



European Securities and
Markets Authority

MiFID II Review report on position limits and position management





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Acronyms used

CA	Competent Authority
ACER	Agency for the Cooperation of Energy Regulators
CFTC	Commodity Futures Trading Commission
COT	Commitment of Traders
CP	Consultation Paper
EEOTC	Economically Equivalent OTC Contracts
EMIR	Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories
ESMA	European Securities and Markets Authority
EC	European Commission
EU	European Union
MAR	Regulation (EU) No 596/2014 of the European Parliament and the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC and Directives 2003/124/EC, 2003/125/EC and 2004/72/EC
MiFID I	Directive 2004/39 of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directive 85/611/EC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC
MiFID II	Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (OJ L 173, 12.6.2014, p. 349)
MiFIR	Regulation (EU) No 600/2014 of the European Parliament and of the Council on markets in financial instruments and amending Regulation (EU) No 648/2012 (OJ L 173, 12.6.2014, p. 84)
MTF	Multilateral Trading Facility
NFC	Non-Financial Counterparties
OTC	Over-The-Counter
OTF	Organised Trading Facility
REMIT	Regulation (EU) No 1227/2011 of the European Parliament and of the Council of 25 October 2011 on wholesale energy market integrity and transparency
RTS	Regulatory Technical Standard



RTS 21

Commission Delegated Regulation (EU) 2017/591 of 1 December 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards for the application of position limits to commodity derivatives

1 Executive Summary

Reasons for publication

Article 90 of MiFID II requires the European Commission (EC), after consulting ESMA, to present a report to the European Parliament and the Council on the review of various MiFID II/MiFIR provisions. Following a call for evidence and a consultation paper (CP), this MiFID II review report covers the impact of the application of position limits and position management on liquidity, market abuse and orderly pricing and settlement conditions in commodity derivatives markets as provided for under Article 90(1)(g) of MiFID II.

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Section 3 provides a summary of the position limit regime under MiFID II and an assessment of the impact of the application of position limits on market abuse, orderly pricing and settlement conditions. Section 3 also provides an assessment of the impact of position limits on the liquidity of commodity derivatives markets and sets out proposals for amending the Level 1 text in order to improve the efficiency of the position limit regime. Section 4 assesses the impact of position management controls on commodity derivatives markets and proposes to amend the Level 1 text to further enhance convergent implementation by trading venues. Section 5 considers the impact of Brexit on the position limit regime and the commodity derivatives framework. Section 6 provides a summary of the proposals made in this report.

A summary of the responses to the CP is provided in Annex I. A summary of the industry roundtable organised by ESMA is provided in Annex II.

Overall, with the input provided via this final report ESMA is trying to better achieve the objectives pursued with the commodity derivatives embedded in MiFID II. ESMA's proposals are designed to find the right balance between an ambitious application of position limits, reporting and management focussing on the main issues while simplifying the regime to the extent possible with the aim to make it work more efficiently for market participants and competent authorities.

Next Steps

This report is submitted to the EC and is expected to feed into the review report on the impact of the application of position limits and position management on liquidity, market abuse and orderly pricing and settlement conditions in commodity derivatives markets.

ESMA stands ready to provide any additional technical advice on the legislative amendments suggested in the report.

2 Introduction

1. MiFID II/MiFIR requires the EC, after consulting ESMA, to present reports to the European Parliament and the Council reviewing many provisions in MiFID II/MiFIR. This report covers the mandate relating to “the impact of the application of position limits and position management on the liquidity, market abuse and orderly pricing and settlement conditions of commodity derivatives markets”, as provided for in Article 90(1)(f) of MiFID II.
2. In order to form a more exhaustive and informed view of the issues to be considered and addressed in its report to the EC, ESMA first issued a call for evidence¹ on 24 May 2019 inviting stakeholders to share their experience with the application of the MiFID II position limit and position management provisions, explain how trading in commodity derivatives may have been impacted, either positively or negatively, by this new regime and provide thoughts for potential amendments. ESMA received 26 responses to the call for evidence.
3. Building on the responses to the call for evidence, ESMA published² a CP on 5 November 2019 that provided an initial assessment of the impact of position limits and position management on liquidity, market abuse, orderly pricing and settlement conditions in commodity derivatives markets and seeking stakeholders’ views on some suggested amendments to the legal texts. ESMA received 50 responses to the CP. A summary of the responses received is provided in Annex I.
4. ESMA also organised an industry roundtable on 17 December 2019 with a limited number of participants representing key categories of stakeholders (trading venues, financial and non-financial counterparties). A summary of the roundtable is provided in Annex II.

3 MiFID II Position limits

3.1 Legal Framework

5. In response to the 2009 Pittsburgh G20 summit’s agreement to improve the regulation, functioning and transparency of financial and commodity derivatives markets and the 2011 Cannes G20 summit’s call for market regulators to have formal position management powers, MiFID II introduced a new set of provisions governing trading in commodity derivative markets. Those commodity derivative provisions are one of the key changes in MiFID II compared to MiFID I.
6. In addition to pre-trade and post-trade transparency as well as transaction reporting requirements, MiFID II introduces a position limit, a position reporting and a position management regime for commodity derivatives.

¹ ESMA70-156-1101

² ESMA70-156-1484

7. Under Article 57(1) of MiFID II, Competent Authorities (CAs) have to establish and apply position limits on the size of a net position which a person can hold at all times in commodity derivatives traded on trading venues and in economically equivalent OTC (EEOTC) contracts. The limits apply to all positions held by a person and those held on its behalf at an aggregate group level.
8. The position limits must be set so as to prevent market abuse and support orderly pricing and settlement conditions, including preventing market distorting positions, and ensuring, in particular, convergence between prices of derivatives in the delivery month and spot prices for the underlying commodity, without prejudice to price discovery on the market for the underlying commodity.
9. Position limits do not apply to positions held by, or on behalf of, non-financial entities and which are objectively measurable as reducing risk directly related to the commercial activity of that non-financial entity where that non-financial entity has applied for an exemption in accordance with Article 8 of RTS 21.
10. Position limits apply to all commodity derivatives traded on a trading venue, irrespective of the underlying commodity and whether the derivative contract is physically settled or cash-settled. Position limits also apply to securitised derivatives which relate to a commodity or an underlying referred to in Section C(10) of Annex I of MiFID II. As regards derivatives based on C(10) underlyings, ESMA clarified in its Q&As on MiFID II/MiFIR commodity derivatives topics³ that position limits should only apply to freight rate derivatives (wet and dry freight) and to derivative contracts relating to indices if the underlying index is materially based on commodity underlyings. ESMA considers that the underlying index is materially based on commodities if such commodities have a weighting of more than 50% in the composition of the underlying index.

³ https://www.esma.europa.eu/sites/default/files/library/esma70-872942901-36_gas_commodity_derivatives.pdf

Definition of commodity derivatives

MIFIR

Article 2(1)(30): commodity derivatives' means those financial instruments defined in point (44)(c) of Article 4(1) of Directive 2014/65/EU; which relate to a commodity or an underlying referred to in Section C(10) of Annex I to Directive 2014/65/EU; or in points (5), (6), (7) and (10) of Section C of Annex I thereto;

MiFID II

Article 4(1)(44)(c): any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures

Annex I Section C

[...]

(5) Options, futures, swaps, forwards and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event;

(6) Options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market, a MTF, or an OTF, except for wholesale energy products traded on an OTF that must be physically settled;

(7) Options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in point 6 of this Section and not being for commercial purposes, which have the characteristics of other derivative financial instruments;

[...]

(10) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event, as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this Section, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market, OTF, or an MTF;

[...].

11. Position limits do not apply to physically settled wholesale energy products traded on an Organised Trading Facility (OTF). Under Annex I, Section C(6) of MiFID II, those products do not qualify as financial instruments and therefore are outside the scope of MiFID II. Wholesale energy products are defined by reference to Article 2(4) of REMIT, which refers to “[...] derivatives related to electricity or natural gas produced, traded or delivered in the Union [...].”
12. The position limits set by the CA for the spot month and the other months have to comply with the methodology set out in RTS 21. Whilst Article 57(3) of MiFID II provides a list of factors to be taken into account by CAs when setting the position limits, RTS 21 further clarifies how those factors may be used by CAs to adjust the position limit upwards or downwards compared to a set baseline. RTS 21 also provides for default or “*de minimis*” position limits for new and illiquid contracts that do not reach a minimum level of open interest over a consecutive three-month period.
13. CAs must notify ESMA of the position limits they intend to set for derivative contracts, except for derivative contracts with *de minimis* position limits under RTS 21, and ESMA must issue an opinion assessing the compatibility of the position limits with the objective of preventing market abuse and supporting orderly pricing and settlement conditions and with the methodology established in RTS 21. As of 29 February 2020, ESMA has issued 50 opinions on position limits.
14. The following sections provide an assessment of the impact of position limits on market abuse, on orderly pricing and settlement conditions and on liquidity in commodity derivatives markets.

3.2 The impact of position limits on market abuse

3.2.1 Analysis

15. Under Article 57(1) of MiFID II, one of the objectives to be met by the position limits set by the relevant CA is to “prevent market abuse.”
16. Under the Market Abuse Regulation (MAR), the definition of market abuse comprises practices such as insider dealing, unlawful disclosure of inside information and market manipulation.
17. In general, a position reporting regime may help to identify the build-up of a concentration of positions, which in turn could indicate market abuse. Position limits may cap the financial gain a market participant could potentially make when unlawfully taking advantage of inside information or when manipulating the market in a commodity derivative contract, thereby rendering such abusive practices less attractive. However, that rather appears as an indirect potential consequence of the position limits set than a means of preventing market abuse in its own right.

18. More specifically in relation to market manipulation, Article 12(1) of MAR stipulates that market abuse “shall comprise [...]

- a) entering into a transaction, placing an order to trade or any other behaviour which
 - i) gives, or is likely to give, false or misleading signals as to the supply of, demand for, or price of, a financial instrument, a related spot commodity contract [...]; or
 - ii) secures or is likely to secure the price of one or more financial instruments, a related spot commodity contract [...] at an abnormal or artificial level”,
- b) entering into a transaction, placing an order to trade or any other activity or behaviour which affects or is likely to affect the price of one or several financial instruments, a related spot commodity contract [...] which employs a fictitious device or any other form of deception or contrivance;”.

19. Whereas some characteristics of a commodity derivative contract, such as whether the derivative is cash-settled or physically-settled, whether the index used for settlement is a reliable one or whether the deliverable supply in the underlying commodity can be restricted or controlled, contribute to making the contract more or less readily susceptible to manipulation, the extent to which position limits contribute to preventing market abuse appears less apparent.

3.2.2 Feedback from stakeholders

20. ESMA gathered views from stakeholders on the impact of position limits on market abuse, including in its May 2019 call for evidence. Most respondents considered that position limits have no role, or if any a very limited one, with regard to the prevention of market abuse, noting in particular that a large open position is not per se an evidence of market abuse and that market abuse can also be committed with a small open position. Some stakeholders further stressed that properly addressing market abuse requires transaction monitoring as well as an overall approach of monitoring a combination of the underlying physical commodity market, on-venue derivative markets and associated OTC trading, whereas position limits under MiFID II mainly apply to on-venue trading. According to some stakeholders, position limits would only contribute to market integrity by preventing a market squeeze, i.e. for physically-settled contracts where there is a finite supply of the underlying commodity available for delivery that a market participant can take control of, and for a limited period, immediately prior to maturity.

21. Some trading venues mentioned the role of their market monitoring and surveillance systems in the prevention of market abuse, including before the introduction of position limits in MiFID II. Some other stakeholders considered that MAR and REMIT are more effective and comprehensive tools for addressing market abuse than position limits.

