



Response to the ESMA Call for Evidence on Position Limits and Position Management in Commodity Derivatives

Brussels, 5th July 2019

Introductory remarks

FESE welcomes the possibility to respond to the ESMA call for evidence on position limits and position management in commodity derivatives.

FESE members have considerable experience in operating a position management system. Long before the application of MiFID II, they had developed comprehensive, risk-based regimes based on position, delivery and expiry limits with regards to commodity derivatives traded on their markets. These regimes are calibrated so as to prevent market abuse and ensure orderly delivery while allowing new products to be developed. Since January 2018, they have operated in parallel with position limits set by the relevant National Competent Authorities (“NCAs”) under MiFID II.

We are of the view that the MiFID II/MiFIR position limits regime has so far been able to function in a reasonable manner for a number of well-developed benchmark contracts. These highly developed markets are characterised by a large number of different types of active trading firms and an overall substantial amount of open interest.

However, for the development of new products and further growth of the existing illiquid commodity derivative markets, the position limits regime has proven to be a substantial barrier. Fast growing markets in particular have suffered from an increasingly restrictive standard limit of 2,500 lots as open interest in a market classified as illiquid increases. They have also suffered from an inflexible treatment in terms of their categorisation under the position limits framework and from an inaccurate reflection of the underlying physical markets. Coupled with an immediate availability of OTC or third-country venue commodity derivatives as well as cumbersome regulatory requirements for ETDs, there is a serious risk of contracts moving from EU trading venues into the OTC space and to other jurisdictions.

To avoid hindering the development and growth of new products, as well as the on-venue trading of commodity derivatives, a proportionate and efficient position limits regime should concentrate on a limited number of benchmark contracts. For example, in the US only benchmark products are included in the position limit regime, while the EU regime covers all commodity derivatives traded on EU trading venues regardless of their liquidity profile, size of open interest and underlying market characteristics. Also, cash settled derivatives on broad-based indices composed of commodities related items should not be included in the scope of definitions.

Focusing only on a set of benchmark contracts would prevent market abuse and excessive speculation which may negatively impact global retail prices, while allowing new and nascent products to develop. Furthermore, in order to prevent market squeezes, it would be sufficient to set limits for the period right before expiry rather than covering the entire maturity curve.

Questions

Q1: In your view, what impact, if any, did the introduction of position limits have on the availability and liquidity of commodity derivative markets? What are in your views the main factors driving this development, e.g. the mere existence of a position limit and position reporting regime, some specific characteristics of the position limit regime or the level at which position limits are set? Please elaborate by differentiating per commodity asset class or contract where relevant and provide evidence to support your assessment.

As highlighted in the introduction, we believe that the MiFID II position limits regime has so far been able to function for a number of well-developed benchmark contracts. The current regime has, unfortunately, several shortcomings for what it concerns the development of new contracts and the growth of existing illiquid commodities derivative markets as well as room for improvement for the functioning of liquid markets.

1. Growth of illiquid markets

Fast growing markets in particular have suffered from several challenges:

a) Increasingly restrictive standardised limit

Contracts classed as ‘illiquid’ under the position limits framework receive a standardised limit of 2,500 lots and thereby effectively get a highly restrictive limit (resembling a baseline limit of 25 percent of open interest) when open interest increases close to 10,000 lots. In consequence, market participants are forced to decrease their positions and the open interest returns to a lower level thereby sealing the illiquid status of the product.

And whilst in theory, in line with ESMA Q&A on ‘commodity derivative topics’, NCAs can use different derogations for illiquid markets which have an open interest between 5,000 and 10,000 lots, these remain difficult to apply in practice and are often not sufficient to mitigate the negative impact of disproportionately low position limits.

Any increase of the limit under the available derogation will need to be substantial in order to provide sufficient relief to market participants close to the limits and prevent restricting trading activity in fast growing markets. An increase of a given position limit with for example 500 lots will only have a very limited impact, effectively allowing market participants close to the limit to trade an additional lots equivalent of four Calendar or eight Season contracts.

