globally traded oil-related products and market participants included both EU and non-EU firms.

<ESMA_QUESTION_PLPM_2>

Q3 : Do you consider that position limits contribute to the prevention of market abuse in commodity derivatives markets? Please elaborate by differentiating per conduct, per commodity asset classes or contract where relevant and provide evidence to support your assessment when available.

<ESMA_QUESTION_PLPM_3>
Even though article 57.1 (a) of MiFID specifies that one of the objectives of position limits is to prevent market abuse, we consider the Market Abuse Regulation as a more effective and comprehensive tool to prevent market abuse.

<ESMA_QUESTION_PLPM_3>

Q4 : 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.

<ESMA_QUESTION_PLPM_4>
EFET members have not noticed any significant impact of position limits on orderly pricing and orderly settlement in commodity derivative markets, even though the current 18-month experience may be insufficient to draw firm conclusions.
<ESMA_QUESTION_PLPM_4>

Q5 : 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?

<ESMA_QUESTION_PLPM_5>
EFET members believe that, with the exception of the limits applied to new and illiquid contracts, the position limit regime introduced by MiFID II is generally working well. While the implementation of internal controls, monitoring tools and position reporting framework has been burdensome and costly for market participants, its day-to-day functioning has no adverse impact on the liquidity and orderly functioning of commodity derivative markets.

We agree with the view of ESMA that there “could be merits in limiting the application of MiFID II position limits II to a more limited set of important, critical (benchmark) commodity derivative contracts”. Such a refocus of the position limit regime on benchmark contracts would make it more efficient, mitigate non-intended consequences and reduce the compliance burden for all concerned parties (market participants, trading venues, NCAs; see Q13 below). Otherwise, we would recommend no major changes to the overall design of the position limit regime.

As for the new and illiquid contracts, the limits applied under article 15 of RTS for the application of position limits to commodity derivatives (Comm Del. Reg. 2017/591) (so-called RTS 21), even considering the increased flexibility offered to competent authorities under article 19 of RTS 21, are too low and rigid. In certain cases, they prevent the development of the market for these new contracts. Hence market participants need to enter into imperfect proxy-hedges or trade other products bilaterally in order to not breach the position limits. Additionally, this lack of flexibility can incentivise trading venues to locate these contracts outside of the European Union and create competitive barriers to trading venues seeking to offer products for which another liquid trading venue already exists (see also our response under Q18).
<ESMA_QUESTION_PLPM_5>

Q6 : 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.

<ESMA_QUESTION_PLPM_6>
EFET members did not notice any significant impact on liquidity of commodity derivative markets.

<ESMA_QUESTION_PLPM_6>

Q7 : 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.

<ESMA_QUESTION_PLPM_7>
As argued in Q3 above, we believe there are better tools to prevent market abuse as position limits are effective to prevent only certain types of market abuse.
<ESMA_QUESTION_PLPM_7>

Q8 : 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.

<ESMA_QUESTION_PLPM_8>
EFET members believe that position management controls play a positive role in determining orderly pricing and settlement conditions, even though by their nature they are deemed to be used only in exceptional circumstances. We believe exchanges are best placed to determine how to implement position management controls and when it is necessary to trigger them.

<ESMA_QUESTION_PLPM_8>

Q9 : If you are a commodity derivative trading venue, please explain how you 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?

<ESMA_QUESTION_PLPM_9>
N/A
<ESMA_QUESTION_PLPM_9>

Q10 : Do you have any general comment on the position limit regime and associated position reporting introduced by MiFID II?

<ESMA_QUESTION_PLPM_10>
As argued in Q5 above, EFET members believe that, with the exception of the limits applied to new and illiquid contracts, the position limit regime introduced by MiFID II is generally working well. We only recommend a refocus of the way the rules are applied rather than an overhaul of the system after such a short period of time.

However, we note that there is no centralised tool or source available to access all the position limits set by the various trading venues on which they are active. As a result, it is operationally challenging to monitor all limits and changes, so market participants would welcome action from ESMA to ease this burden by either publishing an aggregate up-to-date list of all limits it has approved as well as the limits for which ESMA approval is pending and/or requiring NCAs to publish their limits in a standard exportable format.

<ESMA_QUESTION_PLPM_10>

Q11 : 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?

<ESMA_QUESTION_PLPM_11>
EFET members do not expect Brexit to have any direct impact on the position limit regime.