3.2.3 Conclusions

22. ESMA is of the view that position limits can contribute to the prevention of market abuse by limiting the ability of counterparties to make use of a dominant position to secure the price of a commodity derivative or of the underlying commodity at an artificial level. ESMA also notes that the ability for a market participant to corner the market and manipulate the price of the underlying commodity through a dominant position in the related commodity derivatives would be less likely to materialise where the overall volume of trading in a commodity derivative accounts for only a portion of trading in the underlying spot market.
23. Beyond the specific risk of a market squeeze and cornering mentioned above, ESMA generally agrees with the views expressed that position limits on their own have little impact on market integrity but they are a valuable tool for the specific risks mentioned.
24. ESMA is also of the view that position reporting is a valuable tool for monitoring by CAs. Where a potential misconduct is identified through the market monitoring and surveillance tools used by CAs, position reporting data is available to the market surveillance and oversight teams and, combined with other data sources, allows to better identify, and sanction, market manipulation.
25. Furthermore, commodity derivatives are captured by transaction reporting, which can detect potential market abuses that may take place during trading hours and are more difficult to identify with end-of-day position reporting. Therefore, the combination of position and transaction reporting can facilitate the identification of potential abuses by CAs.

3.3 The impact of position limits on orderly pricing and settlement conditions

3.3.1 Analysis

26. Under point (b) of Article 57(1), position limits must be set in order to support “orderly pricing and settlement conditions, including preventing market distorting positions, and ensuring, in particular, convergence between prices of derivatives in the delivery months and spot prices for the underlying commodity, without prejudice to price discovery on the market for the underlying commodity”.
27. As stated in the 2011 IOSCO Principles for the Regulation and Supervision of Commodity Derivatives Markets⁴, “With respect to derivatives markets, an orderly market may be characterised by, among other things, parameters such as a rational relationship between consecutive prices, a strong correlation between price changes and the volume of trades, accurate relationships between the price of a derivative and the underlying commodity and reasonable spreads between near and far dated contracts. Numerous conditions can

⁴<https://www.iosco.org/library/pubdocs/pdf/IOSCOPD358.pdf>

negatively affect trading and the characteristics of an orderly market, [...] including unmanaged imbalance between long and short positions resulting from large concentrated positions.”

28. Spot month position limits in particular are important to support orderly pricing and settlement conditions. As further explained in Recital (11) of RTS 21 with regard to the spot month limit, “Restricting the positions a person may hold in the period during which the physical delivery is to be made limits the quantity of the underlying deliverable supply each person may make or take delivery of, thereby preventing the accumulation of dominant positions by individuals, which may enable them to squeeze the market through restricting access to the commodity”. Recital (11) of RTS 21 also clarifies that CAs have the possibility “to implement a schedule of decreasing position limits ranging from the point in time when a contract becomes a spot month contract until maturity in order to more precisely ensure that position limits are adequately set throughout the spot month period and to ensure orderly settlement”.
29. When reviewing the position limits submitted by CAs, ESMA however noted that only one CA made use of decreasing or gliding-path position limits throughout the spot month for agricultural commodity derivatives with one limit applying for the first part of the spot month and a reduced one applying during the last 12 days of the spot month. Another CA did not set different limits across the spot month but relied on the more stringent position limits set by the trading venue for some contracts as part of its position management powers for the period immediately preceding delivery to ensure orderly pricing and settlement conditions.
30. ESMA also notes that under the methodology set out in RTS 21, and with the exception of securitised commodity derivatives and the contracts which are under C(10) of Annex I to MiFID II, the spot month limit is based on available deliverable supply for the underlying commodity. Where there is a significant difference between deliverable supply and open interest in the spot month for a specific contract, even a spot month limit set at the lowest possible percentage of the deliverable supply (5%) may remain far above the spot month open interest and does not have any impact on orderly pricing and settlement conditions. On the contrary, it may also be argued that when deliverable supply is significantly higher than open interest during the spot month, there is no need to restrict trading to address potential risks to orderly pricing and settlement conditions when the contract approaches expiration.
31. Finally, and as recalled earlier, MiFID II position limits apply equally to physically settled and cash-settled contracts. Whilst, depending on the characteristics of the contract and the underlying market, potential risks to orderly pricing and settlement conditions may become all the more significant when a physically-settled contract is coming close to expiry, risks also exist for cash-settled contracts where the position holder would have the capacity to influence the price of the underlying. Spot month limits may then reduce the incentive, and potential benefit, to do so.

3.3.2 Feedback from stakeholders

32. Whilst a limited number of stakeholders expressed views on the impact of position limits on orderly pricing and settlement conditions, most of those did consider that the MiFID II position limit regime did not have an impact on orderly pricing and settlement conditions, albeit for different reasons. Some stakeholders highlighted that the objective of ensuring orderly pricing and settlement conditions had already been achieved by the exchanges' pre-existing position management controls as well as their market oversight systems.
33. According to one trading venue, open positions have little impact on trading activities and play therefore a minor role in orderly pricing and settlement conditions. The settlement price is based on order prices, trade prices or fair value and is entirely independent of members' positions. Hence position limits do not have a positive impact on the settlement of a contract. This trading venue considered that position limits may even have a negative impact on orderly pricing by limiting market participants' ability to trade. A similar concern on the negative impact of position limits on price formation was expressed by another trading venue, which however sees some value in spot month limits for ensuring convergence between the prices of derivatives in the delivery month and spot prices for the underlying commodity.

3.3.3 Conclusion

34. Whilst acknowledging the role of commodity derivatives trading venues towards ensuring orderly pricing and settlement conditions, ESMA considers that position limits are a means to address the potential for large positions in commodity futures and options markets to prejudice orderly market functioning. This is because the capacity of a market to absorb the establishment and liquidation of large positions in an orderly manner is related to the size of such positions relative to the market.
35. ESMA also considers that, when it comes to supporting orderly pricing and settlement conditions, position limits deliver most benefits during the spot month. ESMA also agrees that improperly calibrated position limits may potentially impact the interaction between supply and demand and thereby, affect price discovery. However, ESMA is not aware that this has been the case for any of the bespoke limits set by CAs. As regards de minimis or default limits, ESMA understands that they raise broader issues which are discussed in Section 3.5 on the impact of position limits on commodity derivatives liquidity.
36. ESMA further notes that, although the settlement price of a commodity derivative does not result from members' positions, the size of members' positions around maturity can indeed have an impact on the orderly settlement of a commodity derivative and should therefore be monitored by trading venues, together with orders and transactions as part of position management controls. The role and impact of position management controls are further discussed in section 4.

3.4 The impact of position limits on the structure of commodity derivatives markets

37. The potential impact of position limits on derivatives markets' liquidity is worth considering from various perspectives. Section 3.4. considers the macro impact of position limits on the structure of commodity derivative trading in the EU, such as overall trading volume and allocation of trading across trading venues and alternative trading options. Section 3.5 assesses the micro impact of position limits on the liquidity of specific classes or categories of commodity derivatives. In each section, an analysis of the issues identified is first provided, taking into account the responses received from stakeholders to the ESMA's May 2019 call for evidence. Building on the feedback to the CP, proposals are then made, where appropriate, to amend the Level 1 text to increase the efficiency of the position limit regime and address the major drawbacks identified

3.4.1 On-venue and OTC trading

3.4.1.1 Analysis

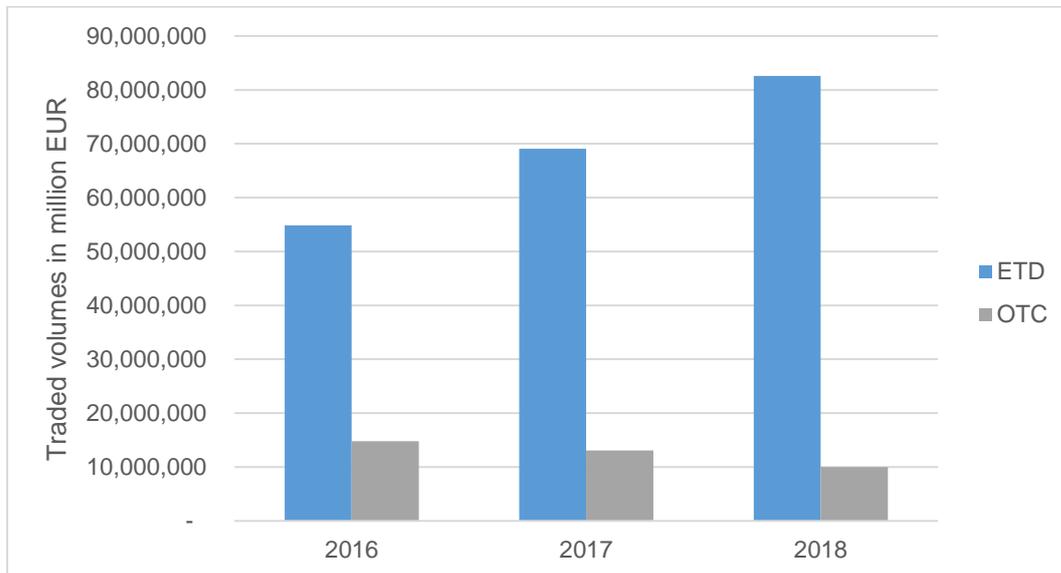
38. Eighteen months after the application of MiFID II and noting that the final impact of the position limit regime may not yet be fully assessable, stakeholders identified some concerns regarding the impact of position limits on commodity derivatives markets.

39. For some stakeholders, the application start date of the MiFID II position limit regime has resulted in an increase in OTC commodity derivatives trading, which is seen by market participants as less burdensome and outside the scope of position limits and position reporting. Other trading venues commented that after the entry into force of MiFID II, they failed to attract clients to trade new commodity derivatives and commodity index derivatives or even noticed a reduction in their client base. In their view, such outcome cannot be deemed in line with MiFID II objective to promote on-venue trading.

40. Based on the data gathering exercise ESMA conducted to update its Opinion on Ancillary Activity Calculations in May 2019, ESMA notes that trading volumes in commodity derivatives on EU trading venues have increased in 2018 compared to 2017⁵, as evidenced by Figure 1.

⁵ https://www.esma.europa.eu/sites/default/files/library/esma70-156-478_opinion_on_market_size_calculation.pdf

FIGURE 1 OVERALL TRADING VOLUMES IN COMMODITY DERIVATIVES – ETD VS OTC



Source: ETD figures are based on data collected from the trading venues, and OTC figures were estimated based on EMIR reporting. The figures are provided double-sided.

41. The increase in overall EU trading volumes has been more significant in gas, power and emission allowances whereas trading in agricultural derivatives and C(10) derivatives slightly decreased. OTC trading in gas derivative contracts, and to a lesser extent in coal derivative contracts, has indeed increased but on-venue trading shows a similar increase.

3.4.1.2 Conclusions and proposals

42. ESMA notes that, based on available data, there is no evidence of a shift of trading in commodity derivatives from on-venue to OTC trading as a result of the introduction of the position limit regime that would have required to be considered and addressed.

43. ESMA further notes that to avoid circumvention of the regime, MiFID II sets out that position limits apply to EEOTC contracts. The move from on-venue to OTC trading noted by some trading venues, combined with the very few EEOTC contracts identified, could therefore have been an indication that the EEOTC concept and definition did not deliver on their objective and would need to be reviewed. However, in the responses to the call for evidence, no stakeholder supported reviewing the definition of EEOTC contracts set out in Article 6 of RTS 21.

44. In the Brexit context, it is worth highlighting that there is still no trading in metal, oil and coal contracts taking place on EU27 trading venues or only in minimal volumes. In all commodity derivatives asset classes except power and C(10) derivatives, on-venue trading is concentrated on UK trading venues. The impact of Brexit on position limits is further discussed in Section 5.

3.4.2 Position limit methodology and competing venues

3.4.2.1 Analysis

45. As highlighted by one trading venue, the methodology for calculating position limits for the other months does not provide for a fair level playing field across trading venues trading commodity derivatives based on the same underlying and sharing the same characteristics. As set out in Level 1, the other months' position limit is based on the overall open interest in that commodity derivative. The most liquid market with the highest open interest hence benefits from the highest position limit and market participants are therefore offered an additional incentive to trade on the already most liquid market to the detriment of less liquid markets. The potential adjustment factors to the baseline limit available under RTS 21 are not sufficient to compensate for a significant difference in open interest. This results in trading venues trading commodity derivatives based on the same underlying and sharing similar characteristics not being subject to fair competition.
46. The "same contract" concept could have potentially addressed this drawback of the other months' limit calculation. Under Article 57(6) of MiFID II, *"where the same commodity derivative is traded in significant volumes on trading venues in more than one jurisdiction, the competent authority of the trading venue where the largest volume of trading takes place (the central competent authority) shall set the single position limit to be applied on all trading in that contract."*
47. The definition of what constitutes the same commodity derivative is provided in Article 5 of RTS 21 and further clarified in ESMA's Q&A 12 on position limit topics⁶. As explained in Recital (5) of RTS 21, demanding conditions have been established *"to prevent persons from inappropriately netting positions across dissimilar contracts in order to circumvent and weaken the robustness of the position limit on the principal commodity derivative contract"*, including that the relevant commodity derivatives form *"a single fungible pool of open interest"*.
48. As a result of the approach set out in Level 1 and supplemented in Level 2, no same commodity derivative contracts have been identified so far, hence the lingering competitive disadvantage for less liquid markets with regards to position limits.

