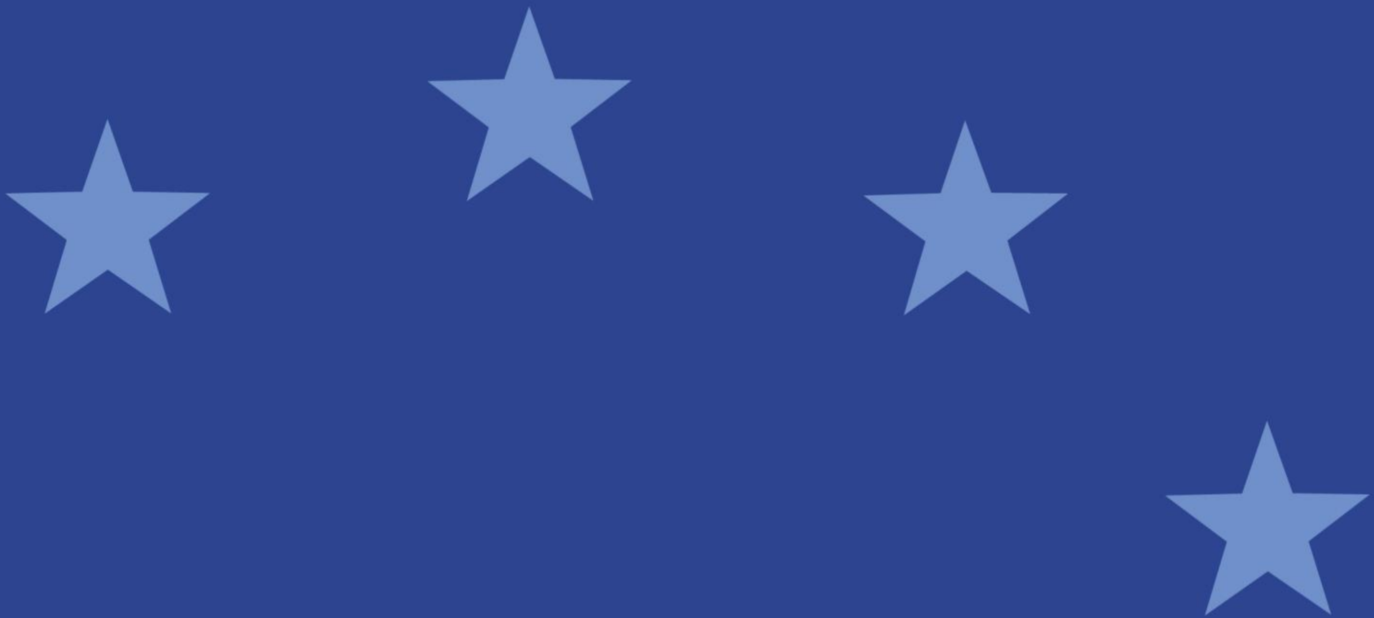
Consultation Paper

MiFID II review report on position limits and position management

Draft Technical Advice on weekly position reports



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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:

1. respond to the question stated;
2. indicate the specific question to which the comment relates;
3. contain a clear rationale; and
4. 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 – Consultation Paper on the impact of position limits and position management and on weekly position reports'.

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 publicly 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

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.

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Acronyms used

CA	Competent Authority
CFTC	Commodity Futures Trading Commission
COT	Commitment of Traders
CP	Consultation Paper
EEOTC	Economically Equivalent OTC Contracts
ESMA	European Securities and Markets Authority
EC	European Commission
EU	European Union
MAR	Regulation (EU) No596/2014 of the European Parliament and the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC and Directives 2003/124/EC, 2003/125/EC and 2004/72/EC
MiFID I	Directive 2004/39 of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directive 85/611/EC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC
MiFID II	Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (OJ L 173, 12.6.2014, p. 349)
MiFIR	Regulation (EU) No 600/2014 of the European Parliament and of the Council on markets in financial instruments and amending Regulation (EU) No 648/2012 (OJ L 173, 12.6.2014, p. 84)
MTF	Multilateral Trading Facility
NFC	Non-Financial Counterparties
OTC	Over-The-Counter
OTF	Organised Trading Facility
REMIT	Regulation (EU) No 1227/2011of the European parliament and of the Council of 25 October 2011 on wholesale energy market integrity and transparency
RTS	Regulatory Technical Standard
RTS 21	Commission Delegated Regulation (EU) 2017/591 of 1 December 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards for the application of position limits to commodity derivatives

1 Executive Summary

Reasons for publication

Under Article 90(1) of MiFID II, "Before 3 March 2020, the Commission shall, after consulting ESMA, present a report to the European Parliament and the Council on […] (f) the impact of the application of position limits and position management on liquidity, market abuse and orderly pricing and settlement conditions in commodity derivatives markets; […]."

Based on a revised timeline agreed with the European Commission (EC), ESMA will be delivering its advice to the Commission's report on the impact of position limits and position management on commodity derivatives markets by 31 March 2020. Drawing on the responses received to the call for evidence published on 24 May 2019, this Consultation Paper (CP) provides an initial assessment of the impact of position limits and position management on commodity derivatives markets and seeks stakeholders' views on the amendments proposed by ESMA to the existing regime.

This CP also seeks views and input from stakeholders on ESMA's proposal to revise the Technical Advice provided to the EC on the delegated acts to be adopted under Article 58(6) of MiFID II on position reporting by categories of position holders. More specifically, ESMA suggests revising the minimum number and size of open positions to be met by commodity derivatives, emission allowances and derivatives thereof to be subject to weekly position reports by the relevant trading venue.

Contents

In the first part of the CP, Section 3 provides a summary of the position limit regime under MiFID II and a preliminary assessment of the impact of position limits on market abuse, orderly pricing and settlement conditions and liquidity in commodity derivatives markets. Section 4 considers the impact of position management controls on commodity derivatives markets. Section 5 sets out ESMA's proposed amendments to the Level 1 text.

In the second part of the CP, Section 6 explains the background to the new Technical Advice on weekly position reports and Section 7 sets out ESMA's proposal.

Next Steps

ESMA will consider the feedback it receives to this CP and expects to deliver a final report to the European Commission by end of March 2020.

PART I: MiFID II Review report on the application of position limits and position management controls

2 Introduction

5. In response to the 2009 Pittsburgh G20 summit's agreement to improve the regulation, functioning and transparency of financial and commodity derivative markets and the 2011 Cannes G20 summit's call for market regulators to have formal position management powers, MiFID II introduced a new set of provisions governing trading in commodity derivative markets. Those commodity derivative provisions are one of the key changes in MiFID II compared to MiFID I.

6. In addition to pre-trade and post-trade transparency as well as transaction reporting requirements, MiFID II introduces a position limit, a position reporting and a position management regime for commodity derivatives. As it is common for newly introduced provisions, under Article 90(1)(f) of MiFID II the co-legislators have asked the Commission, after consulting ESMA, to present a report to the European Parliament and to the Council on "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".

7. In order to form a more exhaustive and informed view of the issues to be considered and addressed in its report to the Commission, ESMA first issued a call for evidence on 24 May 2019 inviting stakeholders to share their experience with the application of the MiFID II position limit and position management provisions, explain how trading in commodity derivatives may have been impacted, either positively or negatively, by this new regime and provide thoughts for potential amendments. ESMA received 21 public responses and 5 confidential responses to the call for evidence.

8. This CP seeks stakeholders' views on ESMA's proposed amendments to the legal texts. The CP takes into account the responses received to the call for evidence and provides a high-level summary of the feedback received in Annex II.

9. Section 3 of this CP provides a preliminary assessment of the potential impact of position limits on market abuse, orderly pricing and settlement conditions and liquidity in commodity derivatives markets. Section 4 considers the impact of position management controls thereon. Finally, Section 5 sets out the amendments proposed by ESMA to Articles 57 and 58 of MiFID II.

10. Based on the responses and feedback received to this CP, ESMA will prepare the final review report for submission to the Commission. The Commission, pursuant to its better regulation principles[1], will conduct an impact assessment in line with evidence-based policy

[1] https://ec.europa.eu/commission/news/better-regulation-principles-2019-apr-15_en

making. Therefore, respondents to this consultation are encouraged to provide the relevant information, in particular quantitative data, to support their arguments or proposals. This quantitative data should allow for a proper assessment of the materiality of the issues for the respective market participants and an appraisal of the potential impacts of the proposed changes to the legal texts.

3 MiFID II Position limits

3.1 The MiFID II Position limit regime

11. Under Article 57(1) of MiFID II, Competent Authorities (CAs) have to establish and apply position limits on the size of a net position which a person can hold at all times in commodity derivatives traded on trading venues and in economically equivalent OTC (EEOTC) contracts. The limits apply to all positions held by a person and those held on its behalf at an aggregate group level.

12. The position limits must be set so as to prevent market abuse and support orderly pricing and settlement conditions, including preventing market distorting positions, and ensuring, in particular, convergence between prices of derivatives in the delivery month and spot prices for the underlying commodity, without prejudice to price discovery on the market for the underlying commodity.

13. Position limits do not apply to positions held by, or on behalf of, non-financial entities and which are objectively measurable as reducing risk directly related to the commercial activity of that non-financial entity where that non-financial entity has applied for an exemption in accordance with Article 8 of RTS 21.