However, we observe Brexit will have two main impacts on commodity derivative markets, notably:

1) As noted by ESMA in paragraph 14 of this Call for Evidence, the liquidity in many commodity derivatives (namely oil, coal and metal) is concentrated on UK trading venues, with very low levels of activity in the EU27. This will have significant consequences on the market size test governing the ancillary activity exemption for own-account traders in commodity derivatives and emission allowances. While this may take time to impact market participants (as the calculation is a three-year average and activities in the UK will be included until at least 31 October 2019), we urge ESMA to start to consider solutions, including the increase of the threshold for these asset classes or a redesign of the test in Level 2 legislation.

The lack of recognition of UK exchanges as equivalent under EMIR would put EU27 NFCs at a disadvantage as their activity on UK exchanges would count towards the so-called EMIR clearing threshold and may cause some of them to breach it.
<ESMA_QUESTION_PLPM_11>

Q12 : 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.

<ESMA_QUESTION_PLPM_12>
EFET members believe that the application of position limits to a large number of contracts is redundant and argued for a more focused scope of application before the entry into force of MiFID II.
<ESMA_QUESTION_PLPM_12>

Q13 : 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?

<ESMA_QUESTION_PLPM_13>
EFET agrees with the view of ESMA that there “could be merits in limiting the application of MiFID II position limits II to a more limited set of important, critical commodity derivative contracts.” The reason is that the position limit regime must be sufficiently flexible and not create an overly cumbersome process for the setting of any limits. As part of this, the scope of contracts that need to be subject to limits should also be looked at as well as how to ensure

emerging liquidity is not damaged Otherwise, we would recommend no changes to the system after such a short period of time.

This refocus would make the system more efficient, mitigate non-intended consequences and reduce the compliance burden for all concerned parties (market participants, trading venues, NCAs/ESMA). Most importantly, such an approach would avoid stifling the development of new and illiquid products. Furthermore, a refocus of the systems is justified as the 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.

The other (non-significant) contracts would remain subject to the current position management of exchanges and, therefore, remain subject to appropriate position monitoring and management measures by exchanges.
<ESMA_QUESTION_PLPM_13>

Q14 : More specifically, are you facing any issue with the application of position limits to securitised derivatives? If so, please elaborate.

<ESMA_QUESTION_PLPM_14>
No comment.
<ESMA_QUESTION_PLPM_14>

Q15 : Do you consider that there would be merits in reviewing the definition of EEOTC contracts? If so, please explain the changes you would suggest.

<ESMA_QUESTION_PLPM_15>
EFET supports the existing EEOTC definition and sees no merit in reconsidering it. A change of the definition could lead to substantial consequences for market participants, trading venues and NCAs, as it is likely to require significant IT investment across the industry. As a matter of further clarification for market participants, we suggest EEOTC should not be included in position reports unless NCA explicitly determines the type of contracts that should be included, for example on the basis of EMIR reporting.

<ESMA_QUESTION_PLPM_15>

Q16 : 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.

<ESMA_QUESTION_PLPM_16>
EFET urges ESMA to promote greater coordination in the implementation of and application for exemptions from position limits across the Union.

Currently non-financial firms (NFC) can apply for a hedging-exemption from position limits for commodity contracts traded at exchanges that they use to reduce their commodity price risk, e.g. volatile power production. Some NCAs impose quantitative limits to this hedging exemption, causing unnecessary administrative burden. This is because NFCs must then apply for a new hedge exemption every time they breach the set limit if they for example have a larger hedging need because of their increased power production. Therefore, we believe that firms should be granted a hedging exemption without the imposition of a quantitative limit to this exemption and that such approach should be harmonised amongst NCAs. Quantitative limits create unnecessary administrative burden. The robustness of the regime and the supervisory capabilities of NCAs would be unaffected as NCAs can monitor the use of the exemption on the basis of the daily position reports.

Moreover, ESMA should give consideration to the proposal to also allow financial firms to benefit from an exemption for positions entered into to objectively reduce the commercial risk of the position holder or their clients. Investment firms / banks, whilst dealing on own account, play a vital role in commodity market as they provide smaller commercial players with access to derivatives markets. Additionally, within some industrial energy groups, a MiFID II authorised investment firm may act as a market-facing entity for the whole Group and manage the positions (including the risk-reducing ones) of non-financial group entities.
<ESMA_QUESTION_PLPM_16>

Q17 : 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.

<ESMA_QUESTION_PLPM_17>
EFET members generally 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 a higher or lower percentage on the basis of a number of intervening factors. In our view, deliverable supply is the appropriate basis for setting limits for commodity derivatives contracts given its strong connection with the underlying physical markets.
However, it would be beneficial to harmonise the definition of spot month for each commodity across different trading venues, so that market participants face a clear set of rules and limits to comply with.

<ESMA_QUESTION_PLPM_17>

Q18 : Would you see benefits to review the approach for setting position limits for new and illiquid contracts? If so, what would you suggest?

