



European Securities and  
Markets Authority

# Opinion

**Draft Regulatory Technical Standards on methodology for calculation and the application of position limits for commodity derivatives traded on trading venues and economically equivalent OTC contracts**



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## **Glossary**

ESMA	European Securities and Markets Authority
RTS	Regulatory Technical Standards
MiFID	Markets in Financial Instruments Directive – Directive 2004/39/EC of the European Parliament and the Council
MiFID II	Markets in Financial Instruments Directive – Directive 2014/65/EU of the European Parliament and the Council
RTS 21	Draft regulatory technical standards on methodology for the calculation and the application of position limits for commodity derivatives traded on trading venues and economically equivalent OTC contracts
EEOTC	Economically equivalent OTC contract

## 1 Legal Basis

1. In accordance with Article 57(3) and (12) of MiFID II, the European Securities and Markets Authority (ESMA) shall develop draft regulatory technical standards to determine:
  - a. the methodology for calculation that competent authorities are to apply in establishing the spot month position limits and other months' position limits for physically settled and cash settled commodity derivatives based on the characteristics of the relevant derivative; and
  - b. the criteria and methods for determining whether a position qualifies as reducing risks directly relating to commercial activities; the methods to determine when positions of a person are to be aggregated within a group; the criteria for determining whether a contract is an economically equivalent OTC contract to that traded on a trading venue; the definition of the "same commodity derivative" and significant volumes; the methodology for aggregating and netting OTC and on-venue commodity derivatives positions to establish the net position for purposes of assessing compliance with the limits; the procedure setting out how persons may apply for the exemption in relation to positions held by or on behalf of non-financial entities which are objectively measurable as reducing risks relating to the commercial activity of that entity; and the method for calculation to determine the venue where the largest volume of trading in a commodity derivative takes place and the identification of significant volumes of trading.

## 2 Background and Procedure

2. On 28 September 2015, ESMA submitted draft Regulatory Technical Standards (RTS) on the methodology for the calculation and the application of position limits for commodity derivatives traded on trading venues and economically equivalent OTC contracts as draft RTS 21 to the European Commission (the Commission) pursuant to Article 10(1) of Regulation No (EU) 1095/2010 (the ESMA Regulation) and Article 57(3) and (12) MiFID II.
3. In a letter of 14 March 2016, DG FISMA informally indicated to ESMA its intention to only endorse draft RTS 21 subject to a number of changes.
4. On 20 April 2016, the Commission notified ESMA of its intention to endorse draft RTS 21 subject to a number of changes, in accordance with Article 10(1) of the ESMA Regulation. In particular, the Commission requested the following changes:
  - a. Lower minimum limits or a lower baseline for certain agricultural commodities for spot and other months' limits.
  - b. Higher maximum limits for contracts with few market participants or with low levels of liquidity.

- c. Adjustment of the other months' limits where there is a significant discrepancy between open interest and deliverable supply so as to reduce the limits when the open interest is significantly higher than the deliverable supply and the other way around.
  - d. Revision of the definition of economically equivalent OTC contracts (EEOTC) to ensure that contracts that yield similar economic exposure for position holders whilst not necessarily identical in contractual terms are considered in scope of the position limits regime. For these purposes, variations in lot sizes, delivery dates, locations or other terms changing the economic exposure of the position should be considered.
  - e. Providing competent authorities with a sufficient degree of certainty with respect to the application of the relevant factors for setting the position limits.
5. Pursuant to Article 10(1) of the ESMA Regulation, this notification from the Commission triggers a period of six weeks during which ESMA may amend its draft RTS on the basis of the Commission's proposed amendments and resubmit it in the form of a formal opinion. ESMA shall send a copy of its formal opinion to the European Parliament and to the Council.
  6. In the interest of avoiding further delays to the MiFID II implementation process ESMA has started working on this opinion immediately after receiving the letter of 14 March 2016. Therefore it has been able to submit this opinion ahead of the expiry of the six week deadline following the formal notification of 20 April 2016.
  7. The amendments proposed by ESMA in RTS 21 have been made on the basis of the draft text submitted by ESMA on 28 September 2015.
  8. It is for the Board of Supervisors to adopt such formal opinion in accordance with Article 44(1) of the ESMA Regulation.