14. Position limits apply to all commodity derivatives traded on a trading venue, whatever the underlying commodity and whether the derivative contract is physically-settled or cash-settled. Position limits also apply to securitised derivatives which relate to a commodity or an underlying referred to in Section C(10) of Annex I of MiFID II. As regards derivatives based on C(10) underlyings, ESMA clarified in its Q&As on MiFID II commodity derivatives topics that position limits should only apply to freight rate derivatives (wet and dry freight) and to derivative contracts relating to indices if the underlying index is materially based on commodity underlyings. ESMA considers that the underlying index is materially based on commodities if such commodities have a weighting of more than 50% in the composition of the underlying index.[2]

[2] https://www.esma.europa.eu/sites/default/files/library/esma70-872942901-36_qas_commodity_derivatives.pdf

Definition of commodity derivatives

MIFIR

Article 2(1)(30): commodity derivatives' means those financial instruments defined in point (44)(c) of Article 4(1) of Directive 2014/65/EU; which relate to a commodity or an underlying referred to in Section C(10) of Annex I to Directive 2014/65/EU; or in points (5), (6), (7) and (10) of Section C of Annex I thereto;

MiFID II

Article 4(1)(44)(c): any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures

Annex I Section C

[…]

(5) Options, futures, swaps, forwards and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event;

(6) Options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market, a MTF, or an OTF, except for wholesale energy products traded on an OTF that must be physically settled;

(7) Options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in point 6 of this Section and not being for commercial purposes, which have the characteristics of other derivative financial instruments;

[…]

(10) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event, as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this Section, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market, OTF, or an MTF;

[…].

15. Position limits do not apply to physically-settled wholesale energy products traded on an Organised Traded Facility (OTF). Under Annex I, Section C(6) of MiFID II, those products do not qualify as financial instruments and therefore are outside the scope of MiFID II. Wholesale energy products are defined by reference to Article 2(4) of REMIT, which refers to "[…] derivatives related to electricity or natural gas produced, traded or delivered in the Union […]."

16. The position limits set by the CA for the spot month and the other months have to comply with the methodology set out in RTS 21. Whilst Article 57(3) of MiFID II provides a list of factors to be taken into account by CAs when setting the position limits, RTS 21 further clarifies how those factors may be used by CAs to adjust the position limit upwards or downwards compared to a set baseline. RTS 21 also provides for default or "*de minimis*" position limits for new and illiquid contracts that do not reach a minimum level of open interest over a consecutive three-month period.

17. CAs must notify ESMA of the position limits they intend to set for derivative contracts, except for derivative contracts with de minimis position limits under RTS 21, and ESMA must issue an opinion assessing the compatibility of the position limits with the objective of preventing market abuse and supporting orderly pricing and settlement conditions and with the methodology established in RTS 21. As of 30 September 2019, ESMA has issued 43 opinions.

3.2 The impact of position limits on market abuse

18. Under Article 57(1) of MiFID II, one of the objectives to be met by the position limits set by the relevant CA is to "prevent market abuse."

19. Under the Market Abuse Regulation (MAR), the definition of market abuse comprises practices such as insider dealing, unlawful disclosure of inside information and market manipulation.

20. In general, a position reporting regime may help to identify the build-up of a concentration of positions, which in turn could indicate market abuse. Position limits may cap the financial gain a market participant could potentially make when unlawfully taking advantage of inside information or when manipulating the market in a commodity derivative contract, thereby rendering such abusive practices less attractive. However, that rather appears as an indirect potential consequence of the position limits set than a means of preventing market abuse in its own right.

21. More specifically in relation to market manipulation, Article 12(1) of MAR stipulates that market abuse "shall comprise […]

    a) entering into a transaction, placing an order to trade or any other behaviour which

i) gives, or is likely to give, false or misleading signals as to the supply of, demand for, or price of, a financial instrument, a related spot commodity contract […]; or

ii) secures or is likely to secure the price of one or more financial instruments, a related spot commodity contract […] at an abnormal or artificial level",

b) entering into a transaction, placing an order to trade or any other activity or behaviour which affects or is likely to affect the price of one or several financial instruments, a related spot commodity contract […] which employs a fictitious device or any other form of deception or contrivance;"

22. Whereas some characteristics of a commodity derivative contract, such as whether the derivative is cash-settled or physically-settled, whether the index used for settlement is a reliable one or whether the deliverable supply in the underlying commodity can be restricted or controlled, contribute to making the contract more or less readily susceptible to manipulation, the extent to which position limits contribute to preventing market abuse appears less apparent.

23. Most respondents to the call for evidence were of the view that position limits have no role, or if any, a very limited one, with regard to the prevention of market abuse, noting in particular that a large open position is not per se evidence of market abuse and that market abuse can also be committed with a small open position. Some respondents further stressed that properly addressing market abuse requires transaction monitoring as well as an overall approach of monitoring a combination of the underlying physical commodity market, on-venue derivative markets and associated OTC trading, whereas position limits under MiFID II mainly apply to on-venue trading. According to some stakeholders, position limits would only contribute to market integrity by preventing a market squeeze, i.e. for physically-settled contract where there is a finite supply of the underlying commodity available for delivery that a market participant can take control of, and for a limited period, immediately prior to maturity.

24. Some trading venues mentioned the role of their market monitoring and surveillance systems in the prevention of market abuse, including before the introduction of position limits in MiFID II. Some respondents considered that MAR and REMIT are more effective and comprehensive tools for addressing market abuse than position limits.

25. ESMA is of the view that position limits can contribute to the prevention of market abuse by limiting the ability of financial counterparties to make use of a dominant position to secure the price of a commodity derivative or of the underlying commodity at an artificial level. ESMA also notes that the ability for a market participant to corner the market and manipulate the price of the underlying commodity through a dominant position in the related commodity derivatives would be less likely to materialise where the overall volume of trading in a commodity derivative accounts for only a portion of trading in the underlying spot market.

26. Beyond the specific risk of a market squeeze and cornering mentioned above, ESMA generally agrees with respondents that position limits on their own have little impact on market integrity but they are a valuable tool for the specific risks mentioned.

27. ESMA is also of the view that position reporting is a valuable tool for monitoring by CAs. Where a potential misconduct is identified through the market monitoring and surveillance tools used by CAs, position reporting data is available to the market surveillance and oversight teams and, combined with other data sources, allows to better identify, and sanction, market manipulation.

28. Furthermore, commodity derivatives are captured by transaction reporting, which can detect potential market abuses that may take place during trading hours and are more difficult to identify with end-of-day position reporting. Therefore, the combination of position and transaction reporting can facilitate the identification of potential abuses by CAs.

3.3 The impact of position limits on orderly pricing and settlement conditions

29. Under point (b) of Article 57(1), position limits must be set in order to support "orderly pricing and settlement conditions, including preventing market distorting positions, and ensuring, in particular, convergence between prices of derivatives in the delivery months and spot prices for the underlying commodity, without prejudice to price discovery on the market for the underlying commodity".

30. As stated in the 2011 IOSCO Principles for the Regulation and Supervision of Commodity Derivatives Markets[3], "With respect to derivatives markets, an orderly market may be characterised by, among other things, parameters such as a rational relationship between consecutive prices, a strong correlation between price changes and the volume of trades, accurate relationships between the price of a derivative and the underlying commodity and reasonable spreads between near and far dated contracts. Numerous conditions can negatively affect trading and the characteristics of an orderly market, […] including unmanaged imbalance between long and short positions resulting from large concentrated positions."

31. Position limits are a means to address the potential for large positions in commodity futures and options markets to prejudice orderly market functioning. This is because the capacity of a market to absorb the establishment and liquidation of large positions in an orderly manner is related to the size of such positions relative to the market.

32. Spot month positions limits, in particular, are important to support orderly pricing and settlement conditions. As further explained in Recital (11) of RTS 21 with regard to the spot month limit, "Restricting the positions a person may hold in the period during which the

[3] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD358.pdf

physical delivery is to be made limits the quantity of the underlying deliverable supply each person may make or take delivery of, thereby preventing the accumulation of dominant positions by individuals, which may enable them to squeeze the market through restricting access to the commodity". Recital (11) of RTS 21 also clarifies that CAs have the possibility "to implement a schedule of decreasing position limits ranging from the point in time when a contract becomes a spot month contract until maturity in order to more precisely ensure that position limits are adequately set throughout the spot month period and to ensure orderly settlement".

33. When reviewing the position limits submitted by CAs, ESMA however noted that only one CA made use of decreasing or gliding-path position limits throughout the spot month for agricultural commodity derivatives with one limit applying for the first part of the spot month and a reduced one applying during the last 12 days of the spot month. Another CA did not set different limits across the spot month but is relying on the more stringent position limit set by the trading venue for some contracts as part of its position management powers for the period immediately preceding delivery to ensure orderly pricing and settlement conditions.

34. ESMA also notes that under the methodology set out in RTS 21, and with the exception of securitised commodity derivatives, the spot month limit is based on available deliverable supply for the underlying commodity. Where there is a significant difference between deliverable supply and open interest in the spot month for a specific contract, even a spot month limit set at the lowest possible percentage of the deliverable supply (5%) may remain far above the spot month open interest and does not have any impact on orderly pricing and settlement conditions. On the contrary, it may also be argued that when deliverable supply is significantly higher than open interest during the spot month, there is no need to restrict trading to address potential risks to orderly pricing and settlement conditions when the contract approaches expiration.

35. Finally, and as recalled earlier, MiFID II position limits apply equally to physically-settled and cash-settled contracts. Whilst, depending on the characteristics of the contract and the underlying market, potential risks to orderly pricing and settlement conditions may become all the more significant when a physically-settled contract is coming close to expiry, risks also exist for cash-settled contracts where the position holder would have the capacity to influence the price of the underlying. Spot month limits may then reduce the incentive, and potential benefit, to do so.

36. A limited number of stakeholders expressed views on the impact of position limits on orderly pricing and settlement conditions. Most of them considered that the MiFID II position limit regime did not have an impact on orderly pricing and settlement conditions, albeit for different reasons. Some respondents highlighted that the objective of ensuring orderly pricing and settlement conditions had already been achieved by the exchanges' pre-existing position management controls as well as their market oversight systems.

37. According to one trading venue, open positions have little impact on trading activities and play therefore a minor role in orderly pricing and settlement conditions. The settlement

price is based on order prices, trade prices or fair value and is entirely independent of members' positions. Hence position limits do not have a positive impact on the settlement of a contract. According to this respondent, position limits may even have a negative impact on orderly pricing by limiting market participants' ability to trade. A similar concern on the negative impact of position limits on price formation was expressed by another trading venue, which however sees some value in spot month limits for ensuring convergence between the prices of derivatives in the delivery month and spot prices for the underlying commodity.

