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association of european energy exchanges

Setting Them Right:

Position Limits in the Current MiFID Review

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I. Context

The legislative proposals by the European Commission for MiFID II (Arts 59-60) and MiFIR (Arts 34-35) provide ESMA with new competences for the setting and management of position limits. While we understand the intention of this step, we consider that energy commodity and especially electricity and gas markets could suffer from significant unintended damage if MiFID II / MiFIR were to enter into force in their current versions. In this context, it is important to note that market squeezing - the actual target of position limits – is very unlikely to happen in electricity and gas markets due to their specific physical characteristics (delivery is done over time periods and not at one point in time, etc.). Nevertheless, if general position limits for commodity markets on ground of avoiding excessive speculation on agricultural products, e.g., were to be widely and generally imposed by ESMA, this could significantly hamper commercial hedging activities as an essential part of risk mitigation efforts in the real economy.

Moreover, in order to make position limits work efficiently and to avoid possible loopholes, it is essential that the entire market is taken into consideration. This explicitly comprises trading venues as defined in MiFID as well as the OTC market. Position limits that only apply to Regulated Markets and/or Multilateral Trading Facilities would create regulatory arbitrage and result in a shift of trading from these markets to others that are not regulated. This would totally undermine the very concept of a position limits regime, and must therefore be imperatively avoided.

Although – as stated above – market squeezing is much harder to realise in the electricity and gas markets than in other commodity markets, many Energy Exchanges providentially allow already today for the possibility of imposing position limits in their Exchange Rules. In addition, the constant market surveillance takes the risk of market squeezing into account. However, so far, there was no perceived need to ever apply position limits to electricity or gas trading in Europe.

II. Policy Recommendations

In consideration of the above stated, we would like to emphasise the following aspects:

1) Given that the most efficient way to avoid market squeezing comprises constant position monitoring (and if needed management) by market surveillance offices of market venues [or similar structures] in close cooperation with the competent national and European authorities, action should be taken at the most appropriate level by the best suited actor(s). As position limits directly relate to market conditions at trading venues, the limits should be coherently defined by these trading venues in close cooperation with the competent authority which should be given a coordinating role when multiple venues offer trading in similar products. ESMA should not be allowed to set general position limits for entire market clusters (e.g. commodity markets in general) as individual commodities are very diverse and have different underlying fundamentals. Depending on the fundamentals of the commodity, clarification is needed on which body should be involved in setting position limits. This also includes a geographical dimension. Hence, we suggest that position limits should be set by those parties closest to the market they relate to.

This means that:

- Locally traded and delivered products should be dealt with by the respective trading venue(s) and competent authority;
- Globally traded and delivered products should be dealt with by the respective trading venue(s) and competent authorities in coordination with ESMA.

2) Considering that effective position management is only possible when taking the entire market into account, it is crucial to analyse both trading on regulated venues and the OTC market. It is also important to consider both cleared and non-cleared contracts[1] together in order to allow appropriate defining of position limits based on the aggregate total market position limit.

3) Unlike the Commission's proposal which refers to the number of contracts traded rather than to open positions, we believe that position limits should target open positions as this is a more appropriate way to prevent market squeezing.

4) In order to avoid unintended damage and to make sure that position limits are being applied smartly and in a targeted manner, it is important to proceed by setting different levels of position limits on a market-by-market basis.

5) If adequate, "alternative arrangements" should be used first, and position limits should only be applied once there is no other suitable alternative.

6) There should be a clear distinction between [bona fides] hedge positions and speculative positions. If position limits were to be applied to a market, hedge positions must not be automatically closed as this would have a significant negative impact on the commercial activities of the concerned market participants. Thus, any position limit imposed on non-financial firms should take into consideration the existing need to conduct risk management for other primary activities. In addition, there is a risk that position limits may be used by third parties to intentionally damage competitors.

7) New and developing markets must be treated differently as they risk disappearing if position limits were imposed on them.

8) The playing field between regulated markets and the OTC market must not be undermined by the introduction of position limits to individual market categories [e.g. RMs, MTFs, OTC] in order to avoid regulatory arbitrage resulting in a shift of trading activity and liquidity from regulated venues to unregulated trading venues/ routes.

9) Article 35 of the MiFIR proposal leaves a particularly wide room for interpretation to ESMA that goes significantly beyond any technical implementation competence. Hence, the future Level I legislation should be clearer and more detailed in order to provide for more legal clarity and to allow for early implementation.

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[1] In our understanding, non-cleared contracts that are physically delivered are not considered financial instruments under MiFID, even when traded on a trading venue. As a result, they would not be within the scope of position limits although they have exactly the same function as cleared contracts with physical delivery.