### **3 Executive Summary**

9. In response to point 4a., ESMA has devised a system that enables competent authorities to set a lower position limit of 2.5% for liquid derivatives with foodstuffs as underlyings.
10. In response to point 4b., ESMA proposes to widen the range of possible position limits up to 50% for contracts with relatively low levels of liquidity as well as for contracts with few market participants.

11. In response to point 4c., ESMA suggests that in circumstances where deliverable supply and open interest diverge significantly, the other months' position limits should be adjusted accordingly. In addition, ESMA proposes an amendment in respect of how to calculate the deliverable supply which should also include any substitute grades or types of a commodity that can be delivered in settlement of a commodity derivative contract. This will help to reduce potential discrepancies between open interest and deliverable supply.
12. In response to point 4d., ESMA has extended the definition of EEOTC by integrating variations in lot sizes and delivery dates as not preventing a contract from being characterised as EEOTC.
13. In response to point 4e., ESMA has further specified the factor “number of market participants”. In addition, ESMA has clarified how each factor that affects the position limit should lead to a downward or upward adjustment of the position limit. The level of the limit will depend on the combination of adjustments made.

## 4 ESMA Opinion

14. ESMA understands that DG FISMA and the Commission in the letters dated 14 March and 20 April 2016 ask ESMA to reconsider five different aspects of the position limits regime. This opinion is structured by assessing those five different aspects in the order they appear in the letter from 20 April 2016 and then introducing changes to the drafting of RTS 21 as submitted by ESMA on 28 September 2015 to the Commission to reflect any changes necessary following such assessments.

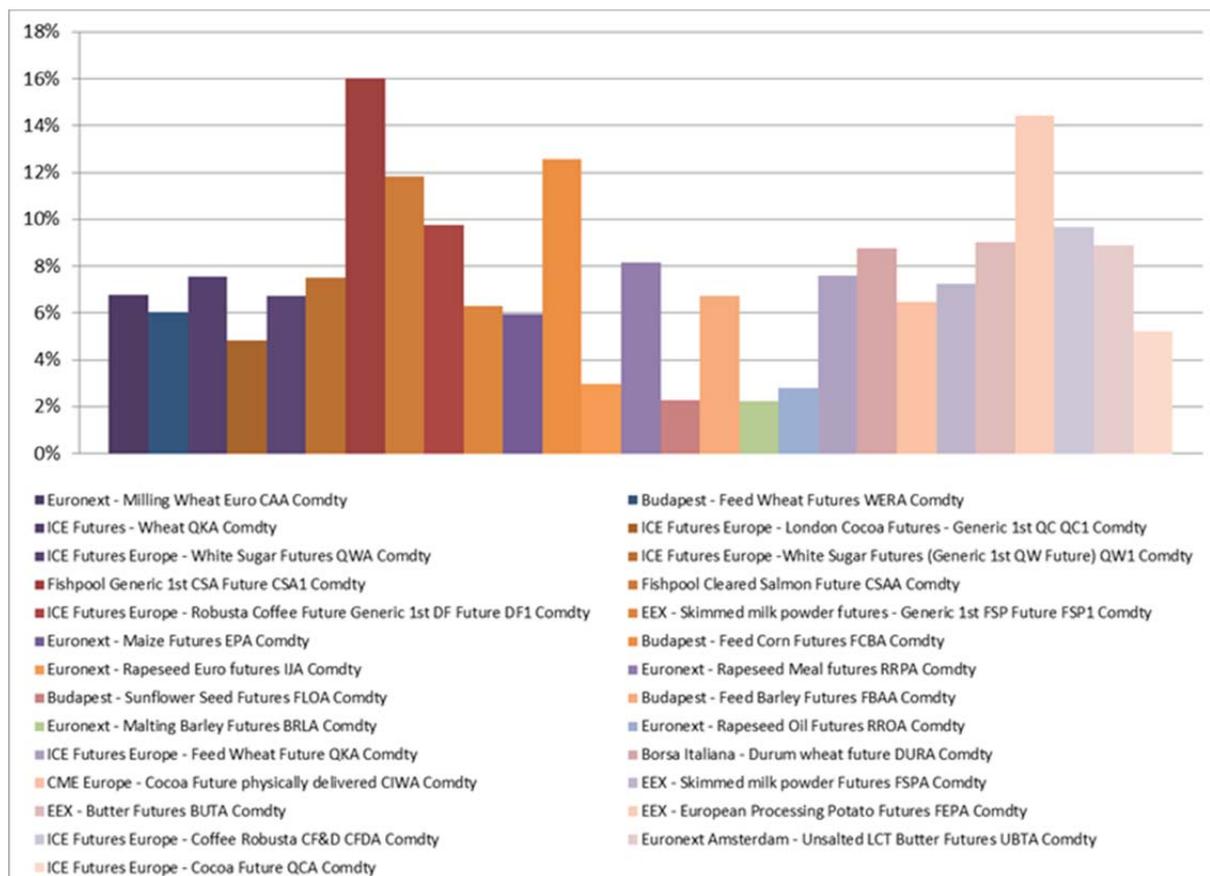
### 4.1 Sensitivity to different types of underlying commodities – lower limits for contracts with certain agricultural commodities as underlyings