38. ESMA agrees with the view expressed by one respondent that position limits deliver most benefits during the spot month when it comes to supporting orderly pricing and settlement conditions. ESMA further notes that, although the settlement price of a commodity derivative does not result from members' positions, the size of members' positions around maturity can indeed have an impact on the orderly settlement of a commodity derivative and should therefore be monitored by trading venues, together with orders and transactions as part of position management controls.

39. ESMA also agrees that improperly calibrated position limits may potentially impact the interaction between supply and demand and thereby, affect price discovery. However, ESMA is not aware that this has been the case for any of the bespoke limits set by CAs. As regards de minimis or default limits, ESMA understands that they raise broader issues which are discussed in Section 5.

3.4 The impact of position limits on liquidity

40. Based on the data gathering exercise ESMA conducted to update its Opinion on Ancillary Activity Calculations in May 2019, ESMA notes that trading volumes in commodity derivatives on EU trading venues have increased in almost all commodity derivatives asset classes in 2018 compared to 2017[4].

41. The increase in EU trading volumes has been more significant in gas, power and emission allowances whereas trading in agricultural derivatives and C(10) derivatives slightly decreased. With Brexit in mind, it is worth noting that there is still no trading in metal, oil and coal contracts taking place on EU27 trading venues or only in minimal volumes. In all commodity derivatives asset classes except power and C(10) derivatives, on-venue trading concentrates on UK trading venues.

42. The call for evidence invited stakeholders to express views on the impact of position limits on the liquidity and availability of liquidity in commodity derivatives markets.

[4] https://www.esma.europa.eu/sites/default/files/library/esma70-156-478_opinion_on_market_size_calculation.pdf

3.4.1 Structural impact on liquidity and availability

43. Some respondents noted that shortly before the entry into force of MiFID II, one major EU venue decided to transfer a sizable number of contracts to its US affiliates. In their view, this choice was driven by the narrower scope of the US position limit regime, which applies only to agricultural contracts, and by the fact that trading activity on third country venues does not count towards the ancillary activity test.

44. ESMA is aware that the introduction of the MiFID II position limit regime might have led some market participants to reconsider their commodity derivative trading strategies. However, ESMA notes that a similar conclusion could be drawn for most of the new provisions and requirements introduced by MiFID II.

45. For some respondents, the application start date of the MiFID II position limit regime has resulted in an increase in OTC commodity derivatives trading, which is seen by market participants as less burdensome and outside the scope of position limits and position reporting. Other trading venues commented that after the entry into force of MiFID II, they failed to attract clients to trade new commodity derivatives and commodity index derivatives or even noticed a reduction in their client base. In their view, such outcome cannot be deemed in line with MiFID II objective to promote on-venue trading.

46. However, as mentioned above and in contrast with some of the responses received, ESMA notes that overall trading volumes in commodity derivatives on EU trading venues have increased in almost all commodity derivatives asset classes in 2018 compared to 2017. OTC trading in gas derivative contracts, and to a lesser extent in coal derivative contracts, has indeed increased but on-venue trading shows a similar increase.

47. ESMA further notes that to avoid circumvention of the regime, MiFID II sets out that position limits apply to EEOTC contracts. The move from on-venue to OTC trading, combined with the very few EEOTC contracts identified, could therefore be an indication that the EEOTC concept and definition did not deliver on their objective and would need to be reviewed. However, trading venues concerned about increased OTC trading did not appear consistent in their responses as they did not support such review of the EEOTC definition.

48. A couple of respondents mentioned that several physically-settled wholesale energy contracts previously traded on regulated markets and MTFs were now traded on OTFs. They considered this shift of trading to OTFs to be a consequence of the so-called C(6) carve-out in MiFID II and the exclusion of physically-settled wholesale energy contracts from the scope of financial instruments, hence from the scope of the position limit regime.

49. One trading venue stressed that the position limit regime, as currently structured, provides an additional competitive advantage to the already most liquid market trading derivatives on a specific underlying. As the other months' limit is based on open interest, the most liquid market benefits from the highest limit and the less liquid venues with a lower limit fail to attract additional liquidity.

50. With regard to securitised derivatives, one respondent noted that some issuers are now limiting their issuance size to 2.5 million securities. This is the consequence of Article 15(1)(c) of RTS 21 setting the limit applicable to securitised derivatives to 2.5 million securities where the total number of securities in issue does not exceed 10 million, and of ESMA Q&A clarifying that no position report is needed for issuance sizes below 2.5 million securities as the limit could then never been exceeded.

51. ESMA's proposed responses to those set of comments are discussed in Section 5.

3.4.2 Other impacts on liquidity in commodity derivatives markets

52. Setting aside the structural changes mentioned above, most respondents considered that position limits had no impact, or no negative impact on well-developed, "benchmark" contracts. More detailed responses are available in Annex II.

53. By contrast, most of them expressed concerns on the negative impact of the position limit regime on new and illiquid contracts. Respondents noted, in particular, that the current de minimis threshold of 2,500 lots for those contracts with a total combined open interest not exceeding 10,000 lots, is too restrictive especially when the open interest in such contracts approaches the threshold of 10,000 lots. The Q&A published by ESMA clarifying that the conditions under which Article 19(2) of RTS 21 could be used for setting limits for new and illiquid contracts was deemed useful but insufficient to deal with the issue.

54. Respondents highlighted that there is typically a small number of rather large counterparties trading new contracts before a broader set of participants seeking liquidity potentially joins. Due to overly restrictive limits, participants are often forced to reduce their positions, which results in a reduction of the overall open interest and ultimately impacts the growth of the contract and the move to bespoke limits.

55. Furthermore, some respondents noted that the lack of an exemption for financial counterparties providing liquidity to non-financial counterparties' (NFCs) hedging transactions proves especially challenging in illiquid markets often characterised by one player (or a very limited number of players) acting as market maker/liquidity provider. Some market participants have indeed ceased to provide liquidity in new and illiquid contracts for fear of breaching the limit.

56. Finally, some stakeholders stressed that position limits for new and illiquid contracts are particularly ill-suited for contracts with high-volatility or contracts with a fast-growing open interest where further growth is hampered by the time needed by the CA to move from a de minimis to a bespoke limit.

3.4.3 Suggestions made by respondents to address concerns

57. To address the concerns identified above, respondents made some suggestions that focussed on reducing the scope of commodity derivatives subject to position limits and introducing some exemption for financial counterparties.

3.4.3.1 A smaller set of commodity derivatives subject to position limits

58. Most stakeholders strongly supported reducing the scope of the position limit regime. Given the limited contribution of position limits to the prevention of market abuse and orderly pricing and settlement conditions, many respondents suggested applying position limits only to contracts where position limits can play a valuable role. This would be the case for well-developed key benchmarks contracts where price formation takes place and that have a role in the pricing of the underlying commodity and other commodity derivatives. According to respondents, benchmark contracts are characterised by a large number of different types of active trading firms and an overall substantial amount of open interest.

59. Furthermore, many respondents recommended applying position limits where the risk of potential market abuse is more significant, i.e. to physically-settled contracts where the underlying physical market is restricted to a finite supply with a related risk of a market squeeze. For that same reason, some respondents also considered that position limits should only apply to the spot month or even just during the time period immediately preceding expiry, and not throughout the curve. Respondents noted that a position limit regime applying to a more limited set of commodity derivatives for a shorter time period would provide a level-playing field between the US and the EU and reduce the compliance burden for all parties concerned.

60. A couple of respondents made more specific remarks regarding index-based commodity derivatives. They considered that there was no point in applying position limits to commodity derivatives based on broad-based indices as their individual components are already under the position limit regime of the venue where they are traded and where the index reflects a broad range of underlying commodities, thereby making it less susceptible to manipulation.

61. Some respondents clarified that non-benchmark contracts would continue to be subject to position reporting, position management controls and market oversight by exchanges in compliance with MAR and REMIT, thereby limiting the potential risk to fair and orderly markets.

62. As an alternative to, or pending the Level 1 change needed to reduce the scope of position limits to benchmark contracts, some respondents suggested addressing the more pressing concerns on the negative impact of position limits on new and illiquid contracts by applying position limits only to contracts with an open interest exceeding 20,000 lots over a three-month period or providing more flexibility to CAs for setting limits, including the discretion for not setting any limit at all, for new or illiquid contracts.

3.4.3.2 Exemptions for financial counterparties

63. In order for liquidity providers to be able to fully play their role and respond to the hedging needs of their clients, many respondents suggested introducing a position limit exemption for financial counterparties providing liquidity to NFCs, including when NFCs are trading under the hedging exemptions.

64. Some other respondents focussed on the need to introduce a hedging exemption for financial counterparties conducting documented hedging activities, either in relation to their own activities in the underlying physical market or in relation to a position taken in the OTC or in the underlying market in response to a client's request. A suggestion was also made to allow a financial counterparty in a predominantly commercial group to be exempted from position limits when conducting risk-reducing transactions on behalf of the group.

65. Two respondents to the call for evidence were of the view that there was no need to amend the hedging exemption.

66. ESMA appreciates that the very broad scope of the MiFID II position limit regime may not accommodate the characteristics of all commodity derivatives markets, including new and illiquid ones and suggests addressing some of the concerns expressed by stakeholders in the proposals set out in Section 5.

3.4.4 Impact of Brexit

67. The landscape of EU commodity derivative trading is expected to change significantly upon the UK leaving the EU as some commodity derivative asset classes may no longer be traded on EU venues, or only marginal trading may remain in the EU27. Many respondents to the call for evidence stressed the impact of Brexit on the ancillary activity test and more specifically on the market size test that takes into account the EU overall trading activity per asset class. This would entail more entities potentially being considered as financial counterparties and thereby no longer being eligible to the hedging exemption. Respondents made various suggestions to address this drawback, such as continuing to include UK data in the EU overall trading activity post-Brexit or increasing the thresholds for the market test, but none of these options appears as a legally sound or practical one.