Once the limit is reached participants withdraw from the market, often switching to another trading venue outside of the MiFID II regime, thereby leaving the regulator no time to adjust the limit upwards. Furthermore, in relation to newly launched contracts, it is not unusual that only one participant sits on the buy or sell side of the market. In such cases, even a fifty percent limit is not sufficient to allow the market to take off.

b) Inflexible categorisation of markets and recalibration of position limits

In order to provide for a workable regime for growth markets, NCAs need to be able to process near instant updates to the categorisation of markets and readjust the applicable limits as open interests in a market increases. This is especially true for markets that experience strong increases in open interest in a small period of time. Markets with initially relatively low levels of open interest can develop into liquid markets in a matter of weeks or months. In order for a limit not to impede the development of fast-growing markets:

- the growth of open interest requires a timely reclassification of a market under the position limits regime (for example from ‘illiquid’ to ‘less liquid’) in order to allow

the position limit to be adjusted to a workable level, before it becomes unnecessarily restrictive.

- the calculation of open interest in a market for the purpose of setting a position limit needs to adequately capture the period of growth of open interest. It is therefore essential that an appropriate methodology for calculating open interest is used. The usage of a randomly selected period with an inappropriate duration could furthermore result in relatively frequent requests to amend the established limits, as the newly set limit could be reached with only a limited amount of transactions in a fast growing market.

In practice it has proven to be very difficult for NCA's to reclassify markets and recalibrate the applicable limits and in a manner that would prevent a negative impact on the development of fast-growing markets. To use a practical example: Figure 1 illustrates the negative impact on the ICE Endex Italian PSV Gas Futures previously fast-growing markets when subjected to the MiFID II position limits regime.

The material growth in open interest (area marked in yellow) started in the last month of Q4 2017, but this momentum was severely impaired at the end of 2017 and in the first period of 2018 in anticipation of the introduction of the MiFID II position limits regime. Before any reclassification of this market and subsequent recalibration of the limit could occur, the damage to the development of this market had proven to be irrevocable. This negative effect on the development of commodity derivative markets described above is stereotypical for fast growing markets subjected to the MiFID II position limits regime.