3.4.2.2 Feedback to the CP

49. ESMA agreed that, in case of competing venues trading commodity derivatives based on the same underlying and sharing the same characteristics, the methodology for determining the other months' limit is detrimental to the less liquid market and proposed two options to remedy this situation in the CP.

⁶ https://www.esma.europa.eu/sites/default/files/library/esma70-872942901-36_gas_commodity_derivatives.pdf, page 21

50. Under Option 1, no change would be made to the concept of “same contract” in Level 1. To the extent permitted by Level 1, the definition of the “same contract” would be amended and broadened in Article 5(1) of RTS 21 for example by deleting the requirement that the same commodity derivatives form a single fungible pool of open interest.” ESMA however noted there could be circumstances where two commodity derivatives that do not share the exact same characteristics would nonetheless be treated as the “same contract” and that the consequences of any amendment to the current definition were difficult to anticipate.
51. Option 2 was to amend Level 1 to delete the reference to the “same contract” and introduce a more pragmatic approach. Where CAs would agree that the commodity derivatives traded on their respective trading venues are based on the same underlying and share the same characteristics, the baseline for the other months’ limit, i.e. 25% of the open interest on the most liquid market for that commodity derivative would be used as the baseline limit for setting the other months’ position limit for the competing contracts traded on other venues.
52. The overwhelming majority of respondents recognised and agreed with the rationale for levelling the playing field for commodity derivatives with the same physical underlying that are traded on different venues. The vast majority of respondents supported Option 2, which was considered as an effective mechanism to promote a level playing field between trading venues and offer an adequate choice to market participants. Option 2 was also perceived as a simpler and more pragmatic alternative to operate than the current Level 1 approach. Respondents also welcomed that under Option 2, CAs would continue to set position limits for commodity derivatives traded on trading venues under their supervision and monitor compliance with those limits. A respondent further noted that it is also worth considering the role that ESMA could have in facilitating and coordinating the achievement of agreements between CAs that contracts are sharing the same characteristics in order to ensure that a common approach is in place.
53. A couple of respondents were of the view that no changes were needed to the current framework. One respondent stressed that broadening the definition of “same contract” may undermine legal certainty with potentially increased risks of cross-market manipulation across markets linked by a common position limit but with separate price formation functionalities.

3.4.2.3 Conclusions and proposals

54. In line with the feedback received to the CP, ESMA agrees that amending the Level 1 text to delete the concept of “same contract” and replace it with a more cooperative approach between CAs (Option 2) would be a more efficient way of addressing the level playing field issue between trading venues rather than trying to broaden the definition of “same contract” in Article 5 of RTS 21. Setting the baseline for the other months’ limit for competing contracts based on the same underlying and sharing the same characteristics using the open interest of the most liquid contract would indeed allow the less liquid markets to

develop. This new approach would be all the more relevant in a context where fewer contracts with more convergent open interest thresholds will be subject to position limits.

55. ESMA also welcomes the suggestion to play a role in case of disagreement between CAs as to whether commodity derivatives traded on their respective trading venues share the same characteristics and are price correlated to ensure a harmonised approach between CAs. This would mirror the role ESMA currently has under Article 57(6) of MiFID II to settle any dispute arising from a disagreement between CAs regarding the single position limit to be set for the “same contract”.

56. Option 2 will require amending Article 57(6) of MiFID II dealing with the “same contract” and “central competent authority” approach as well as Article 58(2) of MiFID II on position reporting to the central competent authority.

3.4.3 The C(6) carve-out exemption

3.4.3.1 Analysis

57. Due to the C(6) carve-out, the exact same REMIT contract is subject to different rules, depending on where it is traded. Instruments traded on regulated markets and MTFs are subject to position limits as well as to other applicable MiFID II/MiFIR requirements, while identical instruments traded on OTFs are not considered as financial instruments and fall outside the scope of any of these obligations.

58. A couple of respondents to the call for evidence mentioned that several physically settled wholesale energy contracts previously traded on regulated markets and MTFs were now traded on OTFs. They considered this shift of trading to OTFs to be a consequence of the C(6) carve-out in MiFID II and the exclusion of physically settled wholesale energy contracts from the scope of financial instruments, hence from the scope of the position limit regime.

59. ESMA noted that the creation of the OTF category aimed at making the EU financial markets more transparent and efficient and at levelling the playing field between various venues offering multilateral trading services. In ESMA’s view, the C(6) carve-out does not achieve this objective as it deliberately creates a competitive advantage for OTFs trading REMIT products. More fundamentally, ESMA considers that the same rules should apply to the same instruments independently of the EU trading venues where those instruments are traded.

3.4.3.2 Feedback to the CP

60. In the CP, ESMA suggested that the C(6) carve-out should be reconsidered to remedy the unlevel playing field created between trading venues and address the lack of consistency of this exemption with the objectives of MiFID II.

61. With one exception, all respondents, including energy firms, energy regulators and regulated markets expressed strong disagreement with ESMA's proposal. First, respondents challenged ESMA's assessment of the consequences of the C(6) carve-out which, in their view, does not create an unlevel playing field as operators of regulated markets have the possibility to create OTFs. They further disagreed with the suggestion that due to the C(6) carve out, trading in REMIT products has been shifting from regulated markets and MTFs to OTFs since the introduction of MiFID II. Respondents provided data suggesting the opposite, i.e. that the share of gas and power derivatives trading on exchanges has slightly increased over the last few years as a consequence, in their views, of the introduction of EMIR and the general incentive to move trading to cleared markets. Suggestions were made that the level playing field issue raised by ESMA, if any, could be addressed by extending the C(6) carve-out to regulated markets and MTFs.
62. Second, stakeholders generally argued that the C(6) carve-out has been introduced intentionally by the co-legislators on the basis of solid and structural grounds which have neither changed since the introduction of MiFID II, nor introduced any negative effects on the functioning and stability of financial markets. These include notably the fact that REMIT instruments fundamentally differ from financial instruments (they are used for hedging purposes, and not for speculative purposes by financial firms, trading takes place between professional counterparties without retail participation, gas and power are public goods with limited storage capacity and contracts are very often physically settled) and that the electricity and gas markets are regulated by sector specific regulations (REMIT, the Third Energy Package) and supervised by National Energy Regulatory Authorities and ACER.
63. Third, stakeholders expressed concerns about the proportionality of ESMA's proposal, stressing that the negative impact of the C(6) carve-out removal would far outweigh the benefit that such removal is intended to deliver. The list of unintended consequences provided include impacts on the real economy as energy firms, that will likely have to be regulated as financial counterparties will incur massive regulatory costs (MiFID II/MiFIR, breach of EMIR clearing thresholds, MAR). Increased costs in hedging will be passed on to the end-consumers whilst some energy firms may be forced out of business. Liquidity may dry-out. According to respondents, the capital allocated to face additional costs will reduce the capacity of energy firms to invest in the decarbonisation of the European economy thereby endangering the European Green Deal. As regards the regulatory framework, the transfer of supervision from the specialised regulator (ACER) to the regulator not covering all related areas of the energy markets (ESMA) will lead to less effective supervision. Damage to wholesale energy markets may ultimately reduce security of supply.

3.4.3.3 Conclusions and proposals

64. In response to stakeholders' feedback, ESMA acknowledges that the reference in the CP to the "shifting" of trade in REMIT products from regulated markets and MTFs to OTFs may not have been an appropriate wording but remains generally unconvinced by the arguments put forward by respondents in support of the C(6) carve-out.

65. First, ESMA recalls that the policy intention behind the creation of OTFs in MiFID II was to bring more trading onto regulated venues and, as clarified in Recital (8) of MiFID II “to make Union financial markets more transparent and efficient and to level the playing field between various venues offering multilateral trading services”. The C(6) carve-out did not allow MiFID II to deliver on this objective, even if the general incentive towards more cleared markets have contributed to a slight increase in on-venue trading. ESMA does not share the view that there is no level playing field issue between multilateral trading venues as long as the operator of a regulated market or an MTF can set up an OTF.
66. Second, ESMA disagrees with the analysis provided to support the C(6) carve-out that REMIT instruments would be fundamentally different from financial instruments because they are used for hedging purposes, because most of them are physically settled or because trading does not include retail participation. Beyond the fact that a financial instrument is legally defined by its own characteristics and not by the purpose it intends to serve, such as hedging or speculative activity, or the type of trading participants, this analysis fails to take into account that wholesale energy products are classified by MiFID II as a financial instrument when traded on a regulated market or an MTF, and not when traded on an OTF, and does not provide a rationale for this differentiation.
67. Third, most of the negative consequences identified by respondents to the CP that the removal of the C(6) carve-out would have, are based on the assumption that, should the C(6) carve-out be removed, energy firms would no longer be able to benefit from the ancillary activity exemption and would have to be authorised as investment firms. ESMA however notes that no evidence has been provided to support this assumption. In particular, one of the reasons provided to maintain the carve-out is that the instruments are used for hedging purposes. If this is the case, then the related transactions would not count toward the ancillary activity test. Furthermore, ESMA notes that since the application of MiFID II, no commodity firm had so far to be registered as an investment firm as a consequence of failing the ancillary activity test. It therefore appears doubtful that bringing physically settled wholesale energy products traded on OTFs in the scope of financial instruments for the calculation of the ancillary activity test would lead to a different result.
68. Respondents also fear that the removal of the carve out would imply the classification of energy firms as non-financial counterparties above the clearing threshold under EMIR and therefore subject to the clearing obligation and bilateral margin requirements. However, in the case of EMIR as well, hedging transactions do not count toward the clearing thresholds. Therefore, if as the respondents argue their transactions are executed for hedging purposes, then there should be no effect from the removal of the C6 carve-out.
69. ESMA however understand that in their responses to the consultation, some stakeholders may have referred to the use of REMIT products “for hedging purposes” in a broad sense that extends beyond the definition of risk reducing transactions under MiFID II and EMIR. On the other hand, should REMIT products actually be used for other purposes than reducing risks, the arguments provided by stakeholders in support of the C(6) carve-out based on the unique characteristics of those products appear questionable.

70. Finally, the fact that the electricity and gas markets are regulated by REMIT and supervised by National Energy Regulatory Authorities and ACER does not appear sufficient to justify that physically settled wholesale energy products traded on OTFs fall outside the scope of MiFID II as the scope of the two regulatory frameworks are fundamentally different. Most notably, REMIT does not include any requirement for pre-trade or post-trade transparency to the benefit of market participants and for position reporting. It does not include either organisational requirements for trading venues.
71. Should the C(6) carve-out not be maintained, ESMA appreciates that position reporting would be a source of additional costs for energy firms trading those instruments. However, ESMA does not share the concerns expressed about double reporting obligations under REMIT and MiFID II or EMIR as Article 8(3) of REMIT explicitly provides that persons that have reported transactions in accordance with MiFID or applicable Union legislation on derivative transactions, central counterparties and trade repositories shall not be subject to double reporting obligations.
72. Although some of the arguments put forward by the respondents to the CP in support of the C(6) carve-out are not consistent and in line with the applicable EU legislation, ESMA also notes that in the CP, stakeholders were asked whether they agree that the C(6) carve out creates an unlevel playing field and should be reconsidered. According to an overwhelming majority of respondents this is not the case. No trading venue trading commodity derivatives contracts has mentioned being put at a competitive disadvantage. Considering the responses received to the issue initially brought forward by ESMA in the CP and the lack of perceived unlevel playing field arising from the C(6) carve-out no further policy proposal appears to be required.