68. ESMA shares the views expressed by stakeholders on the potential impact of Brexit on the ancillary activity test and considers that this may ultimately require a change to Level 1. In the shorter term, ESMA has issued a statement clarifying for how long UK data would be included in the calculation of the total market size in its Opinion on the ancillary activity test in case of a no-deal Brexit on 31 October 2019.[5]

69. Other comments made by stakeholders on the impact of Brexit on the liquidity assessment of commodity derivatives for transparency purpose or on potential equivalence decisions by the EC with respect to the UK did not relate to position limits.

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[5] https://www.esma.europa.eu/sites/default/files/library/esma70-155-7658_statement_brexit_esma_it_systems_oct_19.pdf

4 MiFID II Position management

4.1 The MiFID II position management regime

70. Under Article 57(8) of MiFID II, "Member States shall ensure that an investment firm or a market operator operating a trading venue which trades commodity derivatives apply position management controls. Those controls shall include at least, the powers for the trading venue to:

    (a) monitor the open interest positions of persons;

    (b) access information, including all relevant documentation, from persons about the size and purpose of a position or exposure entered into, information about beneficial or underlying owners, any concert arrangements, and any related assets or liabilities in the underlying market;

    (c) require a person to terminate or reduce a position, on a temporary or permanent basis as the specific case may require and to unilaterally take appropriate action to ensure the termination or reduction if the person does not comply; and

    (d) where appropriate, require a person to provide liquidity back into the market at an agreed price and volume on a temporary basis with the express intent of mitigating the effects of a large or dominant position."

71. Information on position management controls in place at commodity derivative trading venues is available on ESMA's website[6]. In most cases, the information provided explains with a varying degree of detail, how the position management controls in place achieve compliance with the Article 57(8) requirements. However, two trading venues have mentioned position management controls that extend beyond the ones set out in Article 57(8) of MiFID II. ICE Futures Europe may promulgate limits and associated arrangements in relation to open positions that may be owned, controlled or carried by a member or person for his own account or for another person. The London Metal Exchange (LME) has introduced a requirement for the provision of additional information upon request, for positions held by members either directly or on behalf of their client(s) that are above the accountability levels set by the venue for each contract code.

72. Position management controls in relation to commodity derivatives may also be considered in conjunction with the broader obligation for trading venues to establish and maintain effective arrangements, systems and procedures aimed at preventing and detecting insider dealing, market manipulation and attempted insider dealing and market manipulation under Article 16(1) of MAR.

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[6] this information is available on ESMA's website https://www.esma.europa.eu/sites/default/files/library/position_management_controls.xlsx

4.2 The impact on the MiFID II position management regime

73. ESMA had no indication that position management controls by trading venues may have had an impact on commodity derivatives markets and therefore asked stakeholders for their views on this issue.

4.2.1 The impact of position management controls on market abuse

74. Respondents to the call for evidence expressed different views on the impact of position management controls on market abuse. Some trading venues considered that position management controls, along with their market supervision and surveillance systems, have a significant role in preventing market abuse, some of them stressing that position management is only useful for physically-settled contracts that can give rise to a market squeeze.

75. By contrast, two trading venues considered that their market oversight activities and pre-existing regulations were better tailored to prevent manipulation than position management controls. One trading venue explained that trading venues had limited ability to prevent market abuse as they do not have information on the positions held by market participants in other competing contracts on other trading venues or OTC.

4.2.2 The impact of position management controls on orderly pricing and settlement conditions

76. Stakeholders also had split views on the role of position management controls on orderly pricing and settlement conditions. Some respondents considered that position management controls play a positive role in determining orderly pricing and settlement conditions whereas some trading venues considered that position management controls, which are based on position holdings, do not contribute to orderly pricing and settlement, which are based on orders and trading activities. One trading venue was of the view that position management controls may negatively impact price formation, since they might lead participants to reduce positions by the end of the day to remain compliant.

4.2.3 The impact of position management controls on liquidity

77. Few respondents expressed an opinion on the impact of position management controls on liquidity and split views were again expressed. According to a non-financial counterparty, position management controls increase confidence in the market, a view further supported by a trading venue noting that position management controls ensure fair and liquid markets by managing rather than by limiting the positions a person may hold.

78. By contrast, two trading venues stated that position management control limits have led to a loss of liquidity especially in new and illiquid contracts as they prevented those contracts to grow and attract new clients. A trading venue was concerned about the potential long-term impact of position management controls, such as the uncertainty created for market

participants that may have to provide liquidity back to the market. To avoid such uncertainties, market participants may rather turn to OTC trading, outside the scope of position management controls and limits. A couple of other respondents considered that position management controls have no impact or no negative impact on the liquidity of commodity derivative markets.

79. The great variety of responses received from stakeholders, including from trading venues did not allow ESMA to form a clear view on the actual impact of position management controls. More substantially, ESMA is concerned that the diverse, if not diverging, views expressed may reflect significant dissimilarities in the way positions are indeed managed by trading venues as well as a possible lack of a shared understanding of trading venues' roles and responsibilities with regard to position management controls. Further clarification of the purpose and substance of position management controls may be needed to ensure a more convergent approach and a meaningful implementation, as further discussed in Section 5.4.

5 Proposed way forward

80. ESMA has considered the impact of position limits and position management controls on market abuse, orderly pricing and settlement conditions as well as on the liquidity of commodity derivative markets. To address the concerns identified, ESMA is suggesting the following amendments to the Level 1 text identified as part of its report to the Commission. ESMA also appreciates that any Level 1 change to MiFID II may be a somewhat lengthy process and will consider whether some amendments to the Level 2 measures on position limits may be appropriate in the meantime.

5.1 Address structural impacts of the position limit regime

5.1.1 Review the "Same Contract" provisions

81. As highlighted by one trading venue, the methodology for calculating position limits for the other months hinders fair competition across trading venues trading commodity derivatives based on the same underlying and sharing similar characteristics. As the other months' limit is based on the overall open interest in that commodity derivative, the most liquid market with the highest open interest benefits from the highest position limit and therefore an additional incentive is offered to market participants for trading on the already most liquid market to the detriment of less liquid venues. The potential adjustment factors available under RTS 21 to the baseline limit are not sufficient to compensate for a significant difference in open interest.

82. The "same contract" concept could have potentially addressed this drawback of the other months' limit calculation. Under Article 57(6) of MIFID II, *"where the same commodity derivative is traded in significant volumes on trading venues in more than one jurisdiction, the competent authority of the trading venue where the largest volume of trading takes*

place (the central competent authority) shall set the single position limit to be applied on all trading in that contract."

83. The definition of what constitutes the same commodity derivative is provided in Article 5 of RTS 21 and further clarified in ESMA's Q&A 12 on position limit topics[7]. As explained in Recital (5) of RTS 21, demanding conditions have been established *"to prevent persons from inappropriately netting positions across dissimilar contracts in order to circumvent and weaken the robustness of the position limit on the principal commodity derivative contract"*, including that the relevant commodity derivatives form *"a single fungible pool of open interest"*.

84. As a result of this approach, no same commodity derivative contracts have been identified so far, hence the lingering competitive disadvantage for less liquid markets. ESMA considers that this is a valid concern and is considering two options to ensure that fair competition between venues offering trading in commodity derivatives based on the same underlying is not hampered by the methodology for determining the other months' limit.

85. The first option (Option 1) would be to amend, and broaden, the definition of the "same contract" in Article 5(1) of RTS 21, for example by deleting the requirement that the same commodity derivatives form a single fungible pool of open interest. This would potentially leave the definition of "same contract" as being commodity derivatives that "have identical contractual specifications, terms and conditions, excluding post-trade risk management arrangements."

86. However, there could be circumstances where two derivative contracts that do not share the exact same characteristics would nonetheless deserve being treated as the "same contract" to address the fair competition issue identified above. At the same time, should the "identical" characteristics criteria made somewhat more flexible to accommodate a broader set of "same contracts", this would have a direct impact on the definition of EEOTC contracts that may then have a narrower definition than "same contracts". Striking the right balance between limiting the risk of undue netting of dissimilar contracts whilst ensuring a fair level playing field across competing venues appears as a real challenge and the consequences of any decision are difficult to anticipate.

87. The second option (Option 2) would be to amend Level 1 to delete the reference to the "same contract" procedure and introduce a more pragmatic approach. Where CAs would agree that the commodity derivatives traded on their respective trading venues are based on the same underlying and share the same characteristics, the baseline for the other months' limit, i.e. 25% of the open interest on the most liquid market for that commodity derivative would be used as the baseline limit for setting the other months' position limit for the competing contracts on other venues. Each CA could then adjust the common baseline limit using the adjustment factors relevant for its own market to determine the final other months' limit. Each CA would continue to receive daily position reporting with regard to

[7] https://www.esma.europa.eu/sites/default/files/library/esma70-872942901-36_qas_commodity_derivatives.pdf, page 21

their domestic contracts and CAs would establish cooperation arrangements with each other, including exchange of information on an as-needed basis on market participants trading similar contracts, for the exercise of their respective responsibilities.

Q 1: 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.

5.1.2 Reconsider the C(6) carve-out exemption

88. ESMA shares the concerns expressed by some respondents with regard to the shift of trading in physically-settled wholesale energy contracts (REMIT contracts) from regulated markets and MTFs to OTFs post-MiFID II as a result of the C(6) carve-out and the unlevel playing field this exemption has created.

89. Indeed, under the current framework, the exact same REMIT contract is subject to different rules, depending on where it is traded. Instruments traded on regulated markets and MTFs are subject to position limits as well as to other applicable MiFID II/MiFIR requirements, while identical instruments traded on OTFs are not considered as financial instruments and fall outside the scope of any of these obligations.

90. Unsurprisingly, the C(6) carve-out has proved a significant and successful incentive for market participants to move trading in REMIT contracts to OTFs and is the source of a major competitive disadvantage for regulated markets and MTFs, which ESMA can find no justification for.