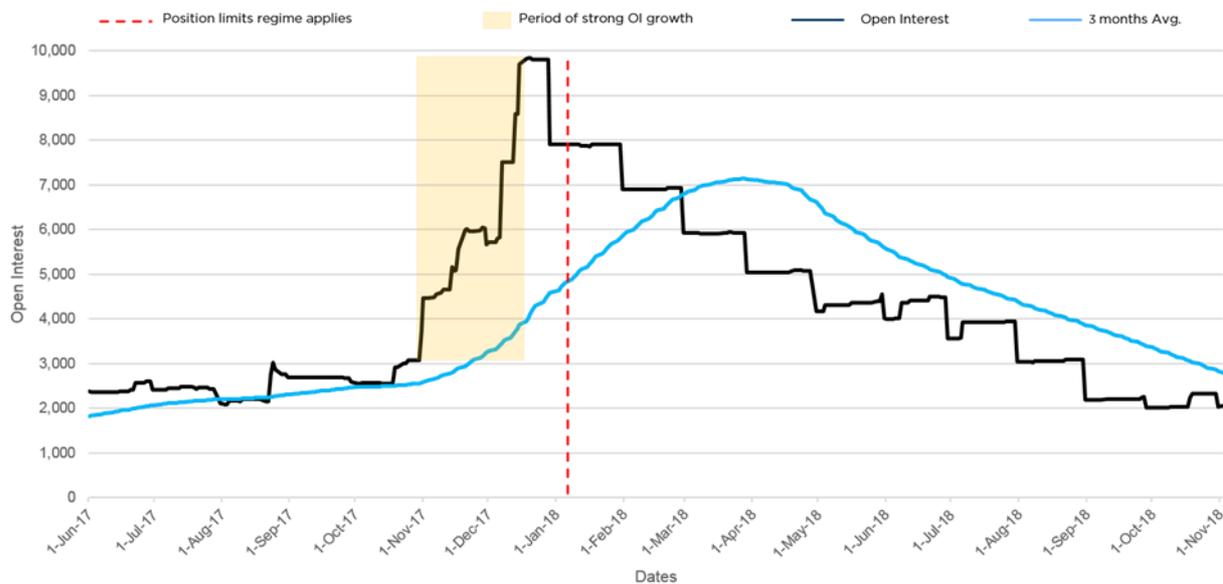


Figure 1. Impact of position limits regime on development of ICE Endex Italian PSV Gas Futures market.

c) Inaccurate reflection of the underlying physical markets

Furthermore, for some commodity derivatives, the characteristic of the underlying physical market is such that an effective hedge can only be achieved by trading a specific number of lots. Such a number cannot be traded without exceeding the limit. Yet, under the current MiFID II provisions, the limit cannot be raised without sufficient increase of the open interest.

For example, the recently launched ICE Futures Europe TD20 West Africa to UK-Continent (Baltic) Future has grown significantly over the past few months, reaching over six thousand lots of open interest. The contract is a Suezmax crude route, West Africa to UK Continent for tankers sized on average 130,000 MT (DWT). The biggest positions exceeding 1.9k lots

are held by commodity traders, some of which are located outside of the EU and do not hold hedging exemptions. Companies with Suezmax types of tankers fleets tend to hedge calendar years forward, fleet sizes up to 20 tankers and above.

To hedge a fleet of ten tankers on a year forward basis - the trade size will be (either as a single trade or done in a sequence of multiple smaller trades for the same Calendar Year tenor, keeping positions open throughout expiry):

130 lots * 12months * 10 tankers = 15,600 lots to hedge freight rates exposure for a single Calendar year (i.e. Cal 2019 trade)

With fast growing trading volumes in wet freight, companies are now seen extending hedges down the curve, trading to cover Cal19 / Cal20 and even Cal21 tenors that we are now seeing in a VLCC TD3C route (Arab Gulf to China crude route). The [International Maritime Organization's regulation going live in 2020](#) has been a significant factor behind the longer-dated hedges as companies are seeking certainty and stability of "locked in" freight levels that are expected to become volatile as the new sulphur caps for bunker fuel will start affecting the cost of shipping from January 2020.

Since the traders active in TD20 have indicated the business need to hedge multiple calendar years forward in TD20 route that would result in tripling trading volumes in the traded volume calculation scenario above, with potential volumes amounting to 46,800 lots.

However, the growth of the contract is restricted by the current de minimis position limit. Further development of this contract requires dynamic changes of the current limit from a fixed 2,500 lots level to a much higher limit based on the open interest.

2. Supporting the development of cross-border electricity and gas markets classified as liquid and the objectives of Energy Union

Electricity and gas derivatives play an important role in the development of the EU Internal Energy Market by allowing European energy trading companies to hedge their risks which arise from cross-border trading. They are subject to a bespoke regulatory regime within the REMIT framework aimed at preventing market abuse and ensuring integrity of the market. Certain level of integration of electricity and gas markets has been observed across Europe, with multiple liquidity pools co-existing in some underlying deliverables such as German Power. It is important that these liquidity pools are allowed to develop in accordance with genuine economic needs of the market and its participants, rather than as a result of financial regulation.

Within that context, FESE notes that, since the application of the position limits regime, growing liquidity in some of these pools has proven more difficult than in trading venues on which the benchmark contracts are traded. This is often due to much higher position limits available in 'other months' for the benchmark contracts than for contracts in other, smaller liquidity pools.

