Europex
Association of European Energy Exchanges

Europex response to the BMF consultation on MiFID II experiences

Brussels, 15 March 2019 | Europex, the Association of European Energy Exchanges, welcomes the opportunity to contribute to the present consultation on MiFID II / MiFIR experiences[1]. In the following, we would like to share our concerns on three main aspects: 1) pre-trade transparency requirements for commodity derivatives, 2) position limits for commodity derivatives and 3) the scope of the hedging exemption in relation to the previous two points.

1) Pre-trade transparency requirements for commodity derivatives (MiFIR, Arts. 8 & 9)

Europex members have long argued that the MiFIR pre-trade transparency regime in its present form is not fit for purpose and cannot be applied to trade registration facilities in commodity derivatives markets without compromising their vital role in supporting the hedging activity of commercial market participants and in mitigating wider systemic risks.

Background

MiFIR Art. 8(1) requires trading venues to make public current bid and offer prices and the depth of trading interests at those prices which are advertised through their systems. Exchanges have no oversight of or information on applicable bid and offer prices throughout the negotiation process of pre-arranged trades. They are only informed of the actual agreed prices which means that under the current rules the exchanges would have to reject these trades unless they can benefit from a waiver or exemption: e.g., the Large in Scale ('LIS') waiver for transactions above a certain volume threshold and the Illiquid Instrument ('IL') waiver for transactions in instruments which are classified as illiquid, regardless of their volumes.

However, with respect to commodity derivatives, the methodology for calculating the LIS and IL thresholds has proven unworkable in practice. Calculations based on insufficiently granular sub-asset classes, besides arbitrarily selected and inappropriately calibrated parameters, result in disproportionately low LIS thresholds for highly liquid products and overly high thresholds for developing markets. Furthermore, the current methodology has led to a significant number of niche and nascent products being incorrectly (re-)classified as liquid, and thus becoming subject to significantly broader transparency requirements, which were previously reserved for developed markets.

[1] Orginial title: *Konsultation des Bundesministeriums der Finanzen zu Erfahrungen und möglichem Änderungsbedarf im Hinblick auf die EU-Finanzmarktrichtlinie (MiFID II) und die EU-Finanzmarktverordnung (MiFIR). See link.*

As a consequence, the MiFIR pre-trade transparency regime has a materially adverse impact on commodity derivatives markets by:

- Preventing pre-negotiated trades to be submitted to exchanges, thereby limiting the ability of market participants to hedge their commercial exposures;
- Forcing the trading activity to move away to the OTC space, thereby limiting transparency and undermining the price discovery process as well as limiting the possibility of physical delivery to take place under the exchange / clearing house rules;
- Limiting the number of cleared trades and therefore increasing systemic risk and market concentration;
- Preventing nascent commodity derivatives markets from developing;
- Pushing small and medium sized members towards more bilateral (OTC) trading, ultimately resulting in more direct trading with the large(r) producers, often referred to as origination business.

This is in stark contrast to MiFID II/MiFIR's policy objective as well as the 2009 G-20 Pittsburgh Commitments, i.e. higher transparency standards and the promotion of central clearing.

In order to solve the issue, Europex has made two alternative proposals for the revision of the Commission Delegated Regulation (EU) 2017/583 (RTS 2), which stipulates the methodology for calculating the thresholds. The first proposal suggests replacing the current methodology for calculating Large in Scale (LIS) and Illiquid Instrument (IL) waiver thresholds for commodity derivatives with a product-specific approach based on well-established practices of trading venues. The second proposal suggests a 'quick-fix' approach, whereby the current thresholds for commodity derivatives are to be recalibrated in order to better reflect the actual market conditions.

To provide further details on the two proposals, we have attached two position papers: the first one of April 2018 gives an initial overview of the two alternative proposals for the revision of RTS 2 and the second one of June 2018 contains further technical details on both proposals. Please note that the suggested thresholds in the 'quick fix' approach have been based on the assumption that the liquidity assessment is conducted per financial instrument per venue.

2) Position limits (MiFID II, Art. 57)

Background

Article 57 of MiFID II has introduced position limits on the size of a net position that a person can hold at all times in commodity derivatives traded on trading venues and economically equivalent OTC contracts. Pursuant to its implementing Regulation 2017/591 (RTS 21), these limits are set as a percentage of the deliverable supply available in the underlying physical market with regards to spot month contracts and a percentage of open interest with regards to contracts expiring in all other months.

Furthermore, Article 15 of RTS 21 has introduced a specific regime for new and illiquid contracts whereby a fixed limit of 2,500 lots is set for all months in contracts not exceeding 10,000 lots of open

interest. In addition, contracts between 10,000 and 20,000 lots of open interest are eligible for a higher percentage limit of up to 40% of deliverable supply in spot month and open interest in other months.

Europex has long been of the view that a proportionate and efficient position limits regime should concentrate on a limited number of benchmark contracts, similar to the way the U.S. has developed its position limits regime. This 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. Also here, we believe that a similar approach to the one taken for the U.S. position limits regime would be advisable.