91. ESMA first notes that the creation of the OTF category aimed at making the EU financial markets more transparent and efficient and at levelling the playing field between various venues offering multilateral trading services[8]. In ESMA's view, the C(6) carve-out does not achieve this objective as it deliberately creates a competitive advantage for OTFs trading REMIT products. Furthermore, ESMA notes that the C(6) carve-out penalises the already more heavily regulated trading venues. More fundamentally, ESMA considers that the same rules should apply to the same instruments independently of the EU trading venues where those instruments are traded and that the logic for any such differentiation remains unclear.

92. Consequently, ESMA is of the view that the current rules allowing for the exemption of the wholesale energy products traded on OTFs should be reconsidered.

Q 2: 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.

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[8] See Recital (8) of MiFID II

5.2 Reduce the scope of commodity derivatives under the position limit regime

5.2.1 Exclude securitised derivatives from the position limit regime

93. In ESMA's view, 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.

94. As opposed to commodity derivative contracts, securitised derivatives based on commodities are transferable securities. As explained by one respondent to the call for evidence, the commodity securitised derivatives market is characterised by a large number of different issuances, each one registered within the central securities depository for a specific size and any possible increase follows a specific procedure duly approved by the relevant CA.

95. This contrasts with standard commodity derivatives where the amount of open interest, and thereby the size of a position, is potentially unlimited. It is also worth noting that at the time of issue, the issuer or the intermediary in charge of the distribution of the issuance holds 100% of the issue, which challenges the very application of a position limit regime. In addition, most of securitised derivatives are then ultimately held by a large number of retail investors, which does not raise the same risk of abusing a dominant position or to orderly pricing and settlement conditions as for ordinary commodity derivative contracts.

96. It is also worth noting that securitised derivatives are very similar to Exchange Traded Commodities (ETCs), which are classified as debt instruments and do not fall under the position limit regime. Contracts for differences (CFDs) based on commodities are not classified either as commodity derivatives and fall outside the position limit regime as well. ESMA would support a more consistent approach of the MiFID II Level 1 text to instruments sharing similar characteristics. Such an approach could notably consist in excluding securitised derivatives from the scope of the position limit regime.

97. Moreover, the notion of spot month and other months, for which position limits are to be set under Article 57(3) of MiFID II, is not applicable to securitised derivatives. The concept of open interest is not well suited to those instruments either and ESMA had to find a meaningful approach to position limits in securitised derivatives in Article 15 of RTS 21.

98. A couple of respondents considered that the approach adopted by ESMA with regards to securitised derivatives and the clarification provided that position reporting does not apply when the issuance size is below 2.5 million set forth an adequate framework for dealing with position limits in those instruments. Another trading venue with substantial trading in securitised derivatives however stressed that the position limit regime has only led to an artificial limitation of the issuance size by issuers and more fundamentally called for the exclusion of securitised derivatives from the definition of commodity derivatives.

99. Given the specificities of the commodity securitised derivatives market set out above, ESMA recommends excluding securitised derivatives from the scope of position limits in Article 57 of MiFID II.

Q 3: Do you agree that the position limit framework should not apply to securitised derivatives? If not, please explain why.

5.2.2 Review the scope of other commodity derivatives under the position limit regime

100. In order to address the concerns expressed by most stakeholders on the negative impact of position limit on new and illiquid contracts, ESMA is considering two potential ways forward.

<u>Option 1</u>

101. The first option would be to reduce the scope of position limits to a more limited set of significant or critical contracts where position limits would provide most benefits. In ESMA's views, this would be the case for contracts that are sufficiently mature to influence the price of the underlying asset or of other commodity derivatives.

102. Under this option, Article 57 of MiFID II would be amended to set forth that position limits are established and applied with regard to positions held in critical commodity derivatives traded on a trading venue and economically equivalent OTC contracts. Article 57 would mandate ESMA to draft regulatory technical standards (RTS) to determine the characteristics to be met by a derivative contract to qualify as a critical contract, considering at least the following factors assessed over a one-year period:

   a. The number of market participants;

   b. The type and variety of market participants;

   c. The size of open interest; and

   d. The underlying asset.

103. As suggested by some stakeholders, and in order to facilitate access and increase legal certainty, the Level 1 text would also require ESMA to publish the list of critical contracts and the associated position limits on its website.

104. ESMA is of the view that such a more limited scope of commodity derivatives subject to position limits will also have the benefit of addressing the concerns expressed by stakeholders with regard to the impact of position limits on new and illiquid contracts. As the assessment of whether a commodity derivative qualifies as a critical contract, hence subject to position limits, would be made based on a one-year observation period, this entails that no position limit would apply to new contracts for a period of 12 months. This would allow trading in new contracts to develop and stabilise without the constraints of a

position limit regime that does not have the flexibility to accommodate the trading characteristics of such contracts, as explained earlier in Section 3.

105. As the critical contract approach would reduce the number of commodity derivatives subject to position limits, ESMA notes that it could also partially reduce the unlevel playing field created by the C(6) carve-out between regulated markets/MTFs and organised trading facilities and decrease the attractiveness of OTC trading in commodity derivatives no longer subject to position limits.

106. This option would also be more in line with the approach prevailing in the US where the Commodity Futures Trading Commission's (CFTC) position limits currently apply only to a limited set of nine agricultural contracts, with consideration being given by the CFTC to a potential extension of position limits to an additional set of 16 agricultural, oil and metal contracts.

107. ESMA notes that this option would require critical work at Level 2 to define the appropriate parameters and thresholds for critical contracts and the conditions for on-going compliance. It may also require more complex calculations to be performed by CAs based on position reporting to determine whether a commodity derivative meets and continues to meet the critical contract criteria.

Option 2

108. As most of the concerns expressed by stakeholders related to new contracts and contracts subject to de minimis position limits, Option 2 would be more focussed on addressing those specific concerns. Under this option, Article 57 of MiFID II would be amended to mandate ESMA to develop specific Level 2 measures with regard to new commodity derivatives, and in particular determine when position limits should start applying to those derivatives. The Level 2 would then set out that position limits for new commodity derivatives are determined after a 12-month period. At the end of a 12-month period, a commodity derivative would then be classified as liquid if the total combined interest over the last three months has exceeded 20,000 lots. If the commodity derivative is deemed illiquid, the maximum spot month and other months' limits would be increased to 50% of the reference amount, compared to 40% under Article 15(1)(b) of RTS 21.

Q 4: 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.

Q 5: 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.

Q 6: Which open interest and participant threshold would you suggest for qualifying a commodity derivative as a critical one?

109. In addition to monitoring compliance with position limits, position reporting data provides an additional source of information to CAs. Combined with other data sources, it allows to better identify, and sanction, potential market manipulation. The data on positions held in commodity derivatives also provides CAs with more insight in the composition of the market and the activities of the various types of market participants, including financial and non-financial counterparties and may be used as well to support policy developments and supervisory processes. ESMA is therefore of the view that all commodity derivative contracts, and the related EEOTC, should continue to be subject to daily position reporting to CAs even when not subject to position limits under Option 1 or 2 above. ESMA notes that MiFID II already offers a precedent with emission allowances, which are subject to position reporting and not subject to position limits. ESMA further notes that all relevant market participants have set up position reporting systems as part of their MiFID II compliance programmes and that the continued operation of such systems would only come at a marginal cost.

5.3 Introduce limited exemptions for financial counterparties

110. Many respondents to the call for evidence put forward proposals to introduce exemptions to the position limit regime for financial counterparties to accommodate some specific circumstances, including liquidity provision to non-financial counterparties, as further detailed in the responses to question 13 (see Annex II).

111. ESMA notes that the commodity derivative framework introduced by MiFID II aims at fulfilling the G20 commitments to improve the regulation, functioning and transparency of financial and commodity markets and to address excessive price volatility.

112. ESMA is concerned that introducing significant exemptions to the position limit regime for financial counterparties would not be consistent with the objective of limiting excessive speculation in commodity derivatives by financial firms. ESMA also notes that any exemption granted must be duly monitored and that the more complex the transactions, or chain of transactions that would ultimately justify a potential exemption being available to financial counterparties, the more challenging it is to assess compliance with the conditions thereof.

5.3.1 An exemption for mandatory liquidity provision

113. As suggested by one respondent to the call for evidence, ESMA could see merits in introducing a position limit exemption in Level 1 for “mandatory” liquidity provision. Positions held by a financial counterparty in commodity derivatives which are objectively measurable as fulfilling obligations to provide liquidity on a trading venue would not be subject to position limits where such obligations are required by regulatory authorities in accordance with Union law or with national laws, regulations and administrative provisions or by a trading venue. This exemption would mirror the exclusion of the related transactions from the ancillary activity test under letter c) of the fourth sub-paragraph of Article 2(4) of MiFID II. This would include the positions held by an investment firm as a result of its

market-making activities when that investment firm has entered into a market-making agreement with a trading venue under Article 17(3) of MiFID II[9]. Positions not subject to position limits would remain subject to position reporting. A financial counterparty eligible to the liquidity exemption would notify its CA. ESMA could be mandated to develop a harmonised application document to be used across Member States.

114. ESMA notes 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. Calls in support of a broad liquidity exemption for financial counterparties may become less relevant as the scope of position limits is refocussed on critical contracts and positions in non-critical contracts are left to trading venues' management controls, under CAs' monitoring and supervision.

Q 7: Would you support a position limit exemption for financial counterparties under mandatory liquidity provision obligations? If not, please explain why.

5.3.2 A limited hedging exemption

115. ESMA appreciates that there may be legitimate circumstances where financial counterparties could be eligible to a hedging exemption. However, ESMA is also concerned whether compliance with those exemptions can be monitored in a straightforward manner by the relevant CA.

116. As a preliminary view, ESMA considers that, where a financial counterparty within a predominantly commercial group acts as the market facing entity for the group and manages the positions of the non-financial group entities, that financial counterparty could benefit from a hedging exemption for the positions which are objectively measurable as reducing risks directly related to the commercial activities of the non-financial entities of the group. Level 1 could mandate ESMA to further specify the application process for that hedging exemption, which could be similar to the application for the NFC hedging exemption under Article 8 of RTS 21. ESMA would not be minded suggesting to introduce in Level 1 a blanket hedging exemption for all trades executed by financial counterparties on trading venues to offset an OTC transaction with an NFC

Q 8: Would you support introducing a hedging exemption for financial counterparties along the lines described above? If not, please explain why.