When position limits are materially different, there is a risk that traders and market makers will look to trade only on the largest market, where they have a lower risk of breaching the position limit. This may prevent the development of liquidity in smaller venues thereby reducing options available to market participants to manage their risks against the volatile day ahead prices on an exchange other than the exchange on which the "benchmark contract" is traded. Comparing the German power contract listed by Nasdaq and the German contract listed by EEX for example, the latter is substantially larger as the open interest in the contract is substantially larger. It therefore may be that the regime contributes to pushing the liquidity to the largest exchange hosting a 'benchmark contract', effectively preventing liquidity from being built elsewhere. Thus, there may be a reason to analyse the role of the position limits regime in supporting the further development of liquid electricity

and gas markets across Europe. Especially, given that the dedicated REMIT regime has been put in place to prevent market abuse in these markets.

3. Redefinition of the scope

We believe that derivatives on broad-based commodity indices are wrongly addressed in the scope of the position limits regime. In our members' experience, the regime creates barriers for new clients' flow and promotes shifts to OTC, and puts liquidity providers and market makers into strenuous situations in performing their role - namely, to provide liquidity.

In the following, we would like to elaborate on these facets, first focusing on the observations since the introduction of MiFIR/ MiFID II, and then recapping on the methodology of the particular type of broad based commodities indices on FESE members and the inadequate deployment of position limits on those types of contracts:

- The position limits create entry barriers for new clients, as they can only trade the products, if they are (technically) set up for the daily reporting of their positions. The laborious reporting requirements set out in the laws seem disproportionate to the style and purpose of trading these derivatives and the small market demand for a niche purpose does not motivate traders, from various buy-side communities interested into these types of derivatives, to move positions from the OTC market into a listed and cleared exchange environment. Thus, prohibitively high barrier for small and illiquid markets like on these types of broad-based index derivatives are experienced.
- The position limits also create hurdles for existing clients. This is in particular true for liquidity providers/ market makers, who often trade against separate clients / funds, but while the clients have therefore separate limits, it is all adding up in the same position for the market makers, the more illiquid the market, the higher the straining on the liquidity provider/ market maker, as chances are high that only few market makers and few clients interact in illiquid markets. The liquidity provider/ market maker will always try to be delta-neutral, i.e. each trade they do in the commodity index futures at one exchange will immediately be offset by a hedge in other products (normally the individual commodity futures in the index). Liquidity providers/ market makers offer exposure to certain product and earn on the spread, but are risk-avoiders by definition. Therefore, position limits are limiting their ability to offer this important service.
- In addition to these concerning developments for the growth of transparent and liquid markets, we would like to further point out that the product design of these derivatives contracts, namely, broad based commodity index derivatives, should not have been included into the scope of the regime in the first place. To better explain this, we would use the following example:
 - Bloomberg Commodity Indices are calculated from futures prices on many single individual commodities and all futures are exchange traded in regulated markets/exchanges even though not all under MiFID legislation. For this reason, several limits are applied on the individual components of the index itself and the calculation of the index ensures that the index reflects a broad range of underlying commodities- i.e. the weighting is very dispersed. This implies, meanwhile, that broad based commodity indices, like the Bloomberg Commodity Indices used as underlying for derivatives at Eurex, cannot be used to speculate or used in a malicious manner by traders- by construction.
 - First, the broad-based index underlying does not allow to manipulate the underlying market into a direction, as no single component would have the weight to bring market participants into a corner or squeeze situation.
 - Secondly, the individual futures components of the index are already receiving position limits in their markets on an individual level. All individual commodity futures used in the underlying of the Bloomberg commodity

indices used for Eurex derivatives have their own position limits, set by the local regulator/exchange. Therefore, defining them on the index level is rather redundant.

- Thirdly, the derivatives product on the broad-based commodity index tradable on Eurex is cash settled. As a regulated market, also using the means of position limits for other asset classes, this measure is only deployed to physically delivered instruments, where it makes sense to deploy such limits - not on cash settled instruments.
- Finally, all trades are published and transactions are reported to regulators by market participants
- Taking all these facets together, we believe that the regimes does not provide a reasonable measure for increasing market integrity but impairs the growth of and demotivates clients' flow to shift to transparent and electronically traded markets. It also limits the capability of liquidity providers to fulfil their role and comply with the regulatory requirements, as these are stemming from a mis-categorisation into the scope of the regime.
- FESE acknowledges that regulators and legislators equally might be concerned that exclusion of scope might open opportunity for loopholes. Therefore, we recapped the aforementioned product design of these derivatives contracts, in order to demonstrate that the product construction and specifications already fulfil many the objectives of the law, to achieve market integrity and transparency, and can be taken into consideration when the definition scope will be revisited.

