FESE Response to the ESMA Consultation Paper on Technical Standards for Commodity Derivatives

23rd July 2021, Brussels

Introduction

Please make your introductory comments below, if any:

FESE welcomes the opportunity to provide feedback to ESMA on the Technical Standards for Commodity Derivatives.

While overall we would support most of ESMA's proposals, we disagree with the suggested methodology for determining the baseline figure for spot month limits, favouring instead maintaining the current regime.

Furthermore, we would caution ESMA against stipulating a highly prescriptive process for position management controls which reserves little room for trading venues' discretion. To function properly, position management controls need to be cautiously calibrated and tailored to the circumstances of each individual exchange, such as the nature of its membership and the characteristics and underlying markets of contracts it admits to trading.

Part I

Q1: Do you agree with ESMA's proposal regarding the impact of the new hedging exemption on the aggregation of positions? If not, please elaborate.

Yes, FESE agrees with ESMA's assessment and proposal.

Q2: Do you agree with ESMA's proposal for positions qualifying as risk-reducing? If not, please elaborate and provide an alternative proposal.

Yes, FESE agrees with ESMA's assessment and proposal.

Q3: Do you agree with ESMA's proposal on the application procedure for financial entities?? If not, please elaborate and provide an alternative proposal.

Yes, FESE agrees with ESMA's assessment and proposal.

Q4: Do you agree with ESMA's proposal on the application procedure for mandatory liquidity provision exemption? If not, please elaborate and provide an alternative proposal.

Yes, FESE agrees with ESMA’s assessment and proposal.

Q5: Do you agree with ESMA’s proposal on qualifying positions? If not, please elaborate and provide an alternative proposal.

Yes, FESE agrees with ESMA’s assessment and proposal.

Q6: Do you agree with ESMA’s proposed definition of financial entities? If not, please elaborate.

Yes, FESE agrees with ESMA’s assessment and proposal.

Q7: Do you agree with ESMA’s proposal regarding the aggregation and netting of positions in a commodity derivative? If not, please elaborate and provide an alternative proposal.

FESE supports the deletion of the reference to “the same commodity derivative”.

We would suggest not to set out in Level 2 that position limits should apply to the use of spread contracts. When spread trading is merely a trading strategy, contracts ESMA refers to are not actual outright contracts but rather trading strategies whereby the two constituent legs of a spread consist of outright futures contracts; both of those legs count towards the position limits of the respective outright futures contracts. FESE notes that in the event a trading venue admits to trading a differential contract whose contract terms reflect the economics of two separate outright markets, a separate position limit is also not required. Instead, the position in the differential contract can be deconstructed into equivalent long and short positions and aggregated with any positions of the respective outright markets reflecting the economics of the differential.

We agree with the proposal to aggregate the positions of commodity derivatives that are based on the same underlying and share almost the same specifications as the principal or main commodity derivative traded on the same trading venue, such as "minis" and "balmos".

Q8: Do you agree with ESMA’s proposal for significant volumes? If not, please elaborate.

Yes, FESE agrees with ESMA’s assessment and proposal.

Q9: Do you agree with ESMA’s proposal? If not, please elaborate and provide an alternative proposal where available.

We strongly disagree. It is unclear which rationale ESMA uses to move to open interest for contracts for which the deliverable supply is sufficiently higher than open interest. We do not consider that markets, because of the fact that deliverable supply is substantially higher than the open interest, are more prone to market cornering. Moreover, using open interest as the basis for the position limit is expected to hinder growth in such markets, which are typically small and not yet developed.

We therefore strongly recommend maintaining the current regime and hence omitting the proposal to add "*Where the deliverable supply is substantially higher than the total open interest, competent authorities shall determine the baseline figure for the spot month limit by calculating 25% of the open interest in that commodity derivative*." to Article 11 par. 1, and "*Where the deliverable supply is substantially higher than the total open interest, competent authorities shall determine the baseline figure for the spot month limit by calculating 20% of the open interest in that commodity derivative*." to Article 11 par. 4.

Furthermore, we believe it would ensure consistency as well as legal certainty should RTS21 refer to the definition of agricultural derivative contracts laid down in the so-called MiFID II "quick fix", instead of "derivative contracts with an underlying that qualifies as food intended for human consumption". The MiFID II "quick fix" defines agricultural commodity derivatives as "derivative contracts relating to products listed in Article 1 of, and Annex I, Parts I to XX and XXIV/1, to, Regulation (EU) No 1308/2013 of the European Parliament and of the Council (*), as well as to products listed in Annex I to Regulation (EU) No 1379/2013 of the European Parliament and of the Council (**).

(*) Regulation (EU) No 1308/2013 of the European Parliament and of the Council of 17 December 2013 establishing a common organisation of the markets in agricultural products and repealing Council Regulations (EEC) No 922/72, (EEC) No 234/79, (EC) No 1037/2001 and (EC) No 1234/2007 (OJ L 347, 20.12.2013, p. 671).