[9] See also ESMA Q&A on MIFID II commodity derivatives topics- Ancillary Activity Q&A 8
https://www.esma.europa.eu/sites/default/files/library/esma70-872942901-36_qas_commodity_derivatives.pdf

5.4 Foster convergence in the implementation of position management controls

117. As explained in section 4.2 above, ESMA is of the view that there would be value in providing further clarity on the expected scope and content of position management controls to support a more convergent implementation across trading venues. ESMA also recognises the need for some flexibility in application to accommodate the characteristics of the different commodity derivatives traded on each venue. This more convergent understanding and implementation of position management controls would be more appropriate and timely should some contracts no longer be subject to the position limit regime and only to position management controls by trading venues.

118. In considering potential amendments to the Level 1 text, some stakeholders highlighted that the effectiveness of management controls by trading venues may be hampered or made less efficient due to the lack of information on the position held by market participants in related contracts based on the same underlying on competing trading venues or traded OTC. ESMA agrees that, to investigate activity of market participants as part of a framework of position management controls, trading venues may need to obtain such information from their members or participants. ESMA therefore recommends amending Article 57(8)(b) of MiFID II to specify that position management controls should also 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, where appropriate.

119. In addition to this Level 1 change, and to support a more harmonised approach by trading venues, a mandate could be given to ESMA to draft RTS to further specify the content and scope of position management controls. Below are some examples of the areas that could be addressed in Level 2.

120. Under Article 57(8) of MiFID II, trading venues are required to have position management controls across all commodity derivatives. However, there may be room for further differentiation between cash-settled and physically-settled contracts. As an example, Article 57(8)(d) of MiFID II provides that a trading venue should have the power to "[…] where appropriate, require a person to provide liquidity back to the market as an agreed price and volume" ESMA understands that this specific power, as opposed to the power to require a person to terminate or reduce a position, is only implemented by a couple of trading venues with respect to physically-settled contracts only. There could be merits in further explaining in Level 2 under which circumstances and for which purposes such power should be used.

121. To ensure fair and orderly trading and prevent market abuse, and as implementing measures of the Level 1 requirement to monitor positions, the Level 2 could also require trading venues 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, as already in place at some regulated markets. Those position levels would be determined based on the characteristics of the commodity

derivative, the market in that derivative, the underlying commodity and other relevant data sources and calibrated in such a way as to trigger alerts for the trading venue. Exceeding the pre-determined limit would trigger an information request from the trading venue to better understand the reason and intention of the position built and the potential risks attached to it. The trading venue would then follow-up as appropriate, and potentially ask a person to reduce or terminate a position if no adequate answer is provided. Those accountability levels would be set, and adjusted, throughout the entire curve.

122. In addition to accountability levels, and to ensure the orderly settlement of physically-settled contracts that would not be subject to position limits set by CAs, trading venues would be required to set, and implement, position limits for the period immediately preceding expiry for those contracts.

Q 9: 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.

PART II: Technical Advice on Position reporting thresholds

6 Background

123. As part of the new commodity derivative framework, MiFID II introduced a requirement for trading venues to publish a weekly report with the aggregate positions held by different categories of persons in a commodity derivative, emission allowance or emission allowance derivative when both the number of position holders and the size of open position in a specific instrument exceed a minimum threshold.

Article 58, MiFID II

1. Member States shall ensure that an investment firm or a market operator operating a trading venue which trades commodity derivatives or emission allowances or derivatives thereof:

(a) make public a weekly report with the aggregate positions held by the different categories of persons for the different commodity derivatives or emission allowances or derivatives there-of traded on their trading venue, specifying the number of long and short positions by such categories, changes thereto since the previous report, the percentage of the total open interest represented by each category and the number of persons holding a position in each category in accordance with paragraph 4 and communicate that report to the competent authority and to ESMA; ESMA shall proceed to a centralised publication of the information included in those reports;

[…]

The obligation laid down in point (a) shall only apply when both the number of persons and their open positions exceed minimum thresholds.

[…]

6. The Commission shall be empowered to adopt delegated acts in accordance with Article 89 to specify the thresholds referred to in the second subparagraph of paragraph 1 this Article, having regard to the total number of open positions and their size and the total number of persons holding a position.

124. Under Article 58(6) of MiFID II, the EC invited ESMA “to provide technical advice on the thresholds referred to in respect of both the number of persons and their open positions which, if exceeded, means that the last subparagraph of paragraph 1 of Article 58 applies”.

125. In the Technical Advice delivered on 19 December 2014, ESMA proposed in particular as regards the size of open positions that the publication of weekly position reports should only take place if the absolute value of the gross long or short volume of total open interest,

expressed in the number of lots of the relevant commodity derivatives, exceeds a level of four times the deliverable supply for the same commodity derivative, as expressed in number of lots.

126. In its Technical Advice, ESMA explained that the proposed thresholds for the number of position holders and the size of open positions were based on achieving an appropriate balance between the two competing objectives of providing transparency to stakeholders and ensuring the prevention of market abuse and preservation of confidentiality by not disclosing details of position holders to the extent that they may be identifiable. However, ESMA also noted that the proposed thresholds were based on the existing arrangements for the US which are limited to the core and most liquid contracts. At the time there was no data available on the number of weekly reports that such thresholds would generate for less-liquid contracts in the Union.

127. ESMA's proposal has been incorporated in Article 83(1) (b) of Commission Delegated Regulation (CDR) (EU) 2017/565 of 25 April 2016.[10]

Article 83, Commission Delegated Regulation (EU) 2017/565 of 25 April 2016.

1.For the purpose of the weekly reports referred to in Art 58(1)(a) of Directive 2014/65/EU, the obligation for a trading venue to make public such a report shall apply when both of the following two thresholds are met:

(a) 20 open position holders exist in a given contract on a given trading venue; and

(b) the absolute amount of the gross long or short volume of total open interest, expressed in the number of lots of the relevant commodity derivative, exceeds a level of four times the deliverable supply in the same commodity derivative, expressed in number of lots.

Where the commodity derivative does not have a physically deliverable underlying asset and for emission allowances and derivatives thereof, point (b) shall not apply.

[…]".

128. Eighteen months after MiFID II started to apply, the thresholds proposed in ESMA's Technical Advice in respect of the size of open positions do not appear to have fully delivered on the objective of providing market transparency to stakeholders and ESMA deems it appropriate to revise its Technical Advice to the EC in this specific area.

[10] Commission Delegated Regulation (EU) 2017/565 of 25.4 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purpose of that Directive

7 New Technical Advice

129. Under Article 58(1)(a) of MiFID II, trading venues have to report weekly positions for commodity derivatives exceeding position holder and size of open position minimum thresholds to the CA and to ESMA. Weekly position reports are also published on the ESMA website.[11]

130. In 2018 and in the first half of 2019, ESMA received on average around 63 weekly position reports meeting the minimum thresholds set out in Article 83(1) of Commission Delegated Regulation (EU) 2017/565. However, it is worth noting that those weekly position reports came almost exclusively from two UK trading venues. One EU27 trading venue started publishing weekly position reports for one commodity derivative in May 2019.

131. Consequently, and should those minimum thresholds remain unchanged, it appears likely that hardly any weekly position reports would be made public anymore once the UK leaves the Union. Such a development would appear to defeat the purpose of Article 58(1)(a) of MiFID II.

132. It is also worth noting that those published weekly position reports are concentrated on a limited set of underlyings, i.e. oil and metals. With the exception of a recent addition of weekly position reports on a gas contract, no commodity derivative based on an underlying other than oil or metal traded on an EU trading venue meets, or has been meeting, the minimum thresholds for weekly position reports. Therefore, very little or no transparency is provided to market stakeholders on a range of contracts, although gas, power and agricultural commodity derivatives account for a non-negligible amount of on-venue commodity derivative trading activity as shown in ESMA's Opinion on Ancillary Activity calculations[12].

133. ESMA understands that the selective transparency provided to stakeholders through weekly position reports focussing on oil and metal commodity contracts is mainly due to the minimum threshold regarding the size of open position and the need for the absolute amount of the gross long or short open interest to be at least four times the size of the deliverable supply. The initial cautious approach concerning this threshold focussed on providing transparency to stakeholders on the various categories of market participants in commodity derivatives with the highest potential of non-hedging trading volume. However, as market participants are getting more familiar with the MiFID II commodity derivative regime, ESMA considers that there would be merit in providing transparency to stakeholders on a broader scope of commodity derivatives, including on instruments with possibly more balanced categories of stakeholders and for which the potential disparity between the size of open interest and the amount of deliverable supply would not be a relevant criterion.

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[11] https://registers.esma.europa.eu/publication/searchRegister?core=esma_registers_coder58
[12] https://www.esma.europa.eu/press-news/esma-news/esma-updates-its-opinion-ancillary-activity-calculations-0

134. ESMA therefore proposes basing the publication of weekly position reports no longer on the size of open interest in comparison with the size of deliverable supply but just on the size of open interest in that commodity derivative, which appears as a more straightforward criterion.

135. As regards the open interest threshold, weekly position reports would be published when the total combined open interest in spot and other months' contracts would be equal to, or exceeding,10,000 lots. The 10,000-lot minimum threshold should ensure that there is sufficient interest in a commodity derivative to justify the publication of weekly position reports. At the same time, this threshold in combination with the criterion of the minimum number of position holders should also ensure that the confidentiality of individual position holders is maintained.

136. This revised measure of the size of open positions will make it easier for trading venues to identify commodity derivatives subject to weekly position reports as they already have access to open interest in contracts traded on their venue. It will also offer additional transparency and certainty to market stakeholders as for commodity derivatives subject to weekly position reporting data on deliverable supply may not always be readily available.

