Position Limits Come to Europe

By Natasha Stromberg

January's agreement on the final text of MiFID II marks an important milestone in the regulation of European commodity markets. For the first time, speculative trading in commodity derivatives will have to comply with position limits established by European regulatory authorities.

Equally importantly, the new framework will apply not only to commodity futures traded on exchanges but also to economically equivalent derivatives traded over the counter or on other types of trading venues.

Michel Barnier, the European Commissioner for Internal Market and Services, welcomed the agreement on position limits, saying that it will limit the harm caused by excessive speculation. "By introducing a harmonized EU system setting limits on the positions held in commodity derivatives, MiFID II will contribute to orderly pricing and prevent market abuse, thus curbing speculation on commodities and the disastrous impacts it can have on the world's poorest populations," Barnier said on Jan. 14.

While MiFID II establishes the legal authority for the new framework, the actual implementation is still several years away and the details are far from finished. The next step will be a lengthy period of consultation with the European Securities and Markets Authority, which will flesh out the framework, determine a methodology for setting position limits, and implement the new regime.

For participants in the European commodity markets, the new regime will create a significant new compliance challenge and may lead to long-lasting changes to trading patterns. Europe will move from a patchwork of position management levels set by individual exchanges to a comprehensive regime that is intended to capture the full scope of commodity trading activity in all types of derivatives markets. This will require market participants to manage compliance with limits on the number of their positions across listed and OTC derivatives markets. It will also require market participants and trading venues to develop new mechanisms for providing regulators with information on positions held by both members of the trading venues and their clients on a daily basis.

Scope

The establishment of position limits was just one part of a wide range of reforms contained in MiFID II, but it was also one of the most difficult to resolve. A key issue during the two years of negotiations that led up to the final agreement in March 2014 was the scope of the regulation and the definition of exactly what constituted a financial instrument. Under the final text, commodity derivatives traded on a regulated market, a multilateral trading facility or an organized trading facility are considered financial instruments under MiFID II and therefore are subject to position limits.

The only exceptions are physically settled gas and electricity forwards that are covered by the pan-European Regulation on Wholesale Energy Market Integrity and Transparency regulation and that are traded on OTFs. Physically settled oil and coal contracts traded on an OTF are currently in scope of MiFID although in what appears to be a concession to the oil and coal industry, a three year phase-in period for the clearing and margining obligations under EMIR has been granted by EU authorities in the MiFID text.

Position limits will not apply to non-financial firms that are hedging risks directly related to their commercial activities. In addition, market-making in commodity derivatives is exempt from MiFID if the activity is ancillary to an entity's main business.

Methodology

Under the new regime, actual position limits will be set by national competent authorities such as the Financial Conduct Authority in the U.K. and then confirmed or amended by ESMA at the pan-European level.

ESMA has been handed overall responsibility for designing the methodology of the regime and is tasked with developing draft regulatory technical standards that will be implemented by national competent authorities within the member states. ESMA's methodology will apply to position limits on the size of a net position which a person can hold in commodity derivatives traded on trading venues and economically equivalent OTC contracts. ESMA will need to take at least the following factors into account when determining its methodology:

- whether the contracts offer physical or cash settlement;
- the maturity of the contracts;
- the deliverable supply in the underlying commodity;
- the overall open interest in that contract and the overall open interest in other financial instruments with the same underlying commodity;
- the volatility of the relevant markets, including substitute derivatives and the underlying commodity markets;
- the number and size of the market participants;
- the characteristics of the underlying commodity market, including patterns of production, consumption and transportation to market; and
- the development of new contracts.

Cross-Border Issues

Where the same commodity derivative is traded in significant volumes on trading venues in more than one jurisdiction, the competent authority of the venue where the largest volume of trading takes place will set the position limit to be applied on all trades in that contract. This means that national competent authorities will have to work closely together to ensure that data is shared across borders and that a position limit regime is implemented, monitored and enforced harmoniously.