3.5 Other impacts of position limits on commodity derivatives liquidity

73. As explained above, the EU MiFID II position limit regime is unprecedented as, under Article 57 of MiFID II, it applies to all commodity derivatives traded on a trading venue and the related EEOTC contracts irrespective of the size of open interest and whatever the underlying instrument. It comes as no surprise that it did not deliver a similar outcome across all commodity derivatives.

3.5.1 Securitised derivatives

3.5.1.1 Analysis

74. As opposed to commodity derivative contracts, securitised derivatives based on commodities are transferable securities. The commodity securitised derivatives market is characterised by a large number of different issuances, each one registered within the central securities depository for a specific size and any possible increase follows a specific procedure duly approved by the relevant CA.

75. This contrasts with standard commodity derivatives where the amount of open interest, and thereby the size of a position, is potentially unlimited. It is also worth noting that at the time of issue, the issuer or the intermediary in charge of the distribution of the issuance holds 100% of the issue, which challenges the very application of a position limit regime. In addition, most of securitised derivatives are then ultimately held by a large number of retail investors, which does not raise the same risk of abusing a dominant position or to orderly pricing and settlement conditions as for ordinary commodity derivative contracts.
76. Moreover, the notion of spot month and other months, for which position limits are to be set under Article 57(3) of MiFID II, is not applicable to securitised derivatives. The concept of open interest is not well-suited to those instruments either and ESMA had to find a meaningful approach to position limits in securitised derivatives in Article 15 of RTS 21.
77. In addition, and not to make position reporting in securitised derivatives on behalf of retail investors unduly complex, ESMA clarified in a Q&A that position reporting does not apply when the issuance size is below 2.5 million securities. The application of the position limit regime to securitised derivatives therefore ultimately led to an artificial limitation of the issuance size of securitised derivatives by many issuers of 2.5 million securities.

3.5.1.2 Feedback to the CP

78. Based on the analysis above, ESMA suggested excluding securitised derivatives from the scope of position limits. Respondents overwhelmingly supported ESMA's proposal. They stressed that the position limit regime fails to recognise the unique characteristics of those instruments and therefore does not represent an appropriate tool for preventing market abuse and ensuring orderly pricing and settlement conditions. One respondent further noted that the concepts of deliverable supply or open interest are meaningless and that the concepts of lots, delivery date, economically equivalent contracts are equally not applicable to securitised derivatives, stressing in particular that there cannot be any economically equivalent contract to a securitised derivative, which by nature is a fungible security.

3.5.1.3 Conclusions and proposals

79. The responses to the CP confirmed ESMA's analysis that the position limit regime is ill-suited for securitised derivatives, which are transferable securities under Article 4(1)(44) of MiFID II. ESMA therefore proposes amending Article 57(1) of MiFID II to exclude financial instruments defined in point (44)(c) of Article 4(1) of MiFID II which relates to a commodity or an underlying referred to in section C(10) of Annex I to MiFID II from the scope of the position limit regime. Given the characteristics of the securitised derivatives market described above and the prevalence of a large number of retail investors, ESMA also propose excluding securitised derivatives from the scope of position reporting in Article 58 of MiFID II.
80. ESMA further notes that securitised derivatives are very similar to Exchange Traded Commodities (ETCs), which are classified as debt instruments and do not fall under the

position limit regime. Contracts For Differences (CFDs) based on commodities are not classified either as commodity derivatives, therefore not subject either to position limits. Excluding securitised derivatives from the scope of the position limit and position reporting regime would also lead to a more consistent approach of instruments sharing similar characteristics under MiFID II.

3.5.2 New and illiquid contracts

3.5.2.1 Analysis

81. In their responses to the call for evidence, most respondents considered that position limits had no impact, or no negative impact on well-developed, “benchmark” contracts. However, most of them also expressed concerns on the negative impact of the position limit regime on new and illiquid contracts. Respondents noted, in particular, that the current de minimis threshold of 2,500 lots for those contracts with a total combined open interest not exceeding 10,000 lots, is too restrictive especially when the open interest in such contracts approaches the threshold of 10,000 lots. The Q&A published by ESMA clarifying that the conditions under which Article 19(2) of RTS 21 could be used for setting limits for new and illiquid contracts was deemed useful but insufficient to deal with the issue.
82. Finally, some stakeholders stressed that position limits for new and illiquid contracts are particularly ill-suited for contracts with high-volatility or contracts with a fast-growing open interest where further growth is hampered by the time needed by the CA to move from a de minimis to a bespoke limit.
83. Given the limited contribution of position limits to the prevention of market abuse and orderly pricing and settlement conditions, many respondents suggested applying position limits only to contracts where position limits can play a valuable role. This would be the case for well-developed key benchmarks contracts where price formation takes place and that have a role in the pricing of the underlying commodity and other commodity derivatives.
84. As an alternative to, or pending the Level 1 change needed to reduce the scope of position limits to benchmark contracts, some respondents suggested addressing the more pressing concerns on the negative impact of position limits on new and illiquid contracts by increasing the position limit for those contracts or providing more flexibility to CAs for setting limits, including the discretion for not setting any limit at all, for new or illiquid contracts.

3.5.2.2 Feedback to the CP

85. To address the concerns expressed by most stakeholders on the negative impact of position limits, and to more broadly increase the efficiency of the position limit regime, ESMA considered that it would be appropriate to reduce the scope of commodity

derivatives subject to position limits far beyond securitised derivatives. To that end, ESMA considered two potential ways forward in the CP.

86. Under Option 1, Article 57 of MiFID II would be amended to limit the scope of position limits to significant or critical contracts where, in ESMA's view, position limits would provide most benefits. Article 57 would mandate ESMA to draft regulatory technical standards (RTS) to determine the characteristics to be met by a derivative contract to qualify as a critical contract, considering factors such as open interest, number and variety of market participants and underlying asset.
87. Under Option 2, Article 57 of MiFID II would be amended to mandate ESMA to develop specific Level 2 measures with regards to new commodity derivatives and in particular determine when position limits should start applying to those derivatives., e.g. after a 12-month period. The liquidity assessment contract would then be performed. If the contract is deemed illiquid, i.e. has a total combined open interest over the last three months not exceeding 20,000 lots, the maximum spot month and other months' limits would be increased to 50% of the reference amount, compared to 40% under Article 15(1)(b) of RTS 21.
88. All respondents supported Option 1 as a means of moving towards a more proportionate and efficient position limit regime. Such a regime would not only allow new and nascent products to develop but also it would better fulfil the overall objective of MiFID II to "improve the functioning and transparency of commodity markets and address excessive commodity price volatility". In their views, Option 1 would deliver a much-needed simplification of the regime without significantly impacting its effectiveness in terms of market abuse and orderly markets considering the limited impact of position limit on market abuse and orderly pricing. Respondents considered that to achieve the objective of avoiding excessive speculation, it is sufficient to only consider contracts that are relevant for the price formation in the underlying commodity, i.e. mature products which serve as a benchmark for the respective market. New and nascent products constitute a minor share of commodity markets. In their views, such contracts are unlikely to influence price movements in the underlying physical commodity markets and thus do not negatively impact consumers.
89. A trade association further stressed that the "non-critical" contracts would remain subject to the position reporting regime under Article 58 of MiFID II, to the pre-existing position monitoring and position management measures by exchanges and oversight of the exchanges' market supervision and market surveillance departments that apply the principles set out in REMIT and MAR. Thus, in their views, removing 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.
90. The criteria suggested by ESMA for a commodity derivative to qualify as a "critical contract" were generally considered as relevant by respondents. However, most trading venues explained that there is a strong correlation between the size of open interest and the number of active market participants and therefore suggested to focus on the former,

expressed in number of lots. One respondent was concerned that trading venues would play around the lot size to avoid that the commodity derivatives traded on their venues be subject to position limits and recommended that the reference amount of open interest be expressed in notional volume. One trading venue stressed the need for a harmonised calculation of open interest across trading venues.

91. A couple of respondents also suggested considering the existence of non-EU markets for the same commodity and whether the commodity derivative is physically settled. Some others mentioned the underlying asset as a relevant criterion with one respondent noting that certain commodity derivatives contracts could be considered as critical by nature.
92. Most respondents that suggested an open interest threshold for contracts to qualify as critical referred to 300,000 lots over a one-year period to ensure that only contracts the price of which serves as a benchmark for the underlying commodity are captured. According to those respondents, the 300,000 lot threshold would result in around 20 commodity derivatives mainly based on power, oil, gas and metal underlyings being classified as critical in the EU. Should a criterion based on the number of market participants be added, respondents suggested a minimum number of market participants ranging from 20 to 50. One trading venue mentioned a threshold of 800 market participants but rather referred to end users. On a separate note, one respondent suggested an open interest threshold of 100,000 lots or 1 billion EUR.
93. A handful of non-financial counterparties stressed the need for extensive stakeholder consultation to ensure that all relevant elements and views are taken into account, noting that trading venues have the best understanding of the markets they operate and possess a vast amount of information about participants, orders and trades.
94. Whilst supporting Option 1, most respondents also stressed the need to urgently remedy the negative impact of current position limit on new and illiquid markets and supported amending RTS 21 in line with Option 2 as an alternative pending the level 1 change required by Option 1. When amending RTS 21 along the line of Option 2, respondents however suggested extending the “black out period” for nascent contracts from 12 to 24 months. The spot and other months limit for illiquid contracts (below 20,000 lots of open interest) should also be set at 10,000 lots to allow for the rapid growth of a contract and leave sufficient time for CAs to set bespoke position limits.

3.5.2.3 Conclusions and proposals

95. ESMA fully supports the objective of the EU’s G20 commitment to improve the regulation, functioning and transparency of commodity derivatives markets and to address excessive price volatility. However, the responses to the consultation confirmed ESMA’s preliminary analysis that the case for applying position limits to every individual commodity derivative contract remains to be made, including in the context of fulfilling the G20 commitment and in achieving the legislative goals of MiFID II to prevent market abuse and to support orderly pricing and settlement conditions.

96. In the US, where the largest commodity derivative markets have developed and where the Commodity Futures Trading Commission (CFTC) has a long track record of regulating and supervising commodity derivative markets, position limits apply to only nine physically settled agricultural futures contracts. On 30 January 2020, the CFTC issued proposed rules to extend federal position limits to seven new physically settled agricultural contracts, five physically settled metal contracts and four physically settled energy futures contracts. However, for those additional “core referenced futures contracts”, federal position limits would only apply to the spot month, and not to the other months. Designated contract markets where those additional core referenced futures contracts are traded will be responsible for setting exchange limits or accountability levels outside of the spot month. It would therefore appear that the US fulfilment of the G20 commitment to improve the regulation, functioning and transparency of commodity derivatives markets and to address excessive price volatility is focusing on the essential contracts rather than imposing position limits for a large number of smaller contracts, with additional responsibility even entrusted to exchanges for setting position limits or otherwise managing positions held in referenced contracts in other months.
97. ESMA shares the views expressed by stakeholders that the scope of position limits should be limited to commodity derivatives where position limits can play a valuable role, i.e. to well-developed critical contracts where price formation takes place and that have a role in the pricing of the underlying commodity and other related commodity derivatives. Less developed contracts do not have that same impact on the underlying commodity or other commodity derivatives. ESMA appreciates that limiting position limits to “significant or critical contracts” would be a substantial change to the current MiFID II approach but considers that it would be to the benefit of more efficient EU markets. ESMA further notes that even when not subject to position limits, less developed contracts would remain subject to position reporting as well as to other MiFID II/ MiFIR obligations, such as transparency and transaction reporting requirements, to MAR and to position management controls by trading venues with therefore a limited additional risk for the operation of those commodity derivatives markets.
98. Although one stakeholder disagreed with maintaining the position reporting obligation for commodity derivatives that would no longer be subject to position limits, ESMA considers that position reporting data serves a broader purpose than monitoring compliance with position limits. Combined with other data sources, position reporting data is an additional source of information that allows CAs to better identify, and sanction, potential market manipulation. The data on positions held in commodity derivatives also provides CAs with more insight into the composition of the market and the activities of the various types of market participants, including financial and non-financial counterparties and may be used as well to support policy developments and supervisory processes. Furthermore, under the proposed approach whereby commodity derivatives would become subject to position limits when the open interest exceeds a certain threshold, CAs should receive position reporting data to be able to check if and when those thresholds are being passed and set position limits accordingly.