Experiences with the MiFID II position limits regime so far

As a matter of fact, Europex members have considerable experience in operating a position management system. Long before the application of MiFID II, they had developed a comprehensive, risk-based regime based on position, delivery and expiry limits with regards to commodity derivatives traded on their markets. This regime is calibrated so as to prevent market abuse and ensure orderly delivery while allowing new products to be developed. Since January 2018, it has been operated by exchanges in parallel with position limits set by the relevant National Competent Authorities (NCAs) under MiFID II.

In our opinion, the MiFID II 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 (1) an increasingly restrictive limit as open interest increases, (2) an inflexible treatment in terms of their categorisation under the position limits framework and 3) an inaccurate reflection of the underlying physical markets.

a) Increasingly restrictive standardised limit

Contracts classed as 'illiquid' under the MiFID II position limits framework receive a standardised limit of 2,500 lots and are thereby effectively imposed a highly restrictive limit (resembling a baseline limit of 25% of open interest) when open interest comes close to 10,000 lots. As a 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 the ESMA Q&A on 'commodity derivatives 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 in a meaningful manner 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 unreasonable restrictions on

trading activity in fast growing markets. An increase of a given position limit with, for example, 500 lots will only have a very modest impact, effectively allowing market participants close to the limit to trade an additional lots equivalent of four calendar or eight season contracts. Additionally, NCAs tend to reserve the use of the derogation for cases for which the exchanges can bring forward other arguments than the fact that the contract is illiquid and needs room to grow, while this is one of the most critical arguments that apply to all contracts coming close to 10,000 lots.

Once the position limit is nearly reached, market participants will withdraw from the market, often switching to another trading venue outside of the MiFID II regime, thereby leaving the NCA 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 further develop.

b) Inflexible classification of markets and recalibration of position limits

To provide for a workable regime for growth markets, and given that the NCAs cannot set position limits on the basis of anticipated open interest growth, the latter need to be able to process near instant updates to the categorisation of markets and to re-adjust the applicable limits as the open interest in a market increases. This is especially true for markets that experience strong growth in open interest in a short period of time. Markets with initially relatively low levels of open interest can develop into liquid markets in a matter of months, weeks or even days. In order for a limit not to impede the development of fast-growing markets the following principles should be taken into account:

- The growth of open interest in a given market requires a **timely reclassification** of this market under the position limits regime (e.g. from ‘illiquid’ to ‘less liquid’) to allow the position limit to be adjusted to a workable level before it becomes unnecessarily restrictive. The use of administrative acts to implement or adapt position limits, as required by some Member States’ national legislation, is an example of how inflexible requirements can hamper the ability of NCAs to adapt to the fast pace with which contracts can grow.
- It is essential that NCAs take an **adequate approach with regard to the time period they take as a basis to calculate open interest** for the purpose of setting a position limit and classifying a market. Not looking at the right time period could result in relatively frequent requests to NCAs for adjustments of the limit, as the newly set limit could be reached with only a small amount of transactions in a fast-growing market.
- In certain cases, such as the transition to a new benchmark contract, it would even be desirable for NCAs **to be able to categorise markets and set limits based on anticipated growth** in open interest. One example for this is the EEX Supramax Freight Future, for which there is a process in the market to update the existing index methodology from Supramax-6TC (STCM) to Supramax-10TC (SPTM). The process of transferring to a new index means that the market will switch trading over time from one product to the other. At the point in time where the market participants have switched over to the new index, they typically also want to transfer positions in the old to the new contract as this enables them to actively manage their open positions in a single contract. Without this transfer, positions in the old contract become 'stranded' and members are forced to hold them until expiry, as finding a counterparty prepared to trade the old contract becomes very difficult. However, this is currently prevented by the fact that the *de minimis* limit for the new

contract is not sufficiently high to allow market participants to transfer their old position to the new contract. As a consequence, EEX becomes locked into a scenario where an action that would enable a position limit increase cannot be conducted as it would initially result in some members breaching limits. For these particular cases, the NCAs should be entitled to base the position limit of the new contract on the open interest of the old contract.

In practice it has proven to be impossible for NCAs to reclassify markets and recalibrate the applicable limits in a manner that would prevent a negative impact on the development of fast-growing markets.

c) Inaccurate reflection of the underlying physical markets

Moreover, 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 given limit. Yet, under the current MiFID II provisions, the limit cannot be raised without a sufficient increase of the open interest.

As an 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 6,000 lots of open interest. The contract is a Suezmax crude route, West Africa to UK Continent for tankers with an average size of 130,000 MT (DWT). The biggest positions, exceeding 1,900 lots, are held by commodity traders, some of which are located outside the EU and do not hold hedging exemptions. Companies with Suezmax type tanker fleets tend to hedge calendar years forward for fleet sizes of 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 * 12 months * 10 tankers = 15,600 lots to hedge the freight rates exposure for a single calendar year (i.e. a Cal19 trade)

With fast growing trading volumes in wet freight, companies are now extending hedges down the curve, trading to cover Cal19 / Cal20 and even Cal21 tenors on the VLCC TD3C route (Arab Gulf to China crude route). The go-live of a new regulation[2] on cutting sulphur oxide emissions by the International Maritime Organisation 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 trading have indicated the business need to hedge multiple calendar years forward in TD20 route contracts, and based on the traded volume calculation scenario above, this would result in tripling trading volumes with potential volumes amounting to 46,800 lots.