15. As the Commission under the bullet “*Sensitivity to different types of underlying commodities*” in the letters of 14 March and 20 April 2016 requests two different amendments, ESMA assesses those as separate points in sections 4.1 and 4.2.
16. The first Commission request refers to very liquid and highly traded agricultural commodity derivative contracts and suggests that because of their high volatility and impact on the real economy, they should, if appropriate, for the spot and the other months, either have a lower baseline position limit than 25% applying to them or have a lower minimum position limit than 5% taking into account the specific characteristics of the underlying commodities.

17. ESMA notes that its approach in draft RTS 21 was driven by the fact that the position limits regime will apply immediately on implementation to thousands of different commodity derivative contracts in the Union. Therefore the only practicable approach is for draft RTS 21 to set the framework in the form of a common methodology for the Union to enable the individual competent authority to set an appropriate limit on a per contract basis, paying due regard to that contract's individual characteristics.
18. That is why it remains imperative that the technical standard maintains a range of position limits the national competent authority can use to set the position limit that is suitable for each specific contract by applying the various factors listed in Level 1 and further specified in draft RTS 21.
19. ESMA understands that agricultural contracts require special consideration when certain factors are present such as high liquidity, high volume of trading or high volatility as outlined in the letters by the Commission.
20. The Commission in its letter from 14 March 2016 asked ESMA to look into stricter limits for those agricultural contracts which have a high degree of volatility. In the letter of 20 April 2016, the Commission requested that very liquid and highly traded agricultural commodity derivative contracts should attract lower limits.
21. ESMA has performed an analysis of price volatility for a sample of agricultural contracts traded in Europe. ESMA has excluded spread contracts and contracts listed on trading venues that have no trading volumes as these would show an unrepresentatively low price volatility. The contract types used in this analysis were either 'Futures' or 'Active Futures'<sup>1</sup>.
22. In order to compare price volatility across contracts, ESMA has used a relative measure of volatility. Volatility was evaluated by looking at the coefficient of variation of price (using closing day price) over the last year: 20/03/15-20/03/16. This statistical metric uses the standard deviation of price relative to the average price over the period of time considered, and is expressed as a percentage. It indicates how much the price moved up or down on a relative basis based on the average price for that particular contract during that period of time.
23. Looking at the findings below, the relative volatility of those agricultural contracts in the near past is low. The maximum volatility observed by ESMA over this past year amounts to a mere 10% for more liquid contracts and 16% for less liquid ones. By comparison, average price volatility of Eurozone equities during 2015 reached nearly 20% (source: ThomsonReuters/ECB).

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<sup>1</sup> As classified by Bloomberg



24. Based on the low levels of price volatility observed in the past year ESMA considers the better approach to not decrease the baseline for contracts with a commodity underlying in the absence of firm evidence that agricultural contracts should be treated differently as an asset class from contracts with other underlying commodities.
25. ESMA instead proposes to permit national competent authorities the capability of imposing a lower minimum limit on agricultural contracts with foodstuffs as underlyings with the characteristics described above. Such minimum limit should be set at 2.5% for both the spot and the other months' limits.
26. To ensure that this minimum limit only applies to liquid and highly traded agricultural contracts, ESMA proposes that the relevant contracts should have a minimum open interest in spot and other months' of at least 50,000 lots over a consecutive three month period. The revised language of draft RTS 21 addresses these requirements.
27. However, this should not be taken as a guarantee that the lowest limit will always be imposed on each agricultural contract above the level of open interest. The position limit applied will have to take into account the full range of factors identified in Level 1 and detailed in the draft RTS.