Therefore, FESE strongly recommends taking into consideration the above-mentioned descriptions and explanations on cash settled derivatives on broad-based indices, to better delineate and calibrate a definition for commodities derivatives that focus on contracts that would be adequately captured by the regime.

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.

Exchanges have observed an increased difficulty for financial counterparties, such as investment banks or commodity trading houses, to efficiently serve their clients in commodity markets (for example cocoa producers or oil refineries). This has been caused by inability of those counterparties to hedge risk through more structurally complex transactions than simply trading on client's account.

Indeed, the position limits regime includes exemptions for market participants pursuing hedging activity. However, the MiFID II definition of hedging as set out in RTS 20 is clear that only non-financial entities can engage in such activity, thereby rendering the exemption unviable to investment banks or commodity trading houses which both play a vital role in providing smaller commercial players with access to commodity derivatives markets. Therefore, the hedging exemption cannot be considered a universal solution to inappropriately designed pre-trade transparency regime or disproportionate position limits.

An example of such situation is the so called Refining Margin Hedge often used in oil markets, whereby an investment bank agrees with its client, a refiner, on a single price of a basket comprising various refined products. Once the refiner agrees the single price for the basket, the bank executes the offsetting trades in the futures market on its own account.

1. Banks' Client-Facing Trade (either directly/bilaterally or on an ICE Cleared basis)

ICE Contract Code	ICE Contract Name	No of Lots
I	Brent 1st Line	1000
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BAR	Fuel Oil 3.5% FOB Rotterdam Barges Future	31
ULA	Low Sulphur Gasoil 1st Line Future	540
JCN	Jet CIF NWE Cargoes (Platts) Future	13
AEO	Argus Eurobob Oxy FOB Rotterdam Barges Future	24
NEC	Naphtha CIF NWE Cargoes Future	11

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

ICE Contract Code	ICE Contract Name	No of Lots
B	Brent Future	1000
DBF	Dated Brent vs Brent 1st Line Future	1000
UCF	Urals Med vs Dated Brent CFD Future	1000
BOB	Fuel Oil 3.5% FOB Rotterdam Barges vs Brent 1st Line Future	31
G	LS Gasoil Future	670
ULJ	Jet CIF NWE Cargoes (Platts) vs LS Gasoil 1st line Future	13
EOB	Argus Eurobob Oxy FOB Rotterdam Barges vs Brent 1st Line Future	24
NOB	Naphtha CIF NWE Cargoes vs Brent 1st Line Future	11

Even though within the context of such transaction the bank clearly performs a hedging activity, it would not be able to make use of the exemption envisaged under MiFIR Article 8 or MiFID Article 57.

In addition, since the introductions of the position limits regime, a shift to bilateral trading has been observed across the European electricity trading landscape. Market participants trading on European electricity exchanges need to comply with the position limit regime, but they do not when trading bilaterally. The bilateral trading is therefore commonly viewed as cheaper and less burdensome from a regulatory perspective. Several of the major utilities now offer physical bilateral trading services to their large-scale customers via proprietary electronic platforms. These volumes are hedging with physical delivery, which is exempted from position limits. For example, on Nasdaq's markets the bilateral activity has increased from 3-5% to ca. 12-15% during the past 5 years, and the German bilateral market share has grown from ca. 50% to ca. 66%.