137. For the avoidance of doubt, a weekly position report would need to be published under Article 58(1)(a) of MiFID II as for commodity derivatives traded on a trading venue when both 20 or more persons hold a position in that commodity derivative, as currently foreseen in Article 83(1)(a) of CDR (EU) 2017/565CDR; and when the absolute amount of the gross long or short volume of total open interest in that commodity derivative is equal to, or exceeds,10,000 lots.

Draft Technical advice

Article 83, Commission Delegated Regulation (EU) 2017/565 of 25 April 2016.

1.For the purpose of the weekly reports referred to in Art 58(1)(a) of Directive 2014/65/EU, the obligation for a trading venue to make public such a report shall apply when both of the following two thresholds are met:

[…] and

(b) the absolute amount of the gross long or short volume of total open interest expressed in the number of lots of the relevant commodity derivative equals or exceeds 10,000 lots.

For emission allowances and derivatives thereof, point (b) shall not apply.

[…]

Q 10: 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.

Q 11: Do you have any comment on the current number of position holders required for the publication of weekly position reports?

8 ANNEX

8.1 Annex I

Summary of questions

Part I

Q 1: 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.

Q 2: 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.

Q 3: Do you agree that the position limit framework should not apply to securitised derivatives? If not, please explain why.

Q 4: 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.

Q 5: 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.

Q 6: Which open interest and participant threshold would you suggest for qualifying a commodity derivative as a critical one?

Q 7: Would you support a position limit exemption for financial counterparties under mandatory liquidity provision obligations? If not, please explain why.

Q 8: Would you support introducing a hedging exemption for financial counterparties along the lines described above? If not, please explain why.

Q 9: 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.

Part II

Q 10: 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.

Q 11: Do you have any comment on the current number of position holders required for the publication of weekly position reports?

8.2 Annex II

Feedback on the call for evidence

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.

1. Respondents generally considered that the MiFID II position limit regime has been working reasonably well for well-developed, benchmark contracts characterised by a large number of different types of active trading firms and a substantial amount of open interest. Position limits did not have a noticeable impact on the liquidity of such contracts.

   One respondent however noted that the calculation of the other months' limit as a percentage of the open interest negatively impacted competition across trading venues trading the same underlying and favours the already most liquid market. Another respondent stressed that, due to the burdensome and costly position reporting regime, some market participants withdrew from trading on its facility.

   Most respondents were of the view that the de minimis thresholds for new and illiquid contracts with an open interest below 20,000 lots are overly restrictive and have hampered the development of such contracts. The following drawbacks of the position limit regime for new and illiquid contracts were mentioned more specifically:

   a. A hedging exemption is not available to the few financial counterparties providing liquidity and participants unable to hedge withdraw from the market;
   b. When a new contract is launched, it is usually traded by a limited number of large participants typically financial counterparties. When the limit is reached, participants withdraw from the market, switching to trading venues outside MiFID II position limit regime;
   c. Position limits set based on past open interest do not accommodate specific situations such as transition from one contract to another or contracts with high volatility; and
   d. Reclassification and move to bespoke limits by the CA take too much time in case of fast-growing open interest.

   One respondent further noted that setting up position reporting arrangements is too costly when only trading a niche contract and deters new participants from entering the market.

   As a way forward, many respondents suggested restricting the scope of position limits to benchmark contracts.

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.

2. Many respondents referred to the transfer of a substantial number of commodity derivative contracts to-non EU trading venues not subject to position limits and where trading does not count towards the ancillary activity test thresholds, such as the transfer of about 250 contracts mainly in oil -related products from ICE Futures Europe to ICE Futures US or the move by CME Group of its physically-settled TTF Futures contracts from the EU to the US prior to MiFID II. A trade association further referred to the transfer of several physically-settled wholesale energy contracts from MTFs to OTFs benefiting from the C(6) carve-out exemption.

   Some trading venues also noted that position limits and position reporting do not apply to OTC trading, which is seen as a cheaper and less burdensome trading alternative and is getting increased interest post MiFID II. This contradicts the MiFID II objective of promoting on-venue trading. One of those venues further stressed the decline in its member base due to the EMIR and MiFID II package and the significant impact of increased OTC commodity derivatives trading on the liquidity of regulated markets.

   Many respondents also noted the increased difficulty for financial counterparties to efficiently serve their clients due to the inability of those counterparties to hedge risks in structurally complex transactions. In addition, some market participants have ceased to perform a market maker role due to the risk of breaching limits.

   One trading venue respondent noted the specific impact of position limits on securitised derivatives and the limitation of the issuance size for such instruments to 2.5 million securities by some market operators.

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.

3. Many respondents considered that position limits have a limited role, if any, in the prevention of market abuse. They noted that monitoring of trading activity is needed to investigate potential market abuse. Furthermore, properly addressing market abuse requires an overall approach of both the underlying spot market and the derivative markets as well as on-venue and OTC trading whereas position limits only apply to on-venue trading.

   Some respondents however stressed that position limits can have a role in limiting market power, including the ability to squeeze or corner the market, rather than limiting market manipulation. As such, position limits would only contribute to market integrity in a limited set of circumstances, i.e. for physically-settled contract where there is a finite supply of the

underlying commodity available for delivery that a market participant can take control of, and for a limited period of time immediately prior to maturity. According to those respondents, market squeezes are unlikely to happen in cash-settled contracts even though they noted that an underlying reference price or index that is not robust enough, such as narrow-based index can be manipulated.

One trading venue further stressed that by their very nature, position limits have the objective and ability to alter – and may well distort – demand and supply conditions in a commodity derivative market. They should therefore only be applied in circumstances where clear benefits can be demonstrated (e.g. limitations on the scope for deliberate or unintentional market squeezes).

A large set of respondents combining trading venues and trade associations stressed that the goal of preventing market abuse is achieved through the position management regimes operated by trading venues and their market surveillance and supervision systems rather than through position limits. Some respondents consider that REMIT and MAR are more appropriate and comprehensive tools to prevent market abuse and that possible improvements of prevention of market abuse should be addressed with these instruments in mind rather than position limits.

One trading venue considered that it is the legislative combination of MAR, position management controls, position limits and position reporting that collectively contribute to greater controls and prevention of market abuse of commodity derivative markets.

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.

4. With one exception, all respondents considered that position limits did not have any impact or major impact, on orderly pricing and settlement conditions, noting however that this is only based on an 18-month experience. This objective is rather achieved by pre-existing position management controls and market oversight systems operated by trading venues.

   One trading venue noted that the stated intention of the regime is to ensure convergence between prices of derivatives in the delivery month and spot prices for the underlying commodity and that this is only relevant for the spot month. For other months, position limits might lead participants to reduce positions by the end of the day to stay compliant, which may impact price formation away from what the market would otherwise be.

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?

5. Most respondents reiterated the views that for benchmark, well developed contracts, the MiFID II position limit regime is generally working well or has not created significant

disruption. However, the position limit regime has proven a substantial barrier to the development of new products and further growth of existing less liquid commodity derivatives due to:

a. A too restrictive 2,500 lot de minimis threshold when a contract comes close to an open interest of 10,000 lots over a three-month period;
b. The lack of flexibility available to CAs to deal with specific circumstances such as anticipated growing open interest;
c. The slow pace at which bespoke position limits are set and reviewed; and
d. The complex process for the hedging exemption and the lack of a hedging exemption for financial counterparties.

One trading venue expressed concerns that the scope of position limits is too narrow as it does not cover OTC traded products and excludes around 50% of the electricity and natural gas markets due to the C(6) carve-out.

Many respondents suggested one or more of the following ways forward:

a. Limit position limits to benchmark contracts where price formation occurs. New and nascent contracts constitute a minor share of commodity markets and are unlikely to influence price movements in the underlying physical market, thereby to have a negative impact for consumers;
b. Alternatively, suspend application of spot and other month position limits to commodity derivatives with a total combined interest below 20,000 lots over a three-month period on average (on not on a single day basis); and
c. Set position limits only for the period right before expiry.

In addition, some respondents suggested retaining position reporting for all commodity derivative contracts.

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.

6. Respondents expressed different views on the impact of position management controls on the liquidity of commodity derivative markets.

   Some trade associations considered that position management controls have no impact or no negative impact on the liquidity of commodity derivative markets notably of agricultural derivative markets.

   A couple of trading venues noted that position management controls have led to a loss of liquidity especially in new and illiquid contract as they prevented major market participants to support the exchange on its way to reach the minimum liquidity level that would have attracted a broader set of participants, for instance in freight and gas derivatives.

By contrast, two other trading venues considered that position management controls ensure fair and liquid markets by managing rather than limiting the positions a person may hold and can have a role in preventing market abuse.

One other trading venue was of the view that position management controls such as requiring persons to reduce positions may have a positive impact in the short term by increasing liquidity but create uncertainty in the longer term that would further deter participants to trade on-venue.

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.

7. Respondents expressed different views on the role of position management controls in preventing market abuse.

   A majority of respondents considered that position management controls, including exchanges' market surveillance systems, have a role in preventing market abuse, although some of them noted that many commodity exchanges had already measures in place to that effect prior to MiFID II and that position management controls play a role in preventing market abuse for physically-settled contracts only. Some trade associations also considered that better tools can be used as the position limit regime to prevent only certain types of abuse.

   Two trading venues were of the view that position management controls do not contribute to preventing market abuse. One trading venue considered that market oversight activities (including compliance, supervision and surveillance) are better tailored to prevent market manipulation. Another trading venue stressed that trading venues do not have a full picture of the market as they lack information on OTC trading and on other ETDs based on the same underlying commodity. Consequently, position management controls can only be a very limited tool to prevent market abuse.

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.

8. As for the previous question, respondents had split views on the role of position management controls on orderly pricing and settlement conditions.

   Some respondents considered that position management controls play a positive role in determining orderly pricing and settlement conditions, even though as stressed by one of the respondents, they should be used only in exceptional circumstances.

Some respondents were of the view that position management controls are not a critical element in determining orderly pricing and settlement condition or have had little impact.

A couple of trading venues noted that the position limit regime, including position management controls, have not contributed to orderly pricing and settlement because orderly pricing and settlement are based on orders and trading activities and not on position holdings. One trading venue further mentioned that position management controls might lead participants to reduce positions by the end of the day to stay compliant, which may negatively impact price formation.

