europex
association of european energy exchanges

The Chairman
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Mr Martin Merlin
Director
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MiFID II position limits: changing the timing of the beginning of the application of spot month limits and the use of open interest as a basis for other months limits in the RTS 21

Dear Mr Merlin,

We write to you on behalf of Europex, the association of European energy exchanges, to express our serious concerns about the Level 2 rules for the position limits regime under MiFID II as proposed by ESMA as part of the Regulatory Technical Standards (RTS) that were published on 28 September 2015.

We accept that MiFID II mandates an expansive regime of position limits for commodity derivatives. However, as already highlighted in our letter to Commissioner Hill on 4 September 2015, inappropriately applied position limits will significantly reduce market liquidity and increase volatility in energy derivative contracts. In order to avoid this, two fundamental issues need to be addressed before the Commission sends the RTS to the Parliament and the Council for endorsement:

1. <u>The timing of the application of spot month limits</u>

In the current definition of "spot month" in the RTS 21, deliverable supply based spot month limits apply at the point when a contract month becomes the front month regardless of when the actual delivery obligation materialises. This implies that position limits will be applied throughout the whole period during which a contract is a front month.

Such an approach would be inconsistent with international best practices, including in France, the United Kingdom and the United States. There, spot month limits apply at the moment when delivery obligations take effect when a future contract expires. Article 57 (3) of MiFID II, however, states that ESMA "shall take into account experience regarding the position limits of investment firms or market operators operating a trading venue and of other jurisdictions."

The proposal, as it stands now, is likely to have a negative impact on front-month liquidity in key energy benchmark contracts and will incentivise significant regulatory arbitrage. If implemented in this way, it will not be possible anymore for contracts to quickly evolve into Continental-European benchmark contracts. The simple reason for this is that if position limits were applied throughout the whole period during which the contract serves as the front month, the limits would be constantly breached.

In order to align the application of spot month limits with current international best practices and to allow larger positions to be held and unwound in an orderly manner in the run-up to the commencement of the spot month period, we propose that the deliverable supply based spot month limits only apply during the last three days before the start of the delivery of the contract.

The following amendments to the RTS 21 would embrace this change:

- *(2) 'spot month contract' means the commodity derivative contract in relation to a particular underlying commodity (i) whose maturity is next to expire in accordance with the rules set by the trading venue; and (ii) in respect of which the close of business on the third day of trading before the last day of trading has occurred.*

- *Delete Article 9(3).*

2. The use of open interest as a basis for other months limits

In the current RTS 21 proposal other months position limits are based on open interest rather than deliverable supply. As already stated in the past, we believe that deliverable supply is the most appropriate basis for both spot month and other months position limits as undue behaviour and the control over deliverable supply coupled with holding a significant futures position could lead to a market disorder. In contrast, holding a significant proportion of open interest in future contracts in isolation does not create a disorderly market. Open interest can be highly volatile, and, especially in gas and power markets due to the MiFID II Annex I C.6 REMIT carve-out, might only represent a limited share of the actual overall market.

We support the proposed special regime for new and illiquid contracts. However, we believe that the proposed threshold for contracts with an open interest below 10,000 lots is insufficient. Open interest in new and less liquid or specialised contracts can grow quickly and easily exceed 10,000 lots of open interest while the number of market participants still remains very limited.

The RTS 21 as it currently stands will therefore have a negative impact on new and less liquid contracts and will discourage the transition of OTC derivatives to regulated markets. Recital 130 and Article 57(3)(g) of MiFID II, however, stipulate that the calculation methodology must take into account the development of new contracts.

In order to avoid such an adverse effect, <u>we propose to amend the RTS 21 and to allow for a deliverable supply based other months limit of more than 10.000 lots but less than 500.000 lots of open interest for commodity derivatives</u>.

The following amendments to the RTS 21 would embrace this change:

- Article 15
  New and illiquid contracts

  (3) <u>By way of derogation to Article 9 and Article 14, for commodity derivatives traded on a trading venue with a combined open interest in spot and other months contracts exceeding 10,000 lots over a consecutive three-month period but not exceeding 500,000 lots, and where the trading venue so requests, competent authorities shall determine a baseline figure for the other months position limit in a commodity derivative by calculating 25% of the deliverable supply for this commodity derivative.</u>

Not changing the timing of the application for spot month limits and the use of open interest as a basis for other months open interest will reduce the ability of real economy companies in Europe to manage and reduce their price risk through hedging practices. This would ultimately have a negative impact on consumer prices for the concerned commodities and the related value chain.

Given the importance of the matter and the limited time for action, we would be delighted to meet with you in person and to discuss our concerns as soon as possible.

We look forward to your response and remain at your disposal for any questions you may have as well as for identifying a suitable date for a meeting.

Sincerely yours,

Massimo Ricci	Christian Baer
Chairman	Secretary General
Europex	Europex

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