The shift to the bilateral space limits transparency, undermines the price discovery process and increase systemic risk. Furthermore, this has repercussions in the scenario of a member default. Basically, no other market participants will be able to take over existing positions in a reasonable timeframe, as all banks, who would be theoretically able to do this, are technically not setup to do so. The regime therefore could in a theoretical worst-case scenario even create unwanted risks for CCPs.

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.

FESE members have considerable experience in operating a position management system. Long before the application of MiFID II, they had developed a comprehensive, risk-based regimes based on position, delivery and expiry limits with regards to commodity derivatives traded on its markets. These regimes are calibrated to prevent market abuse and ensure orderly delivery while allowing new products to be developed. Since January 2018, they have

been operated by FESE members in parallel with position limits set by the relevant NCAs under MiFID II.

Exchanges have long been of the view that a proportionate and efficient position limits regime should concentrate on a limited number of benchmark contracts. FESE members' pre-MiFID II position management regime has adhered to that principle. Also, in order to prevent market squeezes, limits have been set by exchanges for the period right before expiry rather than covering the entire maturity curve. The regime has contributed to preventing market abuse and excessive speculation which could negatively impact global retail prices, while allowing new and nascent products to develop.

We believe that a properly calibrated position management regime can play an important role in preventing market abuse. However, FESE does not consider the MiFID II position limits regime to have contributed to preventing market abuse in trading commodity derivatives. Rather, this has been achieved by the exchanges' pre-existing position management regimes as well as their market supervision and surveillance systems. Furthermore, proper addressing of market abuse requires an overall approach of both underlying spot markets as well as derivatives markets, and both exchange traded and OTC markets. Position limits only apply to the exchange traded derivatives markets. For the electricity markets, MAR and REMIT combined are the appropriate instruments and possible improvements of prevention of market abuse should be addressed with these instruments in mind rather than position limits.

As indicated in the response to Q1-Section 3, we would like to emphasise that the overall regime needs to be reconsidered for what it concerns cash settled products. To our experience, position limits unfold their value for market integrity in physically delivered contracts. The underlying is usually a single instrument or a very narrow defined basket, and not a broad-based index.

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.

FESE members believe that a properly calibrated position management regime can play an important role in ensuring orderly pricing and settlement of commodity derivative contracts. However, FESE does not consider the MiFID II position limits regime to have contributed to achieving these objectives. Rather, they have been achieved by the exchanges' pre-existing position management regimes as well as their market oversight systems (including compliance, supervision and surveillance).

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?

The MiFID II position limits regime has so far been able to function for a number of well-developed benchmark contracts. These highly developed markets are characterised by a large number of different types of active trading firms and an overall substantial amount of open interest. However, for the development of new products and further growth of the existing illiquid commodity derivative markets, the position limits regime has proven to be a substantial barrier. Fast growing markets in particular have suffered from (1) an increasingly restrictive limit as open interest increases and (2) inflexible treatment in terms of their categorization under the position limits framework, (3) Inaccurate reflection of the underlying physical markets.

Please see the response to Q1 for further details.

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.

N/A

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.

We agree that position management controls have a role in the prevention of market abuse. Many commodity exchanges utilised these in advance of MiFID II to limit the risk of abusive market squeezes. This is particularly relevant for those contracts which are physically settled. Thus, FESE does not consider MiFID II position management controls to have contributed to the prevention of market abuse. Rather, the pre-MiFID II systems put in place by exchanges have already achieved that goal.

Furthermore, for cash-settled products (please refer to the arguments in Q1-Section3), this tool is not considered useful

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.

Although little impact overall can be seen on exchanges run by FESE members in regards to orderly price formation, it is recommended to take a holistic picture and consider the various unintended consequences depicted in the responses to previous questions, especially Q1.

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?

N/A

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

N/A

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?

N/A

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.

No. Exchanges have long been of the view that a proportionate and efficient position limits regime should concentrate on a limited number of benchmark contracts as these are markets in which price formation takes place. FESE believes that the MiFID II position limits regime has so far been able to function for a number of well-developed benchmark contracts. These

highly developed markets are characterised by a large number of different types of active trading firms and an overall substantial amount of open interest.