(**) Regulation (EU) No 1379/2013 of the European Parliament and of the Council of 11 December 2013 on the common organisation of the markets in fishery and aquaculture products, amending Council Regulations (EC) No 1184/2006 and (EC)".

Q10: Do you agree with ESMA's proposal? If not, please elaborate.

We believe that it would be more appropriate to take the same approach which ESMA is recommending for the open interest reference period, i.e. it should be determined on a case by case basis what is the representative period of time.

Q11: Do you agree with ESMA's proposals regarding Article 14 of RTS 21a? If not, please elaborate and provide alternative proposals.

We agree with ESMA's proposal on how to calculate open interest.

Furthermore, we strongly support the proposal to calculate open interest "over a representative period of time" depending on the characteristics of the commodity derivative. The same flexibility is even more critical in special circumstances, such as trading moving from one venue to another due to a merger or from one contract to another or due to an index transfer. We therefore do not agree with specifying that in such circumstances the "representative period of time" should be six months and suggest leaving out this wording in Art. 14(2).

Q12: Do you see merit in the new approach considered by ESMA for new and less liquid agricultural commodity derivatives? If not, please elaborate and provide an alternative proposal.

Yes, FESE strongly agrees with ESMA's new approach.

Q13: Do you agree with ESMA's proposal regarding Article 19 of RTS 21a? If not, please elaborate.

Yes, we agree with adjusting the other month position limit upwards when open interest is significantly lower than deliverable supply.

We would not agree, however, with the proposal to adjust the spot month position limit downwards when open interest is significantly lower than deliverable supply. As outlined in Question 9, we do not see the rationale for doing so. We do not consider that markets, because of the fact that deliverable supply is substantially higher than the open interest, are more prone to market cornering. Moreover, it could hamper growth in these undeveloped markets.

We therefore recommend amending Article 19 par. 3 as follows: *Where the open interest is significantly lower than the deliverable supply, competent authorities shall adjust the other months' position limit upwards ~~and the spot month position limit downwards~~.*

Q14: Do you agree with ESMA' proposal regarding the upward adjustment factor to be used in case of a small number of market participants or less than three investment firms acting as market makers? If not, please elaborate and provide an alternative proposal.

Yes, FESE agrees with ESMA's assessment and proposal. Furthermore, we would like to request clarification on how commodity derivatives will be assessed in order to identify them as being "based on the same underlying and sharing the same characteristics" in the scope of this proposal.

Part II

Q15: Do you agree with ESMA's proposed amendments to ITS 4? If not, please elaborate.

Yes, FESE agrees with ESMA's assessment and proposal.

Part III

Q16: Do you agree with ESMA's suggestion to introduce such ongoing position monitoring requirement in the draft RTS? If not, please elaborate.

Yes, we would in principle agree with ESMA's suggestion. However, "persons with close links" is a foreign concept for EU commodity derivative trading venues, which have no access to such information. It is therefore highly recommended that ESMA uses the existing reporting formats which include information on end position holder and parent undertaking.

If not, this obligation introduces a much wider obligation which we believe goes beyond the mandate of the changes to MiFID II introduced via the Capital Markets Recovery Package.

Q17: Do you agree with ESMA's suggestion to introduce accountability levels as part of position management controls? Do you agree with ESMA's assessment that accountability levels would be of particular relevance for physically settled commodity derivatives? If not, please elaborate and provide alternative proposals.

FESE commodity exchanges have extensive experience with operating an internal position management system and are committed to the highest standards to ensure fair and orderly trading. This is because exchanges have a genuine interest in the integrity of the markets they offer for trading. Exchanges' market monitoring and surveillance departments ensure compliance with all other relevant requirements under MiFID II/MiFIR, the Market Abuse Regulation (MAR) and the Regulation on Energy Market Integrity and Transparency (REMIT) where applicable, as acknowledged by ESMA.

Furthermore, these regimes would be operated by compliance teams with sufficient staff and technologically advanced tools to monitor, on a daily basis, the open interest in contracts admitted to trading, the positions held in those contracts by exchange members and the activity in physical markets underlying the commodity derivatives admitted to trading.

For example, the compliance team monitoring positions in a crude oil contract may compare these positions with the activity in the underlying physical market and the direction of travel of oil barges in the relevant geographical area. If these movements are not coherent with positions held or if the positions are considered excessive given the activity in the underlying market, the compliance team may decide to open an inquiry with regard to the entered positions and take further action if the response is not satisfactory.

These position management regimes are cautiously calibrated and tailored to the circumstances of each individual exchange, such as the nature of its membership and the characteristics and underlying markets of contracts it admits to trading. There is no 'one size fits all' position management regime.

That is why we would very much caution ESMA against stipulating a highly prescriptive process with little room for trading venues' discretion.