99. As regards the criteria suggested to define critical contracts, and even if the number of active market participants is strongly correlated to the size of open interest, ESMA is of the view that it would be more appropriate to define critical contracts based on a combination of criteria, including size of open interest, number of market participants and underlying commodity, rather than just on a single one. ESMA considers that a “one size fits-all” approach would not be appropriate and that specific attention should notably continue to be paid to commodity derivatives with an underlying that qualifies as food for human consumption, as is currently the case in RTS 21. Those commodity derivatives could for instance be classified as critical contracts based on a lower size of open interest than commodity derivatives based on other underlying commodities or as critical by nature.
100. One stakeholder was concerned that, should the open interest threshold be set in number of lots, trading venues may play around lot sizes to ensure that the commodity derivatives traded on their venues do not pass the open interest threshold. Although ESMA notes that when doing so, trading venues would have to also consider the potential negative impact of increased lot sizes on market liquidity, ESMA also considers that there could be merit in introducing an anti-avoidance provision whereby, for instance, in case of unduly and unjustified increase in lot sizes, the assessment whether a commodity derivative qualifies as a critical contract would no longer take into account the size of open interest and would only be based on the other criteria.
101. ESMA notes that under the 300,000 lot open interest threshold suggested by many respondents, less than 10 commodity derivative contracts would qualify as critical or significant which does not appear as a satisfactory outcome. Further work and consultations will need to be undertaken to determine relevant thresholds for critical contracts in Level 2 and to ensure that an appropriate number of commodity derivatives traded in the EU remain subject to position limits. Setting those thresholds at Level 2 will allow for more timely adjustments as may be required by market developments.
102. ESMA is aware that any amendment to the Level 1 may require a significant amount of time. However, in contrast to many stakeholders’ suggestions, ESMA considers that Option 2 (i.e. disapplying position limits to nascent contracts for a certain period of time) cannot be considered as an interim solution and implemented through a change to RTS 21. Option 2 would also require an amendment to Level 1 since Article 57 (1) of MiFID II does not include any exception to the establishment of position limits. Furthermore, Article 57(3) of MiFID II mandates ESMA to determine the methodology for establishing limits taking into account, among other factors “the development of new contracts”. Whilst Option 2 cannot be implemented through a Level 2 change, ESMA is minded to consider the potential amendments that could be introduced to RTS 21, and notably to Article 15 of RTS 21, in the shorter term to address the negative impact identified of the de minimis position limits for nascent and illiquid contracts.

3.5.3 Financial counterparties

3.5.3.1 Analysis

103. In their analysis of the negative impact of position limits on new contracts, respondents to the call for evidence also highlighted that there is typically only a small number of rather large counterparties trading new contracts before a broader set of participants seeking liquidity potentially joins. Due to overly restrictive limits, participants are often forced to reduce their positions, which results in a reduction of the overall open interest and ultimately impacts the growth of the contract and the move to bespoke limits.
104. Furthermore, some respondents noted that the lack of an exemption for financial counterparties providing liquidity to non-financial counterparties' (NFCs) that seek to hedge their positions proves especially challenging in illiquid markets often characterised by one player (or a very limited number of players) acting as market maker/liquidity provider. They stressed that some market participants have indeed ceased to provide liquidity in new and illiquid contracts for fear of breaching the position limit.
105. Another respondent pointed out the specific case of a financial entity within a predominantly commercial group that acts as the market-facing entity for the risk reducing transactions of the commercial entities of the group. Because the decision had been made by the group prior to MiFID II to register that entity as an investment firm, the risk reducing transactions of the group are not eligible to the hedging exemption.

3.5.3.2 Feedback to the CP

106. ESMA took note of the concern expressed that financial counterparties acting as market makers may not be able to fully play their role as liquidity provider, including in less liquid contracts, for fear of breaching of position limits when doing so. In the CP, ESMA therefore suggested introducing a position limit exemption for financial counterparties that are under mandatory liquidity provision obligations. This exemption would mirror the exclusion of transactions entered to fulfil obligations to provide liquidity on a trading venue from the ancillary activity test under Article 2(4) of MiFID II.
107. The overwhelming majority of respondents supported ESMA's proposal. However, most of them also suggested extending this liquidity provision exemption to non-financial counterparties. Such exemption would be notably helpful for new and illiquid contracts with a 2,500 lot de minimis position limit. Exchanges might need to contract a "panel" of liquidity providers to ensure that the 2,500 lots limit is not exceeded, and this appears challenging in nascent markets.
108. Whilst not supporting a blanket hedging exemption for financial counterparties, ESMA considered that there could be legitimate cases where financial counterparties could benefit from a hedging exemption. ESMA sought views on the possible introduction of a hedging exemption for a financial counterparty acting within a predominantly commercial

group, where such positions are objectively measurable as reducing risks directly related to the commercial activities of the non-financial entities of the group.

109. The overwhelming majority of respondents supported ESMA's proposal. There was also strong support to broaden the scope of this hedging exemption and make it available to financial counterparties outside predominantly commercial groups when the positions entered into objectively reduce the risk of the position holder or of its clients. According to respondents, exempting from position limits the positions held for genuine hedging purposes by market participants, regardless of their legal status and nature of business would allow commodity market participants to manage their risks efficiently. In their view, CAs receive sufficient information to be able to monitor that such genuine hedging exemption would be used properly.

110. Several respondents urged ESMA to further harmonise the hedging exemption procedure across the EU. They notably stressed different practices at national level regarding the quantitative limits that may be attached to the hedging exemptions.

3.5.3.3 Conclusions and proposals

111. ESMA would in principle agree with the proposal made by stakeholders to extend the liquidity provision exemption to non-financial counterparties. Under Article 2(1)(j) of MiFID II, non-financial counterparties can indeed, subject to certain conditions, act as market makers in commodity derivatives, emission allowances and derivatives thereof without having to be authorised as investment firms. Extending the liquidity provision exemption to non-financial counterparties would notably help address the issue arising from the limited number of market participants active in nascent contracts.

112. The proposals set out in this report should however be considered in a holistic way. Therefore, should the proposal made above to reduce the scope of the position limit regime to the most developed commodity derivatives be supported by the EC, ESMA considers that there would be no need to extend the liquidity provision exemption to non-financial counterparties as suggested by some respondents to the CP. Should this proposal not be acted upon by the EC, then ESMA would propose introducing in Article 57 (1) of MiFID II a position limit exemption for financial and non-financial counterparties for positions resulting from transactions undertaken to fulfil mandatory liquidity provisions, in the circumstances described in the fourth sub-paragraph of Article 2(4)(c) of MiFID II.

113. The procedure to apply for the exemption would be clarified in Level 2. The positions held by an investment firm or a non-financial as a result of its market-making activities, when the firm has entered into a market-making agreement with a trading venue under Article 17(3) of MiFID II, would continue to be subject to position reporting.

114. Notwithstanding any potential amendment to Level 1 on the scope of the position limit regime, and as supported by respondents to the CP, ESMA proposes introducing in Level 1 a narrowly defined hedging exemption for financial counterparties. This hedging exemption would be available where, within a predominantly commercial group, a person

has been registered as an investment firm on a voluntary basis and acts as a market facing entity of the group. The exemption would apply to the positions held by that financial counterparty that are objectively measurable as reducing risks directly related to the commercial activities of the non-financial entities of the group. In ESMA's views, this hedging exemption should not be considered as an additional exemption to the position limit regime but rather as a "transfer" to the financial counterparty of the group of the hedging exemption otherwise available to the commercial entities of the group.

115. Level 1 would also mandate ESMA to draft RTS to determine the procedure setting out how financial counterparties can apply for such exemption. In line with the above, this procedure could be similar to the one to the application for the NFC hedging exemption under Article 8 of RTS 21.

116. Whilst acknowledging that other financial counterparties may see benefits in a wider hedging exemption, ESMA does not suggest introducing an exemption for all trades executed by financial counterparties to offset OTC transactions with an NFC or other positions resulting from financing activities in the underlying market. ESMA considers that introducing significant exemptions to the position limit regime for financial counterparties would not be consistent with the objective of limiting excessive speculation in commodity derivatives by financial firms. ESMA also notes that any exemption granted must be duly monitored. Notwithstanding the feedback received to the CP on CAs' monitoring capacity, ESMA wishes to reiterate that the more complex the transactions or chain of transactions that would ultimately justify a potential exemption being available to financial counterparties, the more challenging it is to assess compliance with the conditions thereof.

4 MiFID II Position management

4.1 Legal Framework

117. Under Article 57(8) of MiFID II, "Member States shall ensure that an investment firm or a market operator operating a trading venue which trades commodity derivatives apply position management controls. Those controls shall include at least, the powers for the trading venue to:

(a) monitor the open interest positions of persons;

(b) access information, including all relevant documentation, from persons about the size and purpose of a position or exposure entered into, information about beneficial or underlying owners, any concert arrangements, and any related assets or liabilities in the underlying market;

(c) require a person to terminate or reduce a position, on a temporary or permanent basis as the specific case may require and to unilaterally take appropriate action to ensure the termination or reduction if the person does not comply; and

(d) where appropriate, require a person to provide liquidity back into the market at an agreed price and volume on a temporary basis with the express intent of mitigating the effects of a large or dominant position.”

4.2 The impact of the MiFID II position management regime on market abuse, orderly pricing and settlement and liquidity of derivatives markets

4.2.1 Analysis

118. Information on position management controls in place at commodity derivative trading venues is available on ESMA’s website⁷. In most cases, the information provided explains with a varying degree of detail how the position management controls in place achieve compliance with the requirement of Article 57(8) of MiFID II. However, two trading venues mentioned position management controls that extend beyond the ones set out in Article 57(8) of MiFID II. ICE Futures Europe may promulgate limits and associated arrangements in relation to open positions that may be owned, controlled or carried by a member or person for his own account or for another person. The London Metal Exchange (LME) has introduced a requirement for the provision of additional information upon request, for positions held by members either directly or on behalf of their client(s) that are above the accountability levels set by the venue for each contract code.

119. Position management controls in relation to commodity derivatives may also be considered in conjunction with the broader obligation for trading venues to establish and maintain effective arrangements, systems and procedures aimed at preventing and detecting insider dealing, market manipulation and attempted insider dealing and market manipulation under Article 16(1) of MAR.

4.2.1.1 Impact of Position management on market abuse

120. Respondents to the call for evidence expressed different views on the impact of position management controls on market abuse. Some trading venues considered that position management controls, along with their market supervision and surveillance systems, have a significant role in preventing market abuse, some of them stressing that position management is only useful for physically settled contracts that can give rise to a market squeeze.

121. By contrast, two trading venues considered that their market oversight activities and pre-existing regulations were better tailored to prevent manipulation than position management controls. One trading venue explained that trading venues had limited ability

⁷ this information is available on ESMA’s website
https://www.esma.europa.eu/sites/default/files/library/position_management_controls.xlsx

to prevent market abuse as they do not have information on the positions held by market participants in other competing contracts on other trading venues or OTC.

4.2.1.2 Impact of position management on orderly pricing and settlement conditions

122. Stakeholders also had split views on the role of position management controls on orderly pricing and settlement conditions. Some respondents considered that position management controls play a positive role in determining orderly pricing and settlement conditions whereas some trading venues considered that position management controls, which are based on position holdings, do not contribute to orderly pricing and settlement, which are based on orders and trading activities. One trading venue was of the view that position management controls may negatively impact price formation, since they might lead participants to reduce positions by the end of the day to remain compliant.

4.2.1.3 Impact of position management on liquidity

123. Few respondents expressed an opinion on the impact of position management controls on liquidity and split views were again expressed. According to a non-financial counterparty, position management controls increase confidence in the market, a view further supported by a trading venue noting that position management controls ensure fair and liquid markets by managing rather than by limiting the positions a person may hold.