However, for the development of new products and further growth of the existing illiquid commodity derivative markets, the position limits regime has proven to be a substantial barrier. Fast growing markets in particular have suffered from (1) an increasingly restrictive limit as open interest increases and (2) inflexible treatment in terms of their categorization under the position limits framework, (3) inaccurate reflection of underlying physical markets.

Furthermore, we would like to stress the need to assess the impact on market participants in commodity asset classes that are wrongly captured under the definition, namely cash settled derivatives on broad-based commodities indices underlying. Especially for these contracts, it does not seem reasonable to have an additional limit on the index derivative, as the individual components are already under a position limit regime on the exchanges where these are traded. In our view, it makes no sense, as a) position limits are already set on an individual level with more thoughts and knowledge on market characteristic and market structural aspects locally and b) the commodity index products are cash-settled and it is not possible to squeeze (corner) a market like in physical delivered derivatives contracts. In addition, it is already defined in the index methodology, that for each individual commodity future, the front-month contract is rolled into the back-month well before expiry. This further describes a corrective market measure.

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?

Yes. FESE is of the view that position limits should only be imposed on key benchmark contracts which are crucial to the orderly functioning of their respective commodity markets. This is because price formation mainly occurs in such benchmark products. Other commodity derivatives contracts follow the benchmark contracts in terms of price formation and thus should not be subject to limits. Also, many of the basis markets trade as spreads to the benchmark contract. In such cases, position limit for basis markets potentially restrict the usage of spread strategies as market participants can only execute the benchmark leg without breaching them.

We would recommend refocusing the application of the regime to fit the legislative objective, the unintended consequence identified, e.g. for cash settled commodities derivatives contracts on broad-based index underlying, the lack of global rule harmonisation and trading needs and standards.

In addition, market participants and supervisor face many challenges in implementing such a broad regime and this has led to various big and small issues across the broader market. We struggle to see how benefits outweigh negative consequences and costs, such as the shrinking share of exchange trading, reduced transparency and regulatory costs for both market participants and public authorities, and barriers to developing illiquid markets into more liquid.

Lastly, we would like to emphasise the fact that exchanges already have sophisticated systems and controls in place to achieve the policy objectives of MiFID II, i.e. ensuring orderly pricing and settlement and preventing market abuse.

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

We believe that the regime provides a workable solution for securitised commodity derivatives - in particular based on the provisions for illiquid securities in Art. 15 of Commission Delegated Regulation (EU) 2017/591 - and therefore we do not ask for any specific amendments in this regard. In the case, that the provisions for illiquid securities will

be amended with regard to other kind of derivatives than securitised derivatives, there is the need for an in-depth assessment of consequences.

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

No, FESE would not support a review of the definition of EOTC contracts. We believe that the key objectives of introducing that concept into MiFID II have been: (i) to prevent circumvention of its provisions by trading equivalent contracts in the OTC market, (ii) to allow for netting of equivalent contracts traded on venues and in the OTC markets. Both objectives have been achieved with the current definition. The mere fact that very few EOTC contracts have been identified is not the 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.

Yes. Whilst the position limits regime includes exemptions for market participants pursuing hedging activity, the MiFID II definition of hedging as set out in RTS 20 is clear that only non-financial entities can engage in such activity, thereby rendering the exemption unviable to investment banks or commodity trading houses which both play a vital role in providing smaller commercial players with access to commodity derivatives markets.

For that reason, the hedging exemption cannot be considered a universal solution to inappropriately designed pre-trade transparency regime or disproportionate position limits.

An example of such situation is the so called Refining Margin Hedge often used in oil markets, whereby an investment bank agrees with its client, a refiner, on a single price of a basket comprising various refined products. Once the refiner agrees the single price for the basket, the bank executes the offsetting trades in the futures market on its own account.

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Even though within the context of such transaction the bank clearly performs a hedging activity, it would not be able to make use of the exemption envisaged under MiFIR Article 8 or MiFID Article 57.