<ESMA_QUESTION_PLPM_18>
We do see benefits in reviewing the approach for setting position limits for new and illiquid contracts.

Under article 15 of RTS 21, ESMA has established a specific regime for new and illiquid contracts for the purpose of calculations of position limits. It states that new contracts traded on a trading venue with a total combined interest in spot and other months not exceeding 10,000 lots over a consecutive three-month period shall be set a limit of 2,500 lots.

Some NCAs have interpreted this requirement under Article 15 of RTS 21 to mean that on day 1 of a new commodity derivative, a limit of 2,500 lots would apply. In some instances, such a limit is too restrictive to allow a new contract to develop into a liquid instrument.

Existing derogations for illiquid markets which have an open interest between 5,000 and 10,000 lots under the ESMA Q&As are welcome and should be applied by NCAs (article 19 of RTS 21). However, they are often not sufficient to mitigate the negative impact of disproportionately low position limits. Fast growing markets, in particular, have suffered from (1) an increasingly restrictive limit as open interest increases, (2) an inflexible treatment in terms of their categorisation under the position limits framework and (3) an inaccurate reflection of the underlying physical markets.

In particular, once a market participant approaches the position limit, it is likely to withdraw from the market and switch to another trading venue outside of the MiFID II regime, leaving the NCA no time to adjust the limit upwards. To not unintendedly breach the limit, market participants might also be obliged to take recourse to imperfect proxy hedging or bilateral trading of a similar product. 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, making a limit of 50% (which is the maximum allowed by the existing derogations) not sufficient to allow the market to further develop. For instance, if there are only two market participants in a new contract, then they each hold a position of 100% of the net open interest.

As argued in Q13, EFET believes there could be merits in limiting the application of MiFID II position limits II to a more limited set of important, critical commodity derivative contracts. If this change is implemented, no limit will apply to new and illiquid contracts and the issues described above will be solved.

In case position limits remain applicable to all commodity derivative contracts, RTS 21 should be revised to suspend position limits applicable to new and illiquid markets along with a review period for these contracts (3 months, 6 months, 9 months, depending on the contract). This would allow the concerned NCA to review the development of the contract and determine a position limit appropriately calibrated regarding the needs of the market. This is supported by the policy objective of the MiFID II as expressed in RTS 21 which provides that “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.”

New and nascent products normally constitute a minor share of commodity markets. Moreover, such contracts are unlikely to influence price movements in the underlying physical commodity markets that could negatively impact consumers. Thus, the suspension of position limits for such contracts would not pose any risk to the transparency and functioning thereof. On the contrary, attracting more volume to regulated venues would contribute to a more transparent trading environment subject to the full scope of the Market Abuse Regulation. At the same time, new and illiquid markets with suspended limits 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 Article 58.
<ESMA_QUESTION_PLPM_18>

Q19 : 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.

<ESMA_QUESTION_PLPM_19>
As argued in Q17, EFET members do not see the need for changes in the existing methodologies. Regulators are already given sufficient flexibility to set limits as a percentage of deliverable supply or open interest, using a higher or lower percentage on the basis of a number of intervening factors.

<ESMA_QUESTION_PLPM_19>

Q20 : 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?

<ESMA_QUESTION_PLPM_20>
EFET is concerned about the unequal level playing field arising from different open interest (OI) calculation methodologies for the purpose of determining the baseline figure for the other month position limits. Position limits based on an OI calculation methodology whereby positions are netted will result in a significantly lower position limits than an OI calculation methodology based on gross position data. Therefore, EFET members believe that ESMA and the NCAs should ensure that the same methodology to calculate open interest is applied for the purpose of setting position limits across the Union. This would allow all venues and market participants to operate in a fair and competitive landscape where the position limit regime is not creating an unequal level playing field.

We support the use of **gross** open interest as the most appropriate methodology considering that the usage of net open interest to determine the other month position limit would be inappropriate as it does not properly reflect trading on behalf of clients. Although it is a common practice in the industry to calculate open interest on a net basis, we believe that for the specific purpose of calculating position limits under RTS 21 a gross methodology would be more appropriate. For example, if a member holds 5 lots long for client A and 5 lots short for client B, this position should not be netted, as the positions belong to different beneficial owners.
<ESMA_QUESTION_PLPM_20>

Q21 : How useful do you consider the information on position management controls available on ESMA's website?

<ESMA_QUESTION_PLPM_21>
No comment.
<ESMA_QUESTION_PLPM_21>

Q22 : 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.

<ESMA_QUESTION_PLPM_22>
No comment.
<ESMA_QUESTION_PLPM_22>