We believe that the only way for the accountability levels to function properly would be to provide that full discretion is given to the trading venue to determine on which contracts to set those accountability levels, when to actively monitor them and whether indeed to request additional information if an accountability level is exceeded. If not, the position management controls are likely to put a heavy compliance burden on both exchanges' market surveillance departments and trading participants' compliance departments.

If ESMA maintains its proposal to require trading venues to set accountability levels, we believe that ESMA should at least introduce the necessary discretion for exchanges to set those accountability levels by replacing the word "shall" with "may" in both paragraph 1, 2 and 3 and the second part of paragraph 4 of Article 2. We believe that such discretion would also be better aligned with the CFTC position management regime and MiFID II Art. 57 par. 8 which grants exchanges powers rather than imposing new requirements on them.

It is evident that financially-settled contracts would not be in focus of such accountability levels. This is because in order to corner or squeeze a financially-settled contract, one has to be able to manipulate the underlying reference price or index. As such indices in Europe are sufficiently robust, it is highly unlikely market squeezes would ever occur in financially-settled contracts.

However, many more parameters are important in the assessment of whether an accountability level would be appropriate and meaningful for market surveillance purposes. Other parameters to be considered are the amount of OTC trading vs on-exchange trading, liquidity established in the respective futures contract, whether there are any potential constraints in the delivery capacity (i.e. the relative size of the deliverable supply) and whether a futures contract is price forming or its pricing is closely linked to a benchmark futures contract.

As these parameters are highly dependent on the characteristics of the market, we believe the exchange should have the discretion to set the accountability levels as they deem appropriate. In addition, we believe that these accountability levels should remain confidential and not be made public as these are internal controls used by the exchange for market surveillance purposes.

Q18: In your view, how should accountability levels be set for the spot month and the other months? Based on which methodology or criteria? Should all types of positions count towards the accountability levels?

Please see our response to Q17. As a market corner or squeeze is only plausible shortly before delivery, we believe accountability levels become less useful the further out they are set on the curve. Again, as it would depend on the individual contract which timeframe would be most appropriate, we believe that exchanges are best suited to decide on this timeframe.

Q19: Do you agree with ESMA's suggestion to introduce requirements for the review of accountability levels? Do you also agree with ESMA's proposal regarding reporting requirements to the NCA on accountability levels? If not, please elaborate.

FESE agrees with ESMA's proposal for the review of accountability levels and for the reporting requirements to the NCA.

Q20: In your view, what other types of position management controls could be further specified in the draft RTS?

Cost Benefit Analysis

CBA Q1: This first question aims at identifying the category of firm/entity you belong to. Please provide the total notional amount traded in commodity derivatives traded on a trading venue (and EEOTC contracts where relevant in 2020 in thousand euros and the related total number of trades in the relevant boxes).

Category	Number of employees	Total notional amount traded in 2020 in thousand euros	Number of trades in 2020
Trading venue	[1-50]		
	[51-250]		
	[251-500]		
	>500		

Financial entity	[1-50]		
	[51-250]		
	[251-500]		
	>500		
Non-financial entity	[1-50]		
	[51-250]		
	[251-500]		
	>500		

CBA Q2: for Financial entities: Do you intend to apply for an exemption for risk-reducing positions related to the commercial activities of the commercial entity of the group? What percentage of your positions do these risk-reducing positions account for?

CBA Q3: Do you intend to apply for an exemption for positions resulting from transactions undertaken to fulfil mandatory liquidity provision? What percentage of your positions do these positions account for?

CBA Q4: Is there any specific provision in draft RTS 21a that you would expect to be a source of significant cost? If so, please elaborate.

CBA Q5: Taking into account the size of your firm, would you qualify overall compliance costs with draft RTS 21a as low, medium or high?

CBA Q6: Is there any specific provision in the draft RTS on position management controls that you would expect to be a source of significant cost? If so, please elaborate.

The absence of sufficient discretion for an exchange to implement the position management controls in an appropriate manner, and the extension of the position management controls to cover 'persons with close links', are likely to result in a significant cost to the exchange and market participants.

Any breach of an accountability level would require an exchange to investigate and obtain a substantial amount of information from market participants. Exchanges will have to hire additional market surveillance staff to handle all investigations prompted by alerts and market participants will have to hire additional compliance staff to respond to all information requests. The extension of the scope of the position management controls to cover 'persons with close links' would require the development of new daily reporting arrangements between an exchange and their clients, as the information about affiliates covered under the ‘persons with close links’ requirement is not covered in existing MiFID II position reporting requirements.

CBA Q7: Taking into account the size of your firm, would you qualify overall compliance costs with amended the draft RTS on position management controls as low, medium or high?

FESE considers the compliance costs of the draft position management rules to be disproportionately high. Depending on how the position management controls are specified by ESMA, they might require many resources with little or no improvement in market integrity.