FESE commodity exchanges have extensive experience with operating a position management system based on hedging exemptions. Under their regimes, they can grant such exemptions to any market participant, regardless of their legal status, provided that the hedging intention is adequately documented and demonstrated. This ensures that the genuine hedging activity is not restricted and allows commodity market participants to manage their risks efficiently.

Exchanges propose that an analogous regime is introduced within the context of MiFID II/MiFIR package.

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.

Yes. FESE agrees that NCAs should have an optionality to set limits based on open interest for both spot and other months. Such a solution would prevent negative unintended consequences of the position limits regime for certain commodity derivative contracts which serve as pricing benchmarks and risk-management proxies in the absence of direct hedging instruments.

However, FESE emphasises that setting limits for both spot and other months based on open interest should be an optionality and by no means a rule in setting position limits. It should be conditioned upon specific characteristics and functions of a commodity derivative contract in question.

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

Yes. Considering the negative impacts that the MiFID II position limits regime has had on the proper functioning and further development of nascent commodity derivatives markets as well as the competitive position of European trading venues, we believe that changes thereto are urgently required.

FESE is of the view that position limits should only be imposed on key benchmark contracts which are crucial to orderly functioning of their respective commodity markets. This is because the price formation mainly occurs in such benchmark products. Other commodity derivatives contracts follow benchmarks in terms of price formation and thus should not be subject to limits.

Equally, new and illiquid and less liquid contracts (i.e. those with open interest below twenty thousand lots) should not be subject to position limits. New and nascent products normally constitute a minor share of commodity markets. Such contracts are unlikely to influence price movements in the underlying physical commodity markets that could negatively impact consumers.

Such an amendment would better fulfil the overall policy objective of MiFID II to “improve the functioning and transparency of commodity markets and address excessive commodity price volatility”. Furthermore, even in the absence of position limits, these contracts would remain subject to internal position monitoring and management by the trading venues and market surveillance procedures aimed at preventing abuse. Thus, the removal of position limits for such contracts would not pose any risk to the transparency and functioning thereof. Rather, attracting more volume to regulated venues would contribute to a more transparent trading environment. <ESMA_QUESTION_PLPM_18>

Q19: Would you see merits in a more forward-looking approach to the calculation of open interest used as a baseline for setting position limits? Please elaborate.

FESE supports the introduction of a forward-looking model whereby the position limit is calculated based on a form of extrapolation of the historical development of open interest

in a certain market, as this approach would be better suited to accommodate for periods of strong market growth.

Under the existing model a position limit is based on a percentage of the average amount of open interest of a certain historical period, which is usually a one, three, six or twelve months period depending on the characteristics of the commodity market. This backward-looking methodology inherently does not properly capture the potential future growth of a market and risks applying an over restrictive limit when a market experiences a period of strong growth. At a minimum and where appropriate, it should therefore be allowed to use the smallest possible period for the calculation of open interest levels (i.e. the average open interest of the most recent trading day) under the existing rules.

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?

For markets classified as “liquid” for other months, position limits are based on open interest. The methodology to calculate the open interest is not harmonised in regulation, so different methodologies are used in different markets. FESE suggests that ESMA analyses the effects of these differences. If methodologies used are resulting in very different outcomes, this may have follow-on effects on the actual setting of position limits, which may not optimally support well-functioning markets across the EU, especially where markets are becoming increasingly integrated.

If ESMA believes there is a need to provide its views on the methodologies used by exchanges to calculate open interest for the purpose of position limits by means of Level 3 guidance, then FESE considers the use of gross open interest as the most appropriate of the different methodologies that NCA’s should be able to allow exchanges to implement.

This is because the usage of net open interest to determine the other month position limit would be inappropriate as it does not properly reflect trading on behalf of clients. For example, if a member holds 5 lots long for client A and 5 lots short for client B, this position should not be netted, as the positions belong to different beneficial owners.

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

N/A

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.

N/A