ESMA has been tasked with ensuring that a single position limit effectively applies 'to the same commodity derivative contract' irrespective of where it is traded and member states have given the competent authorities the power under MiFID to apply sanctions for breaches of their position limit regimes by persons either operating in their own territory or abroad. How this will be enforced in practice has yet to be detailed but it does raise the issue of extra-territorial reach in the broader context of MiFID.

National competent authorities must notify ESMA of the exact position limit they intend to set in accordance with ESMA's methodology and ESMA will then issue an opinion as to whether this is compliant. If it is deemed compliant, trading venues will work closely with NCAs in their own jurisdictions on supervision and enforcement issues. The most important change in supervisory responsibility is that ESMA will annually review the way competent authorities have implemented the position limit methodology. This means that a kind of hybrid model of supervision will ensue with ESMA being the overarching supervisory authority for a pan-European position limits regime.

Hedging Exemptions

The exemption for entities using commodity derivatives to hedge underlying commercial activities is stipulated under Article 59, although the language is strictly defined as "positions held by or on behalf of a non-financial entity and which are objectively measurable as reducing risks directly related to the commercial activity of that non-financial entity."

The language does not allow exemptions for financial entities managing their own risk as a result of exposure to the commercial activity of non-financial entities. This is likely to emerge as a key issue during the next step in the process, when ESMA and the national competent authorities draft the implementation standards. Trade bodies and industry groups will seek to ensure that banks are able to hedge their risks in the commodity derivatives markets without being penalized under a position limit regime.

Another key issue is the aggregation of positions held by affiliated companies. Under the MiFID II text, limits will be set for "all positions held by a person and those held on its behalf at an aggregate group level." It will now fall to ESMA to set the regulatory technical standards that will determine when and how the positions of a market participant should be aggregated within a group entity.

Position Reporting

Article 60 of MiFID II goes into some detail on how position reporting will work in practice. Each trading venue will be required to publish weekly reports on the aggregate positions held by the different categories of persons active on its venue. These reports will specify the number of long and short positions held by each category, the percentage of total open interest represented by each category, and the number of persons in each category. ESMA will move towards centralized publication of these reports in a similar manner to the CFTC's large trader reporting.

In addition, each venue will be required to provide its regulator with daily reports containing a "complete breakdown of positions held by all persons, including members or participants and the clients thereof." The text specifies, however, that the reporting obligations only apply when both the number of persons and their open positions exceed minimum thresholds.

Article 60 also establishes reporting obligations for commodity derivatives that are not traded on exchanges or other types of trading venues. In these cases, the investment firms will be required to provide regulators with a complete breakdown of their positions in commodity derivatives as well as the positions of their clients on a daily basis.

Next Steps

Given the complexity of the task of establishing the practical details and the expected timeframes of the MiFID implementation, it is likely to be the end of 2016 before a comprehensive European position limits regime is fully functioning.

ESMA is now in the process of drafting a package of technical standards to implement that regime. ESMA officials have indicated that this package could run to several hundred pages, a sign of just how much detail still needs to be worked out. A preliminary draft is expected to be released for public comment around the end of the second quarter. Once the consultation period closes, the next step will be for ESMA officials to review the responses and consider whether the draft needs to be amended.

MiFID II will become applicable 24 months after it enters into force, i.e. two years from the date it is published in the *Official Journal* of the EU. It is expected that the official publication will take place around the middle of the year, which means that ESMA will have until mid-2015 to provide its draft technical advice. While some work such as guidelines must be completed six months after the entry into force, the majority of ESMA's work has to be submitted to the European Commission between 12 and 18 months after entry into force.

Natasha Stromberg is a regulation manager at the Futures and Options Association in London, focusing on commodity-related activities. Before joining FOA in December 2012, she worked at the Financial Services Authority as a senior associate in the Derivatives Market Infrastructure and Policy unit.