## **4.2 Sensitivity to different types of underlying commodities – higher maximum limit for contracts with few market participants or with low levels of liquidity**

28. ESMA understands that the Commission is concerned that the maximum limit available under the ESMA proposal (35%) would not be suitable for certain illiquid contracts or contracts that have only few market participants.
29. ESMA agrees with the Commission's suggestion to make the position limits regime more flexible and to allow national competent authorities the setting of adequate limits based on actual market circumstances.
30. ESMA had already developed an approach to deal with the great number of highly illiquid contracts on a pragmatic basis in Article 15 of draft RTS 21. Given the thousands of contracts that are caught by the extremely wide scope of the position limits regime only such a rule allows for an implementation that works in practice without imposing simply unworkable rules on market participants and regulators alike.
31. When the Commission in its letters dated 14 March and 20 April 2016 wishes to address contracts with "low levels of liquidity" ESMA assumes that the Commission means contracts which are not caught by the regime for illiquid contracts in Article 15 of draft RTS 21 (contracts with a combined open interest not exceeding 10,000 lots and securitised derivatives with securities in issue not exceeding 10 million) but rather contracts that are slightly above the limits established in Article 15.
32. ESMA would therefore propose to introduce an additional class of "relatively illiquid contracts" with a combined open interest of spot and other months' not exceeding 20,000 lots (or 20 million securities as the case may be) which can have a maximum limit of 50% for both spot and other months'.
33. As far as the number of market participants is concerned, ESMA has already specified in Article 19 of draft RTS 21 that a high number of market participants requires setting the position limit lower than the baseline.
34. ESMA proposes to supplement that rule by specifying that if a contract has a low number of market participants, national competent authorities can also set a maximum limit for spot and other months' going up to 50%.
35. ESMA also proposes to further specify a contract with a low number of market participants as one which has fewer than ten market participants overall or which has fewer than three investment firms acting as market makers providing liquidity.
36. This should not be taken as a guarantee that the highest limit will always be imposed on each contract with relatively low levels of liquidity or a small number of market participants. The position limit applied will have to take into account the full range of factors identified in Level 1 and detailed in the RTS.

### **4.3 Other month limits – adjustment of the other months’ limits where there is a significant discrepancy between open interest and deliverable supply**

37. ESMA understands that the Commission would like to ensure that in cases where the deliverable supply and open interest figures in respect of a commodity derivative contract differ significantly, no disorderly market conditions occur when a contract moves from other into spot months’ territory.
38. ESMA still considers using deliverable supply as the relevant metric for the spot month and open interest as the one for other months’ as the right approach. The supply of the underlying commodity actually available is what matters when the contracts are nearing maturity whereas it is much less relevant for maturities that can go years into the future where open interest as a reflection of liquidity is the much more readily available and relevant metric. This approach found wide support in ESMA’s consultation and it is also the one used in the US where this approach appears to be working seamlessly in practice.
39. The Commission requests that limits should be set at a lower level if the open interest is significantly higher than the deliverable supply and vice versa.
40. ESMA notes that the existing RTS 21, by imposing ranges for the position limits to be set, already contains one important tool for ensuring an adequate setting of spot and other months’ limits in this respect.
41. ESMA also notes that the concern voiced by the Commission appears to be related often to liquid benchmark contracts where the price determined serves a benchmark function for contracts settled with similar underlyings which however do not meet the contractual specifications of the benchmark contract. The prime example in this respect would be the Brent contract which has a benchmark function for a wide variety of oil types which would cover an extremely large open interest base whereas the deliverable supply of the underlying North Sea oil is much more limited.
42. ESMA certainly acknowledges the discrepancies that can occur when dealing with such benchmark contracts but also believes that an adequate determination of what the deliverable supply actually is can address those concerns. ESMA was initially planning to produce guidance on how the deliverable supply described in abstract terms in Article 10 of RTS 21 should be determined per commodity type and is in favour of determining the deliverable supply for benchmark contracts in a way that does not create disorderly market conditions.
43. Therefore, to address the concern by the Commission in excess of what is already engrained in RTS 21, ESMA proposes introducing two amendments.