124. By contrast, two trading venues stated that position management control limits have led to a loss of liquidity especially in new and illiquid contracts as they prevented those contracts to grow and attract new clients. A trading venue was concerned about the potential long-term impact of position management controls, such as the uncertainty created for market participants that may have to provide liquidity back to the market. To avoid such uncertainties, market participants may rather turn to OTC trading, outside the scope of position management controls and limits. A couple of other respondents considered that position management controls have no impact or no negative impact on the liquidity of commodity derivative markets.

125. A trading venue highlighted that the effectiveness of management controls by trading venues may be hampered or made less efficient due to the lack of information on the positions held by market participants in related contracts based on the same underlying on competing trading venues or traded OTC.

4.2.2 Feedback to the consultation paper

126. The great variety of responses received from stakeholders, including from trading venues did not allow ESMA to form a clear view on the actual impact of position management controls. More substantially, ESMA was concerned that the diverse, if not diverging, views expressed may reflect significant dissimilarities in the way positions are indeed managed by trading venues as well as a possible lack of a shared understanding of trading venues' roles and responsibilities with regard to position management controls.

127. In the CP, ESMA therefore proposed that Level 2 measures be developed to support a more convergent implementation of position management controls across EU trading venues. To address the concern raised about the lack of appropriate information for efficient position management, ESMA also proposed amending Article 57(8)(b) of MiFID II to specify that position management controls should include the power for a trading venue to obtain information from its members or participants on related positions entered by a person on other trading venues or OTC, where appropriate.
128. These proposals received mixed feedback. With one exception, trading venues did not support the introduction of Level 2 measures on position management controls. Some trading venues stressed that trading on their venue was already under the scrutiny of the exchanges' market supervision and market surveillance departments to ensure that the requirements set out in MiFID II, MAR, and where applicable REMIT, were complied with and gave some examples of position management controls currently in place. Some other venues noted that 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 of the contracts it admits to trading and that a 'one size fits all' position management regime would not be appropriate. One venue suggested that any further guidance should be created by the relevant market operator in discussion and consultation with its relevant competent authority.
129. In contrast, and whilst noting that trading venues are best placed to determine how to implement position management controls and when it is necessary to trigger them, some respondents saw merits in establishing a set of measures that would provide a minimum standard with which all trading venues must comply, provided that those measures are not overly prescriptive.
130. Few respondents commented on the proposed amendment to the Level 1 text on access by trading venues to information on positions in related contracts through their members or participants where appropriate. A couple of non-financial counterparties disagreed with it, stressing that this proposal would lead to disproportionate effort for market participants who are already reporting all data under EMIR and REMIT and simply amount to double reporting. One respondent considered that such amendment was unnecessary and that the current wording allows for an appropriate degree of power for operators of trading venues to receive information on positions relating to assets, liabilities and positions on other trading venues. This respondent also noted that such powers can be applied by trading venues within their own rulebook. One trading venue (not trading commodity derivatives contracts) stressed that trading venues have no possibility to verify the data provided through a cross-reference with the competing trading venues, and that such extended monitoring activity is not part of the trading venues duties, stressing that such powers should remain within the CAs' mandate.
131. In addition to Level 1 change, the CP proposed to give ESMA a mandate to draft RTS to further specify the content and scope of position management controls. Examples of areas that could be addressed in Level 2 were the further differentiation between cash-settled and physically-settled contracts for clarifying under which circumstances the power

in Article 57(8)(d) (i.e. to require a person to provide liquidity back to the market as an agreed price and volume) should be used. In addition, ESMA proposed to set pre-determined large position levels, or accountability levels, where exceeding such levels would trigger an information request from the trading venue to better understand the reason and intention of the position built and the potential risks attached to it. Lastly, ESMA proposed to require trading venues to set and implement position limits for the period immediately preceding expiry for those contracts.

4.2.3 Conclusions and proposals

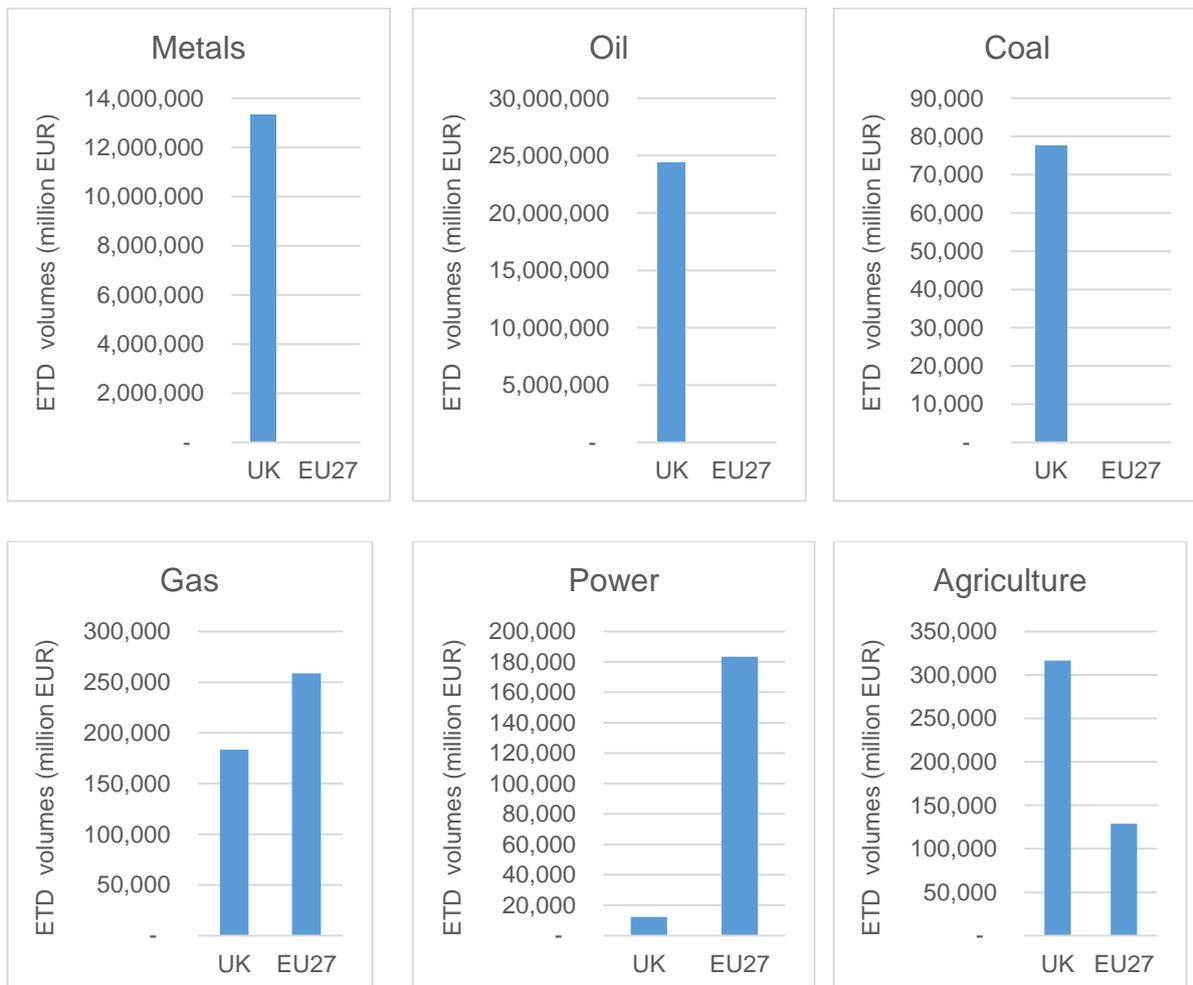
132. In spite of the mixed feedback received to the proposal to introduce Level 2 measures on position management, ESMA still considers that there would be benefits in enhanced convergence in the application of position management controls across EU trading venues.
133. ESMA fully appreciates that trading venues are already required to ensure fair and orderly trading in accordance with MiFID II and that their market monitoring and surveillance departments' mission statement is to ensure compliance with all other relevant requirements under MiFID II/MiFIR, MAR and REMIT where applicable. However, ESMA also notes that position management controls aim at addressing the specific challenges arising from commodity derivatives trading.
134. ESMA agrees that position management regimes may need to be calibrated to the circumstances of individual exchanges, notably to the characteristics and underlying markets of the contracts traded. However, ESMA also considers that this does not prevent more high-level principles from being introduced in Level 2 that would further clarify the requirements set out in Article 57(8) of MiFID II and set some more common ground across trading venues whilst not constraining the ability of a trading venue to implement enhanced controls if deemed necessary. This more convergent understanding and implementation of position management controls would be particularly appropriate and timely should some commodity derivatives no longer be subject to the position limit regime and only to position management controls by trading venues,
135. Examples of position management controls provided in the feedback to the CP, such as accountability levels at or above which members are required to report certain information to the exchange and position, expiry and delivery limits indicating maximum positions that can be held by members in the contract in question at a given time could be part of such Level 2 measures. Further elaboration on the circumstances where it may be appropriate to exercise the power to require a person to provide liquidity back to the market under Article 57(8)(d) of MiFID II could also be useful.
136. The limited feedback provided to the proposal to give trading venues the power to ask information on the positions held in related contracts demonstrated that there was not a clear understanding of the powers entrusted to trading venues by Article 58(7) of MiFID II to exercise position management controls. ESMA therefore continues to consider that it would be useful to clearly set out in Level 1 that position management controls include the power for a trading venue to obtain information from its members or participants on related

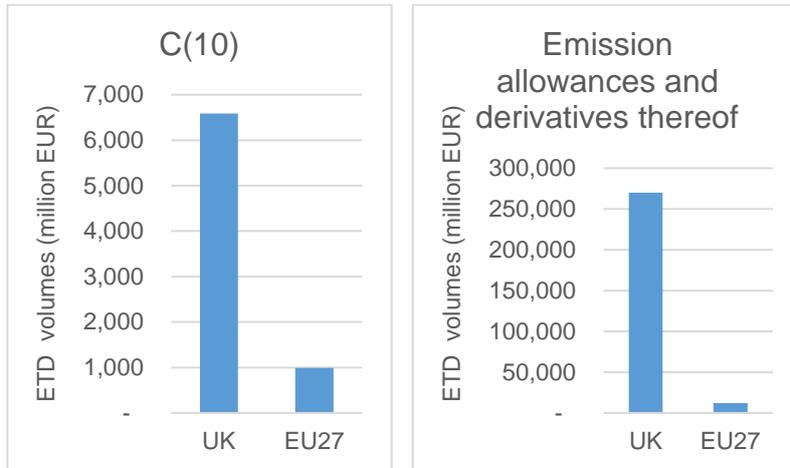
positions entered by a person on other trading venues or OTC, where appropriate, to the benefit of efficient position management controls.

5 Impact of Brexit on position limits and the MiFID II commodity derivatives framework

137. The landscape of EU commodity derivative trading has changed significantly upon the UK leaving the EU. Some commodity derivative asset classes, such as those based on metals, oil or coal are no longer traded on EU venues and some others only marginally traded in the EU27 (e.g. emission allowances). The notable exception are commodity derivatives based on power that are almost exclusively traded on EU venues.

FIGURE 2. ETD TRADING IN COMMODITY DERIVATIVES DURING 2019 – EU27 vs UK





Source: ESMA, reporting to the FITRS system. Data is provided single-sided, in million EUR.

138. The new EU commodity derivatives landscape will have a dramatic impact on the ancillary activity test and more specifically on the market size test. This entails more entities potentially being considered as financial counterparties and no longer eligible to the hedging exemption. Respondents to the call for evidence made various suggestions to address this drawback, such as continuing to include UK data in the EU overall trading activity post-Brexit or increasing the thresholds for the market test, but none of these options appears as legally sound or practical one.

139. ESMA shares the concerns expressed by stakeholders on the impact of Brexit on the MiFID II framework for commodity derivatives and the ancillary activity exemption. As the calculation of the ancillary test is to be performed based on a three-calendar year rolling back period, Brexit will start impacting the ancillary test to be performed in 2021, with the full impact to apply in 2023, when the three year backward period (2020, 2021 and 2022) will only include UK data for January 2020. ESMA is of the view that the consequences of the UK leaving the EU on the ancillary activity test cannot be reasonably and meaningfully addressed by an amendment to RTS 20 and a dramatic increase in the overall market thresholds. ESMA therefore strongly encourages the EC to take the opportunity of the earliest possible amendment to MiFID II to review the ancillary activity exemption and the criteria thereof.