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

[2] www.imo.org/en/mediacentre/hottopics/pages/sulphur-2020.aspx

Proposed solutions to the described challenges

Considering the above illustrated 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 globally, Europex is of the view that changes are urgently required.

Option 1: temporarily suspending position limits for nascent commodity derivative markets

Europex recommends that position limits on new and less liquid contracts are suspended for an interim period to allow them to develop. Within the context of MiFID II, this would mean that the limits for commodity derivatives contracts are suspended until their open interest exceeds 20,000 lots. Once they have exceeded this threshold, the suspension is removed, and the contract becomes subject to a bespoke limit set by the responsible NCA.

Such an approach would provide for the necessary flexibility allowing fast-growing markets to thrive and thus the development of new products is not restricted by disproportionately low position limits. Furthermore, it would be in line with the policy objective of the Directive as expressed in its implementing RTS 21 which stipulates that:

"*Position limits should not create barriers to the development of new commodity derivatives and should not prevent less liquid sections of the commodity derivative markets from working adequately*"

At the same time, Europex believes that 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*". New and nascent products constitute a minor share of commodity markets. Such contracts are unlikely to influence price movements in the underlying physical commodity markets and thus do not negatively impact consumers. Furthermore, even in case of a limit suspension, these contracts would remain subject to internal position monitoring and management by the trading venue, market surveillance procedures aimed at preventing abuse as well as position reporting under MiFID II Article 58.

Thus, the suspension of position limits for such contracts would not pose any risk to the transparency and functioning of the respective markets. On the contrary, attracting more volume to regulated venues would contribute to a more transparent trading environment.

Option 2: increasing the *de minimis* limit for new and nascent commodity derivative markets

Europex believes that the best way forward is indeed that position limits for new and less liquid contracts should be temporarily suspended to allow these contracts to develop. However, should such a change not be immediately possible, Europex recommends that the current provisions are nonetheless adjusted in order to mitigate their adverse negative impact.

For this, Europex proposes that the current *de minimis* limit for illiquid markets is increased to 5,000 lots to better accommodate the nature of fast-growing markets. Such an approach would ensure that (i) the development of contracts is not curbed by an overly restrictive limit once open interest grows closer to the 10,0000 lots upper range of the illiquid markets category and (ii) the overall framework

becomes less dependent on unreasonably high levels of flexibility required from NCAs in terms of re-classifying markets and re-calibrating applicable limits on a near real-time basis.

For contracts between 10,000 lots and 20,000 lots or "less liquid contracts" Europex proposes that the current derogation for the position limit should go up to 50%, and be transformed into a default approach from which derogations could be envisaged, if needed.

Furthermore, Europex recommends to explicitly allow NCAs to base their calculation on anticipated growth in open interest in particular cases, such as the transition from an old to a new index methodology.

3) Scope of the hedging exemption

Both the pre-trade transparency as well as the position limits regimes include exemptions for market participants pursuing hedging activity. They are outlined respectively in Art. 8(1) of MiFIR and in Art. 57(1) of MiFID II. However, both articles limit the availability of the exemption to non-financial entities only, 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. Moreover, also commercial players can be an investment firm under MiFID II. This does not imply that they do not need a hedging exemption anymore for the commercial activities they are undertaking as their main business.

Therefore, the hedging exemption does not achieve the intended objective of ensuring that market participants can use regulated venues to manage their risk, and additionally worsens the problem of having an inappropriately designed pre-trade transparency regime and disproportionate position limits.

An example of such a 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.

Even though within the context of such a 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 II Article 57.

Proposed solution to the described challenges

Europex members have extensive experience in operating position management systems based on hedging exemptions. Under such a regime, exchanges 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.

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

Similar to this issue, and contrary to the general ancillary activity exemption regime, the position limits regime does not include a liquidity provision exemption. An exemption, as outlined in Art. 2(4) of MiFID II, is particularly necessary for new contracts that need financial entities to incentivise trading in the contract. If no such exemption is available, exchanges will have to contract a "panel" of liquidity providers to ensure that none of these firms exceed their position limits. In nascent markets it is highly possible that there may not be the required number of counterparties to build such a 'panel' and even where this is the case, it adds significant costs for the exchange. In order to avoid such a situation, Europex recommends that the position limits regime includes such an exemption based on the same conditions as the liquidity provision exemption outlined in Art. 2(4) of MiFID II and implemented similar to the hedging exemption under the position limits regime.

About

Europex is a not-for-profit association of European energy exchanges with 26 members. It represents the interests of exchange-based wholesale electricity, gas and environmental markets, focuses on developments of the European regulatory framework for wholesale energy trading and provides a discussion platform at European level.

Contact

Europex – Association of European Energy Exchanges
Address: Rue Archimède 44, 1000 Brussels, Belgium
Phone: +32 2 512 34 10
Website: www.europex.org
Email: secretariat@europex.org
Twitter: Europex_energy