44. Firstly, the definition of “deliverable supply” in Article 10 of RTS 21 has been revised. In order to avoid causing disorderly markets as the spot month approaches, and to reduce the scale of discrepancies between deliverable supply and open interest which underlies the Commission and co-legislators’ concerns, deliverable supply is now specified to include any substitute grades or types of a commodity that can be delivered in settlement of a commodity derivative contract under the terms of that contract.
45. Secondly, ESMA has added two paragraphs to the existing Article 18 of RTS 21 clarifying that the other months’ limit should be adjusted if the open interest is either significantly higher or lower than the deliverable supply.
46. These changes should grant the necessary flexibility to deal with individual cases at the stage of setting the actual position limit on an adequate basis.

#### **4.4 Economically equivalent OTC contracts**

47. ESMA understands that the Commission proposes to amend the definition of EEOTC to contracts which yield similar economic exposure for position holders whilst not necessarily identical in contractual terms. ESMA is asked to take factors such as lot sizes, delivery dates, locations or any other terms into account.
48. ESMA is aware of the concern that the definition of EEOTC chosen by ESMA is too specific and therefore may allow contracts that are similar to on-venue contracts not to be considered when establishing the net position of a specific market participant and thus allow circumvention of the position limit regime’s purpose by spreading positions across exchange-traded and OTC contracts.
49. ESMA however is also aware that drafting the EEOTC definition in too wide a fashion carries an even higher risk of enabling circumvention of position limits by creating an ability to net off positions taken in on-venue contracts against only roughly similar OTC positions which would have the potential to undermine a general decision taken at Level 1.
50. Faced with this pair of potential consequences, ESMA opted in favour of a narrow EEOTC definition which has the benefit of clarity, legal certainty and of facilitating the practical day-to-supervision of compliance with the position limits regime.
51. ESMA appreciates that the Commission considers the definition as currently drafted as too narrow and may allow for the building-up of positions OTC which would be outside the position limits regime while being largely economically equivalent.

52. ESMA has therefore covered two additional possibilities where the contractual specifications might not be identical but still qualify as EEOTC. In case the specifications of the OTC contract in respect of lot sizes and delivery dates would be different from the on-venue contract this would not stop the OTC contract from being considered EEOTC. However, in the case of delivery dates the divergence with the exchange-traded contract is limited to one day. Different delivery locations will in ESMA's view, generally mean different economic characteristics. Having given consideration to the benefits and drawbacks of aggregating contracts with different delivery arrangements, ESMA has decided not to propose amendments in this regard. If, however, minor differences in delivery arrangements or other contract parameters are in future used with the apparent intent of circumventing the regime, ESMA may propose further amendments to the definition.

#### **4.5 Applicability of relevant factors**

53. ESMA assumes that the Commission refers, in particular, to the factors in Articles 16 to 19 of draft RTS 21 which provide direction of how to set the position limit of a commodity derivative contract if that contract has specific characteristics in respect of its maturity, the deliverable supply available, the overall open interest and the number of market participants active in it.

54. ESMA understands that the Commission would like to be more specific in how those factors are to be applied, by, for instance, tying them to exceeding certain thresholds.

55. ESMA had already looked into calibrating the additional factors closely when drafting RTS 21. ESMA had at the time calibrated specific measures in respect of new and illiquid contracts in Article 15 of draft RTS 21. ESMA is now proposing to also tie the setting of a wider range of limits to a certain low number of market participants.

56. ESMA however considers that beyond those two measures, the relevant factors cannot be further specified and tied to exceeding specific thresholds because the setting of position limits depends on the individual contract and cannot be overly unified and mechanised. A sufficient degree of discretion for the national competent authority has to remain.

57. This is of particular relevance given the wide scope of application and the number of commodity derivative contracts covered, particularly in comparison to the US.

58. ESMA would also like to point out that any divergent practices that competent authorities may apply would be subject to the ESMA opinion process and its supervisory convergence work.

## **5 Annex: Revised Draft Regulatory Technical Standard**