140. This report does not discuss the other comments made by stakeholders on the impact of Brexit on the liquidity assessment of commodity derivatives for transparency purpose or on potential equivalence decisions by the EC with respect to the UK as they did not relate to position limits.

6 Summary of proposals

141. ESMA proposes to:

- Amend Articles 57(1) and 58 of MiFID II to exclude financial instruments defined in point (44)(c) of Article 4(1) of MiFID II which relates to a commodity or an underlying referred to in section C910) of Annex I to MiFID II from the scope of the position limit and the position reporting regime;
- Amend Article 57(1) of MiFID II to restrict the scope of position limits to critical or significant contracts and mandate ESMA to develop draft regulatory standards to define critical or significant contracts subject to position limits, taking into account at least the size of open interest, the number of market participants and the underlying commodity;
- Should the scope of the position limit regime not be reduced as suggested above, amend the last paragraph of Article 57(2) of MiFID II to introduce a position limit exemption for financial and non-financial counterparties for positions which are objectively measurable as resulting from transactions entered into to fulfil obligations to provide liquidity on a trading venue, in accordance with letter (c) of the fourth subparagraph of Article 2(4) of MiFID II and mandate ESMA to determine a procedure setting how persons may apply for this exemption;
- Amend the last paragraph of Article 57(2) of MiFID II to introduce a hedging exemption for financial counterparties acting as the market facing entity of a commercial group for the positions held to reduce the risks of the commercial entities of the group; and mandate ESMA to determine a procedure setting how persons may apply for this exemption;
- Amend Article 57(6) of MiFID II on position limits for the “same contracts” and Article 58(2) of MiFID II on position reporting to the central competent authority for same contracts;
- Amend Article 57(8) of MiFID II to extend access to information in letter (b) to positions held in related contracts on other trading venues and OTC through members and participants, where appropriate and mandate ESMA to further clarify the content of position management controls taking into account the characteristics of the relevant trading venues; and
- Reconsider the quantitative test approach set out Article 2(4) of MiFID II for eligibility to the ancillary activity exemption following the UK departure from the EU.

7 ANNEX

7.1 Annex I: Feedback to the Consultation paper

Q 1: Which option (Option 1 or Option 2) do you support for dealing with competing contracts? Please explain why. If you support Option 1, do you have any suggestions for amending the definition of “same contract” in Article 5(1) of RTS 21? If you support another alternative, please explain which one and why.

1. A large majority of respondents support Option 2, i.e. deleting the reference to the “same contract” from the legal text, and allowing for a more pragmatic approach, where CAs could take the OI of the most liquid contract as the reference figure for the other months limit in case of contracts sharing the same underlying and characteristics. This solution was perceived as simpler and providing more legal certainty to the market. Correcting Level 1 legislation could limit the risk that some commodity derivatives that do not share exactly the same characteristics could be treated differently, avoiding the potential unintended effects of Option 1. Some respondents supporting Option 2 have perceived Option 1 as triggering a potential risk for the future changes to the definition of EEOTC contracts, which they oppose. Some respondents also stressed that Option 2 should be seen in the future of having potentially less contracts subject to position limits, which will also help address the level playing field issue arising from the other months’ limit calculation methodology.
2. One respondent expressed a clear preference for the Option 1, while also welcoming the proposition put forward as Option 2 as an alternative solution to the level playing field issue identified with regards to competing contracts
3. A couple of respondents were of the view that no changes were needed to the current framework. One respondent stressed that broadening the definition of “same contract” may undermine legal certainty with potentially increased risks of cross-market manipulation across markets linked by a common position limit but with separate price formation functionalities.

Q 2: Do you agree that the C(6) carve-out creates an unlevel playing field across trading venues and should be reconsidered? If not, please explain why.

4. An overwhelming majority of respondents did not support ESMA’s proposal to reconsider the C6 carve-out. The consensus against ESMA’s proposal stems from a wide range of stakeholders including energy firms, energy regulators and regulated markets.
5. The comments are built around three main ideas which are developed at a granular level in the responses:
 - 1) The assumptions put forward by ESMA according to which the C6 carve-out has (1) resulted in a shift of trading from RM/MTF to OTF; and (2) created an unlevel playing field between different types of trading venues are, according to respondents, if not

inaccurate, at least very much overstated hence not deserving such an impactful change to the current legal framework;

- 2) The C6 carve-out has been introduced intentionally by the co-legislators on the basis of solid and structural grounds, which have neither changed since the introduction of MiFID II, nor introduced any negative effects on the functioning and stability of financial markets; and
 - 3) The deletion of the C6 carve-out would lead to numerous and far-reaching negative consequences, which ESMA has not considered when formulating its proposal.
6. In relation to the first item, stakeholders consider that the alleged “shift of trading” in REMIT contracts from RMs and MTFs to OTFs is not supported by any quantitative data. In fact, data provided by stakeholders (based on Trayport) suggest the opposite result. According to this data, the market share of contracts executed on exchanges or cleared has increased in recent years, which would be a consequence of EMIR and the general incentive to move trading to cleared markets.
 7. Overall, stakeholders consider that the C6 carve-out does not create an unlevel playing field between different trading venues. Rather, it creates different requirements for different asset classes used by different types of market participants. They also mentioned that trading venue operators have the possibility to set up OTFs and many of them did so.
 8. While disagreeing with the initial statement that the C6 carve-out creates an unlevel playing field, stakeholders are generally of the view that, should ESMA nonetheless persist in its intention to level the playing field between trading venues, a much less intrusive option would be to extend the C6 carve-out to contracts traded on all types of trading venues, not only OTFs.
 9. In relation to the second item, stakeholders generally argued that the original policy intention of the co-legislators when introducing the C6 carve-out remains valid:
 10. According to those stakeholders, REMIT instruments fundamentally differ from financial instruments because (1) they are used to hedge commercial risks (production and supply) related to underlying physical assets by energy producers and industrial firms; (2) they are not used by financial institutions for speculative purposes; (3) they are considered public goods and have limited possibilities of storage; (4) trading takes place between professional counterparties; (5) most transactions are physically settled as they involve the delivery of the underlying gas or electricity by means of scheduling or nominating to the designated delivery point. Hence the C6 carve-out was created in order to avoid physically settled wholesale energy products being unduly considered financial instruments.
 11. Finally, many responses pointed to the fact that electricity and gas markets are regulated by sector specific regulations (REMIT, the Third Energy Package) and supervised by National Energy Regulatory Authorities and ACER.

12. In relation to the third item, stakeholders described the following unintended negative consequences of removing the C6 carve-out:

- Impacts on the regulatory framework:

13. The transfer of supervision from the specialised regulator (ACER) to the regulator not covering all related areas of the energy markets (ESMA) would lead to less effective supervision;

- Impacts on the real economy:

14. Energy companies would face massive and disproportionate regulatory costs as they would potentially (1) breach the ancillary activity threshold and become subject to MiFID II; (2) breach the EMIR thresholds triggering margining obligations; (3) become subject to MAR and to the EMIR reporting obligation.

15. Increased costs of hedging would be passed on and result in higher energy costs for end users across the EU.

16. Small trading participants might be forced out of business or prevented from acting independently (hence reducing market competitiveness), and energy firms may decide to reduce or stop their hedging activity, leading to potential increase in price and volatility.

17. As avoidance practice, there is a risk of shift of trading from OTFs to purely OTC market, as seen in the Nordic area, leading to less transparency and less regulatory control compared to the current situation.

18. The additional costs of hedging stemming from additional financial regulation would reduce the ability for energy firms to invest in the decarbonisation of the European economy and endanger the long-term goal of the “European Green Deal” of the EU Commission because the affected energy companies would have to reallocate capital and liquidity within their businesses to meet these requirements.

Q 3: Do you agree that the position limit framework should not apply to securitised derivatives? If not, please explain why.

19. The overwhelming majority of respondents that expressed a view supported the proposal to remove securitised derivatives from the position limit regime. Respondents agreed that the position limit regime failed to recognise the unique characteristics of those instruments which made the position limit regime inappropriate for preventing market abuse and ensuring orderly pricing and settlement conditions.

20. Since those instruments are transferable securities, they are subject to the custody and notary functions administered by CSDs, unlike commodity derivatives. In addition to that the concepts used in the position limit regime, such as deliverable supply, delivery date or economically equivalent contracts are not applicable for the securitised derivatives, which

shows that the position limit regime, including the position reporting, should not be applied to them.

Q 4: Which option do you support to address the negative impact of position limits on new and illiquid commodity derivatives: Option 1 or Option 2? Please explain why. If you support another alternative, please explain which one and why.

21. All respondents supported Option 1 as a means of moving towards a more proportionate and efficient position limit regime, with Option 2 being implemented through Level 2 change pending Level 1 change for Option 1.
22. Respondents considered that Option 1 would deliver a much-needed simplification of the regime without significantly impacting its effectiveness in terms of market abuse considering the limited impact of position limit on market abuse. The only value a position limit may have been to avoid excessive price speculation adversely leading to price volatility, although it has not been scientifically demonstrated that excessive speculation leads by default to price volatility. To avoid undue impact on price volatility, it is sufficient to only consider contracts that are relevant for the price formation of the underlying commodity, i.e. mature contracts that serve as a benchmark for the respective market. New and illiquid contracts are unlikely to influence price movements in the underlying physical markets and do not negatively impact consumers.
23. Non-significant contracts would continue to be subject to position reporting to other MiFIR rules (transparency, transaction reporting), MAR and REMIT frameworks as well as to exchanges' market supervision and surveillance and position management. The removal of position limits for those contracts would therefore pose no risk to the transparency, integrity and orderly functioning of the relevant markets. Rather, it may attract more trading volume on regulated venues and contribute to a more transparent trading environment.
24. Option 1 would create more regulatory consistency by bringing the European position limit framework close to the CFTC framework and would maintain the liquidity and competitiveness of EU commodity markets.
25. However, most respondents also stressed the need to quickly fix the negative impact of position limits on new and illiquid contracts and supported option 2 as an interim solution. Some respondents proposed the following amendments to option 2:
 - a. The 12- month period during which no position limit would apply is considered too short for a contract to develop and should be extended to 24 months.
 - b. There should only be one threshold for illiquid contracts set at 20,000 lots with a spot month and other months' limit set at 10,000 lots to facilitate market growth and accommodate the time needed by CAs to move from de minimis to bespoke limits.
26. One trading venue disagreed with applying costly position reporting to contracts that would no longer be subject to position limits. For this respondent, this would be inconsistent with

ESMA's Q&A on securitised derivatives and since the purpose of position reporting is to ensure compliance with the position limit regime, there is no need to report positions when the issuance size is below € 2.5 million and the position limit cannot be exceeded.

Q 5: If you support Option 1 and would suggest different or additional criteria to determine whether a contract qualifies as a critical contract, please explain which ones

27. Most respondents agreed with the criteria suggested in the CP to qualify a contract as critical (number, type and variety of market participants, size of open interest underlying asset). Some trading venues however noted that the size of open interest and the number of market participants, as well as the size of open interest compared to deliverable supply, are highly correlated and that it would be sufficient to define critical contracts based on open interest only. One trading venue considered that open interest as the only relevant criteria. Another trading venue stressed that the lot size was not harmonised across trading venue and that the notional value of open interest, as opposed to lot size, should be taken into account.
28. One trade association suggested as additional relevant criteria the notional value to date, the deliverable supply and the frequency of trading.
29. One respondent also suggested considering whether the contract is subject to position limits in other key jurisdictions (e.g. US, UK post-Brexit). One trade association suggested as relevant criteria the nature of the underlying supply, the importance of the markets for the supply of the underlying commodity across the EU and the existence of non-EU markets for the same commodity.
30. One trading venue agreed that the type of underlying commodity is a relevant criterion and that some commodity derivatives could be classified as “critical” by nature.

Q 6: Which open interest and participant threshold would you suggest for qualifying a commodity derivative as a critical one?