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?

9. All trading venues that responded to this question said they were monitoring positions on a daily basis.

   Some respondents provided additional information on the checks performed and the follow-up actions taken, such as asking further information on the size or purpose of a position when a position amounts to 90% of the limit set by the CA, where a position size or trend appears to depart from usual trading patterns, where the position limit set by the trading venue is exceeded or when a member holds a position that exceeds the accountability level threshold. One trading venue reconciles open positions as provided by the CCP and by investment firms and compares them with the limits.

   Only one trading venue provided quantitative data and explained that it asked for additional information on a position in three instances. One trading venue with only a small market share in competing contracts explained that it has not yet implemented the requirements set out in Article 58(1)(c) and (d) as it has insufficient information regarding offsetting positions to impose own control; and there is insufficient clarity regarding the basis against which to calculate and set thresholds to require reduction or termination of a position or to require that liquidity is provided back into the market.

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

10. Many respondents reiterated the comments made under Q5 according to which the position limit regime was working reasonably well for benchmark contracts but not for nascent and illiquid contacts (see more detailed responses and suggestions under Q5).

In addition, a couple of respondents suggested setting up a centralised source of information for all applicable de minimis and bespoke limits or require CAs to adopt a standard format for the publication of their limits.

Respondents active in agricultural derivatives suggested to align the definition of market participants for weekly position reports under MiFID II, as further clarified by ESMA's Q&A, with the CFTC's definition.

One trade association noted that harmonising the definition of spot month and/other month across trading venues for gas derivatives would reduce the uncertainties for market participants.

For a couple of respondents, given the limited contribution of position limits to the prevention of market abuse and to orderly pricing and settlement, the regime should refocus on selected benchmarks to reduce compliance burden for all parties and avoid a negative impact on new and illiquid contracts.

One respondent suggested applying position limits only when a de minimis threshold of open interest is exceeded. The threshold would vary depending on underlying, notional value of contract and size of relevant market. Position limits would only apply when positions could feasibly influence the price volatility of the underlying commodity.

One respondent suggested exempting securitised derivative issuers (and specialists appointed for the distribution of an issuance) from the position limit regime as they always breach the limit at the time of issuance.

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?

11. The impact of Brexit on the EU commodity derivatives regime most frequently quoted by respondents was the impact on the ancillary activity test. Even though the impact will not be immediate due to the 3-year backward looking calculation, respondents expressed concerns that the EU market size for all commodity derivative asset classes will be substantially reduced post Brexit. Consequently, there is a risk that some non-financial counterparties (NFC) pass the ancillary activity thresholds and are no longer eligible to the hedging exemption. Respondents provided suggestions to avoid such drawback, such as increasing the ancillary activity thresholds, redesigning the Level 2 test or continuing to include UK data for the determination of market size.

    Some respondents expressed concerns about a potential unlevel playing field with the UK post Brexit in case the position limit regime was applied in the UK legal framework in a different way, for example by removing the obstacles to the development of new, illiquid contracts. One UK trading venue noted that EU position limits will no longer apply to contracts traded on its system. However, EU market participants may be impacted by UK

legislation in relation to their activities on UK venues, which could lead to dual reporting and monitoring obligations.

One stakeholder recommended to adapt the liquidity assessments of commodity derivative contracts under RTS 2 post-Brexit. Several stakeholders called for an equivalence decision in respect of the UK under Article 2(a) of EMIR. They consider that the lack of an equivalence decision will put EU NFCs at a competitive disadvantage vis à vis their UK competitors as their activity on UK venues will count towards the EMIR clearing thresholds.

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.

12. All respondents stressed that the current scope of the position limit regime is too broad and should be refocussed on a narrower set of benchmark contracts where price formation takes place. A couple of respondents mentioned in particular that an additional limit on index derivatives serves no purpose as the individual components are already under a position limit regime on the exchanges where these are traded.

    Some other respondents reiterated earlier comments on the negative impact of position limits on new and illiquid contracts. One trade association suggested that the Level 1 and Level 2 texts should clarify that the position limit regime only applies to contracts that have a commodity as an underlying. This would support the objective of the position limit regime to ensure the convergence between prices of derivatives in the delivery month and spot prices for the underlying commodity.

    Respondents also referred to their answers to Q13.

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?

13. Many respondents reiterated the comments made under Q12 above.

    All respondents were unanimous in considering that the position limit regime should be refocussed and applied only to benchmark contracts on key contracts which are crucial to the orderly functioning of their respective commodity market. For other contracts, the negative impact and costs for regulated markets and market participants outweigh potential benefits.

    Some respondents suggested criteria for determining benchmark contracts, e.g. contracts with a large number of different types of active trading firms and a substantial amount of open interest, that are important for price formation in the underlying market and where it is feasible to restrict or control the underlying commodity market.

    Other proposals for amending the current regime included limiting the position limit regime to the period right before expiry rather than covering the entire maturity curve as this is sufficient to prevent market squeezes and disapplying the position limits or providing

additional flexibility to CAs in setting limits, including not applying limits for contracts with an open interest below 20,000 lots over a consecutive three-month period on average.

One respondent noted that the position limit regime introduced under MiFID II encompasses a significantly broader range of commodity derivative contracts than comparable regimes introduced in alternative jurisdictions and suggested aligning the MIFID II approach to position limits with the approach adopted by the CTFC in the US.

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

14. Only a small number of stakeholders responded to this question. Two trading venues considered that the position limit regime is not appropriate for securitised derivatives, noting in particular that securitised derivatives are cash-settled and that position limits are not useful for cash-settled contracts. In addition, securitised derivatives are typically held by retail investors, with limited open positions that do not call for reporting.

    Three respondents were of the view that the regime provides a workable solution for securitised derivatives based on the provisions for illiquid instruments in Article 15 of RTS 21, and that there is no need of specific amendment for this asset class.

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.

15. With one exception, no respondent supported reviewing the definition of EEOTC contracts and multiple reasons were provided. Reviewing the EEOTC definition would in particular:

    a. create a risk of cleared OTC contracts switching to non-cleared, which would reduce market transparency and security;
    b. introduce unnecessary confusion and potential disruptions;
    c. potentially allow for inappropriate netting of dominant positions traded on a venue by trading OTC, thereby challenging the effective operation of the position limit regime; and
    d. drive new streams of position reporting, likely requiring significant IT investment across the industry and its regulators.

    For some respondents, the mere fact that very few EEOTC contracts have been identified is no evidence that the regime is overly restrictive.

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.

16. A vast majority of respondents suggested some amendments or clarification to the exemptions available under the position limit regime.

    Some respondents supported harmonising the hedging exemption for NFCs under Article 8 of RTS 21 by withdrawing the quantitative limit to the exemption imposed by some CAs.

The quantitative limit is a source of unnecessary implementation burden as the NFC need to reapply whenever they breach the quantitative limit set.

Some respondents suggested extending the hedging exemption to financial counterparties conducting documented hedging activities or risk-reducing transactions for the group when the financial counterparty is part of a predominantly commercial group. Many respondents suggested introducing a liquidity provision position limit exemption for financial counterparties when liquidity is provided to an NFC trading under the hedging exemption.

Two trading venues did not support granting an exemption to financial counterparties.

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.

17. A majority of respondents supported the suggestion made in the call for evidence of giving CAs the option of setting the spot month position limit on the basis of open interest, Respondents however stressed that this should only remain an option to be considered by CAs taking into account the specific characteristics and operation of a commodity derivative contract.

    Some respondents explained that the discrepancy between open interest and deliverable supply is due to the fact that trading in gas and power derivatives is taking place predominantly bilaterally as well as across different trading venues. As a result, open interest in exchange-traded derivatives is relatively low compared to the underlying market.

    Three respondents did not see a need for changes in the current methodology and two respondents would prefer deliverable supply to stay as a reference amount for agricultural commodity derivatives.

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

18. Respondents were unanimous in considering that it was both necessary and urgent to amend the rules governing position limits for new and illiquid contracts. Existing rules have had a negative impact on the development of such contracts and put EU exchanges at a competitive disadvantage compared to other trading venues.

    The majority view was that position limits should not apply to new and illiquid contracts, and the regime should only be framed to cover key, benchmark contracts. New and less liquid contracts constitute only a minor share of the commodity markets, are not price-forming and do not influence prices on physical markets. Should such solution not be possible, respondents are of the view that the limits should be significantly increased, e.g. up to 50% of open interest, noting that in some cases even such a high limit may be insufficient as for new contracts it is common that only one participant is active on the buy or sell side of the market.

Some respondents also explained that the Q&A which allowed CAs to set bespoke limits for the less liquid contracts under Article 19 of RTS 21 was insufficient to address the issue as adjustments require time and some participants are leaving the market in anticipation of reaching the limit.

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.

19. A majority of respondents supported the implementation of a more forward-looking approach to the calculation of open interest, noting that such an approach would be particularly well-suited to accommodate periods of strong market growth.

    A few respondents added that this approach should also be used for the determination of whether a contract is liquid. This would help avoiding that the development of a commodity derivative market is hampered by a delay in the application of a bespoke limit by the CA. This would also help facilitating the transition from one contract to another, for instance in case of a methodology update.

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?

20. Most respondents stressed the need for a harmonised approach to the calculation of open interest for the purpose of setting position limits. A harmonised calculation methodology would allow all trading venues and market participants to operate in a fair environment where the position limit regime would not be a source of an unlevel playing field. One trade association noted that if Brexit leads to significant changes to the calculation of deliverable supply, then a full assessment of the methodology would be necessary.

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

21. Very few stakeholders responded to this question. One trading venue considered the information published on ESMA's website as useful. Another trading venue would welcome clearer guidance on the objective criteria governing the circumstances under which a member would be required to reduce positions and/or provide liquidity back to the market.

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.

22. Most respondents did not consider necessary to amend position management controls under Article 57(8) of MiFID II. A trading venue reiterated the comment made above on further guidance in respect of reduction of positions and provision of liquidity back to the market.