31. The vast majority of respondents which suggested thresholds for determining critical contracts (mostly trading venues and their trade associations) came out with an open interest threshold of 300,000 lots on a yearly average for a commodity derivative to qualify as a critical contract. Two trading venues specified that this threshold would result in respectively 3 and 4 of their contracts being considered as critical. Some other respondents expect that this threshold would result in “around” 20 commodity derivatives contracts traded in Europe to qualify as critical. However, it is unclear whether all respondents had the same open interest reference as one trading venue explicitly referred to a 300,000 lot spot month open interest whereas other venues were understood as referring to the overall open interest.
32. Should the number of market participants be used as an additional criterion, four respondents suggested a threshold of 20 active market participants and four other ones a threshold of 50 market participants. However, here again, it is unclear whether there was

a common understanding of the concept of “market participant”. One trading venue suggested a threshold of 800 market participants, using client LEI and then grouping related LEIs into one parent and classifying them as one single entity. Other trading venues did not explain the methodology used.

33. One trading venue did not suggest any threshold of open interest but insisted on the need of a harmonised methodology across trading venue to calculate the open interest.
34. The trading venue supporting a notional value approach suggested a threshold of €10 billion.
35. Four non-financial counterparties did not provide any thresholds and stressed the need for further extensive consultation of stakeholders and in particular trading venues that have the best understanding of the markets they operate.

Q 7: Would you support a position limit exemption for financial counterparties under mandatory liquidity provision obligations? If not, please explain why.

36. All but one respondent expressed their support to an exemption for financial counterparties under mandatory liquidity provision obligations.
37. Many of them suggested that an exemption (based on the same conditions as the liquidity provision exemption outlined in Art. 2(4) MiFID II and the ESMA Q&A on MiFID II/MiFIR commodity derivatives topics) should also be available for non-financial counterparties acting as liquidity providers, especially when dealing with new and illiquid contracts (2,500 lots limit). Many respondents stated that should such exemption not be available, and the 2,500 lots limit continue to apply, exchanges might need to contract with a “panel” of liquidity providers to ensure that none of these firms exceed the 2,500 lots limit. This appears challenging in nascent markets where either a sufficient number of liquidity providers might not be present or having a large number of them could be very costly for the exchange.
38. One respondent stated that allowing for such exemption would imply that the concept of position limit would become theoretical or that the supervision of position limits would impose higher costs for taxpayers.

Q 8: Would you support introducing a hedging exemption for financial counterparties along the lines described above? If not, please explain why.

39. All but one respondent supported the introduction of a position limit hedging exemption for financial counterparties belonging to a predominantly non-financial group. However, many of them further supported the introduction of a hedging exemption for financial counterparties, independently from them being part of a financial or non-financial group, based on genuine hedging intentions.
40. The respondents who supported the introduction of a hedging exemption for financial counterparties part of a financial group disagreed with ESMA’s comments about the

difficulty of monitoring compliance with exemption for more complex hedging strategies. believe that given the amount of information received by CAs, CAs should be able to operate a similar monitoring system, including for financial counterparties' hedging exemption.

41. Several respondents urged ESMA to consider a harmonised process for the application of the hedging exemption across the EU. They further specified that some CAs impose quantitative limits to hedging exemptions, unnecessarily increasing the administrative burden for market participants that face greater hedging needs (for instance, due to an increase in the production of the underlying commodity) and are forced to file new applications.
42. One respondent supported the limited hedging exemption in case of financial innovation or as a measure to be taken in financial crisis.

Q 9: Do you agree with ESMA's proposals to amend Article 57(8)(b) of MiFID II and to introduce Level 2 measures on position management controls? If not, please explain why.

43. The few respondents who commented on the proposed Level 1 text amendments, considered that the current regime was adequate and that no changes were needed. Some non-financial counterparties understood the proposal to translate into a reporting of all transactions to trading venues and considered that such amendment to Article 57(8)(b) of MiFID II would lead to a disproportionate effort for market participants and double reporting on top EMIR and MiFID II. A couple of respondents questioned the legal feasibility of market participants sharing information with trading venues on position held OTC or at other venues.
44. Several trading venues considered that Level 2 measures were unnecessary to foster a more convergent understanding and implementation of position management controls. Most of them considered that the current approach where trading venues have substantial responsibility for position monitoring and control was sufficient, noting that they have operated position management regime before the entry into force of MiFID II.
45. These respondents further mentioned that there was sufficient consistency across trading venues also because activities such as position reporting, monitoring, management and control were already subject to REMIT, MAR and MiFID II principles.
46. However, some respondents that considered the current position management regime as generally adequate, expressed their support for ESMA's proposal of introducing Level 2 measures to harmonise the application of position management regime. They also emphasized that these measures should not be overly prescriptive to allow the specificities of each market to be taken into account. One trading venue agreed with ESMA to provide more clarity on the scope and content of position management controls in order to achieve a convergent implementation.

47. Finally, one respondent suggested that the overall regime for cash-settled derivatives based on broad-based commodity indices should be reconsidered.

7.2 Annex II: Summary of the roundtable

1. On 17 December 2019, ESMA organised a roundtable with a limited number of stakeholders (trading venues, financial and non-financial counterparties) to allow for a more in-depth discussion on the different issues discussed in ESMA's CP.

Impact of position limits and position management on market abuse and orderly pricing and settlement conditions

2. In line with the its response to the call for evidence, a trading venue explained that the position limit regime had a limited impact on market abuse because market cornering can only happen with physically settled contracts. A similar view was expressed by other participants who further mentioned that other pieces of legislation such as MAR and REMIT are better tools to identify and prevent market abuse. One stakeholder stressed the critical need to redesign the position limit regime considering the administrative burden it creates compared to its very limited contribution to the prevention of market abuse and to orderly pricing and settlement conditions. Trading venues already had in place market monitoring and surveillance systems as well as position management controls before the introduction of the MiFID II position limit regime, which also contributes to explaining the limited impact of the latter.

Impact of position limits and position management on the liquidity of commodity derivatives market

3. In line with the responses to the call for evidence, one trading venue explained that position limits had a very negative impact on new and illiquid contract, in particular with respect to nascent contracts with an open interest close to 10,000 lots and where the position limits is set at 2,500 lots for the spot month and for the other months. This limit does not take into account the fact that there are only few market participants active in nascent contracts incurring the risk of breaching the position limit in case of increasing trading activity.
4. In addition, in case of fast-growing liquidity and where the contract has exceeded the 10,000 lots open interest threshold over a three-month period, the contracts remain subject to the 2,500-lot limit threshold pending the determination of bespoke limits by the relevant CA, which may take months.
5. Other participants gave the example of liquid commodity derivatives where the underlying reference had been amended and should therefore be considered as "new" contracts with a 2,500-lot limit, although it was just one contract expected to replace the other with a similar level of liquidity in the short term.
6. All participants agreed that position limits did not have a negative impact on the more developed commodity derivatives where the number of market participants is higher.

Brexit

7. ESMA invited participants to express views on the expected impact of Brexit on the EU commodity derivatives market and notably how they expect to manage the transition to an EU27 environment for the calculation of the ancillary activity test.
8. One UK trading venue explained that it has taken all necessary steps to be able to continue to serve EU market participants post-Brexit, to which one other participant stressed that it would indeed need to continue to access UK trading venues given the predominance of UK trading venues in some underlying commodities.
9. With respect to the ancillary activity test, one respondent suggested including data from third country commodity markets to calculate the overall market size as those are global commodity markets and a European or regional approach may not be relevant. ESMA noted that it would be difficult to gather data from all over the world and remains unconvinced that the impact of Brexit on the ancillary activity test can be dealt with by adjusting Level 2.

CP Proposals

10. Participants were invited to comment on the proposals set out in ESMA's CP.

Same contract definition

11. The CP proposed two options to deal with the unfair level field created between competing trading venues by the other months' limit calculation. Option 1 would consist in broadening, to the extent legally possible, the definition of "same contracts" in Level 2 so that more contracts may potentially fall under that definition. Option 2 would be based on a change to the Level 1 text to provide more flexibility for CAs to agree on whether contracts traded on their respective trading venues and based on the same underlying share the same characteristics, in which case the other months' limit would be based on the open interest of the most liquid contract.
12. All participants expressed a preference for Option 2, which they considered to be more pragmatic. One participant stressed that reducing the scope of position limits to critical contracts would also help reduce the scope of unfair competition between trading venues based on position limits.

C(6) carve-out

13. One non-financial counterparty stakeholder expressed a strong support to the REMIT carve-out, emphasizing that the regime should not be reviewed in a restrictive manner or deleted. In his view, REMIT is a robust market integrity framework and there is no need for a shift from an energy regulator to a financial regulator. Responding to a remark on the somewhat unsuccessful OTF offer developed by some trading venues, this participant explains it by a miscalibration of the offer and not by a level playing field issue.
14. One trading venue echoed the remark above on the REMIT carve-out, stressing that the co-legislators should rather focus on fixing the legislative framework for commodity

derivatives that qualify as financial instruments, notably with respect to pre-trade transparency and position limits.

15. One non-financial counterparty further stressed that removing the C(6) carve-out would mean that small market participants would need to deal a brand-new set of rules they may not familiar with, which would be a source of significant costs.
16. Some participants also challenged the statement made in the CP that trading has been shifting from regulated market to OTFs since the introduction of MiFID II. They also noted that the creation of OTF and the C(6) carve-out as lead to more trading moving to pure OTC to some form of organised trading.
17. Participants generally questioned the need to “fix” the C(6) carve-out framework which, in their views, did not demonstrate any failure.

Securitised derivatives

18. Participants supported the proposals to exclude securitised derivatives from the scope of position limits. Securitised derivatives based on commodities or commodity indices would however remain classified as commodity derivatives.

Reduced scope of contracts subject to position limits

19. ESMA presented the two options set out in the CP to address the concerns raised with respect to the application of position limits to nascent and illiquid contracts 1) reduce the scope of position limits to a more limited set of significant or critical contracts; 2) disapply position limits for new contracts for one year so that they can reach a certain level of liquidity.
20. One participant explained that an agreement in favour of option 1 (i.e. critical contracts only approach) had been reached between energy exchanges. This option would solve many of the position limits issues, including for instance the “same contract” issue and would, at the same time, ensure that “non-critical” contracts would continue to be subject to position reporting and all other applicable requirements such as MAR or REMIT.
21. As a preliminary assessment, some trading venues suggested an open interest threshold of 300,000 lots for a commodity derivative to be considered as critical. One trading venue noted that the size of open interest is strongly positively correlated to the number of participants and that an open interest threshold should be a sufficient criterion.
22. Option 2 was however considered by some participants as a helpful temporary solution that could be implemented before the review of Level 1 for critical contracts takes place.

Exemption for financial counterparties

23. The CP proposed introducing a limited position limit exemption for financial counterparties in two circumstances: 1) when a financial counterparty is under mandatory liquidity

provision and 2) when a financial counterparty within a predominantly financial group acts as the market facing entity for the hedging transactions of the commercial entities of the group.

24. Those proposals were welcomed and considered as a useful tool to mitigate the impact of position limits. However, one participant suggested extending the liquidity provision exemption to non-financial counterparties that also provide liquidity to the market. This suggestion was supported by other participants who noted that the exemption should mirror the one for liquidity provisions under the ancillary activity test.

Level 2 measures on position management controls

25. The proposal to introduce Level 2 measures on position management controls attracted mixed comments. One trading venue commented that venues already had in place effective position management controls that were tailored to the characteristics of the contracts traded on their venue and was concerned that potential Level 2 measures may be overly prescriptive.

26. Some participants however agreed that some Level 2 measures for a more convergent implementation of position management controls could be welcome in a context where fewer commodity derivatives would be subject to position limits.

AOB

27. The CP also included a separate proposal to review the size of open interest for the publication of weekly position reports by trading venues. ESMA explained that this was a Level 2 measure and was therefore not included in the MiFID II review report which focuses on Level 1 amendments.

28. One trading venue was concerned that the lower open threshold proposed by ESMA would not allow maintaining the confidentiality of individual positions and suggested that no weekly position report be published when there are less than five position holders in a category of persons.

29. ESMA invited all participants to respond to the CP by 8 January 2020.