



European Securities and
Markets Authority

Questions and Answers

On MiFID II and MiFIR commodity derivatives topics





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Markets Authority

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Acronyms and definitions used

EEOTC	Economically Equivalent OTC contracts
ESMA	The European Markets and Securities Authority
ETC	Exchange Traded Commodities
ETF	Exchange Traded Fund
EU	European Union
LNG	Liquefied Natural Gas
MiFID I	Markets in Financial Instruments Directive – Directive 2004/39/EC of the European Parliament and of the Council
MiFID II	Markets in Financial Instruments Directive (recast) – Directive 2014/65/EU of the European Parliament and of the Council
MiFIR	Markets in Financial Instruments Regulation – Regulation 600/2014 of the European Parliament and of the Council
MTF	Multilateral Trading Facility
NCA	National Competent Authority
RTS	Regulatory Technical Standards

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	8	Are the net positions held by clearing members usable for the purposes of determining the positions of their clients for the application of position limits under Article 57?	Art. 57 of MiFID II Level 1; Art 12 of RTS 21	19/12/2016
	9	Will there be a different position limit for options and futures? If so, how should options be converted into futures for the application of position limits?	Art. 3 of RTS 21	19/12/2016

¹ Please note that, for ease of reference, RTS have been numbered in this document in accordance with the numbering used in the package sent by ESMA to the Commission in September 2015 (ESMA/2015/1464). Readers are nevertheless invited to consult the Commission and European Parliament websites for updated versions of those RTS.

	10	How is the position limits regime applied to the various underlyings listed in Annex I, Section C(10) of MIFID II?	Annex I, Section C(10) of MIFID II	29/03/2017
	11	Can a hedge exemption be netted against positions in derivatives which are not objectively measurable as reducing risks directly related to that person's commercial activity?	Art 8 of RTS 21	29/03/2017
	12	What is the meaning of the 'single fungible pool of open interest' in Art 5.1(b) of RTS 21? Does it refer only to those commodity derivatives cleared in the same central counterparty?	Art 5.1(b) of RTS 21	29/03/2017
	13	How should contracts that have a high variability of open interest during the year be treated (i.e. minimum open interest is below 10,000 lots but maximum above it)?	Art 15 of RTS 21	29/03/2017
Ancillary activity	1	Do all legal entities that deal in commodity derivatives within a financial group need to be individually authorised as investment firms?	Art 2(1)(j) of MiFID II Level 1	19/12/2016
	2	Does trading activity in C6 contracts which takes place on OTFs after 3 January 2018 need to be counted towards the ancillary thresholds prior to that date?	MiFID II Annex I Section C6 ; Art. 6 of Commission Delegated Regulation (EU) of 25.4.2016; Article 2(4) of REMIT	19/12/2016
	3	Since elements of the ancillary activity tests are to be calculated on a group level, is only the parent undertaking obliged to notify its NCA for the whole group or do the subsidiary undertakings also have to notify their local NCA?	Art 2(1)(j) of MiFID II Level 1	19/12/2016



1 Introduction

Background

The final legislative texts of Directive 2014/65/EU² (MiFID II) and Regulation (EU) No 600/2014³ (MiFIR) were approved by the European Parliament on 15 April 2014 and by the European Council on 13 May 2014. The two texts were published in the Official Journal on 12 June 2014 and entered into force on the twentieth day following this publication – i.e. 2 July 2014.

Many of the obligations under MiFID II and MiFIR were further specified in the Commission Delegated Directive⁴ and two Commission Delegated Regulations^{5,6}, as well as regulatory and implementing technical standards developed by the European Securities and Markets Authority (ESMA).

MiFID II and MiFIR, together with the Commission delegated acts as well as regulatory and implementing technical standards will be applicable from 3 January 2018.

Purpose

The purpose of this document is to promote common supervisory approaches and practices in the application of MiFID II/ MiFIR in relation to the position limits, position reporting and ancillary activity provisions and other aspects of the commodity derivatives regime in MiFID II. It provides responses to questions posed by the general public, market participants and competent authorities in relation to the practical application of MiFID II/MiFIR.

The content of this document is aimed at competent authorities and firms by providing clarity on the application of the MiFID II and MiFIR requirements.

The content of this document is not exhaustive and it does not constitute new policy.

² Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.

³ Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) NO 648/2012.

⁴ Commission Delegated Directive of 7.4.2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any monetary or non-monetary benefits. The Commission Delegated Directive was published on 7 April 2016 and no objection has been expressed by the European Parliament or the Council on the MiFID II Delegate Directive and Delegated Regulation within the period set in Article 89 of MiFID II.

⁵ Commission Delegated Regulation of 25.4.2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive. The Commission Delegated Regulation was published on 25 April 2016 and no objection has been expressed by the European Parliament or the Council on the MiFID II Delegate Directive and Delegated Regulation within the period set in Article 89 of MiFID II.

⁶ Commission Delegated Regulation of 18.5.2016 supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council with regard to definitions, transparency, portfolio compression and supervisory measures on product intervention and positions. The Commission Delegated Regulation was published on 18 May 2016 and no objection has been expressed by the European Parliament or the Council on the MiFID II Delegate Directive and Delegated Regulation within the period set in Article 50 of MiFIR.



Status

The Q&A mechanism is a practical convergence tool used to promote common supervisory approaches and practices under Article 29(2) of the ESMA Regulation.⁷

Due to the nature of Q&As, formal consultation on the draft answers is considered unnecessary. However, even if they are not formally consulted on, ESMA may discuss them with representatives of ESMA's Securities and Markets Stakeholder Group, the relevant Standing Committees' Consultative Working Group or, where specific expertise is needed, with other external parties.

ESMA will periodically review these questions and answers to identify if, in a certain area, there is a need to convert some of the material into ESMA Guidelines and recommendations. In such cases, the procedures foreseen under Article 16 of the ESMA Regulation would be followed.

The Q&As in this document cover only activities of EU investment firms in the EU, unless specifically mentioned otherwise. Third country related issues, and in particular the treatment of non-EU branches of EU investment firms, will be addressed in a dedicated third country section.

Questions and answers

This document is intended to be continually edited and updated as and when new questions are received. The date on which each section was last amended is included for ease of reference.

⁷ Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC Regulation, 15.12.2010, L331/84.



2 Position limits [Last update: 29/03/2017]

Question 1 [Last update: 19/12/2016]

Are position limits applicable only at the end of each trading day or also throughout the trading day?

Answer 1

Position limits are applicable at all times. This is particularly relevant when a commodity derivative is traded OTC outside the normal trading hours of a trading venue.

Question 2 [Last update: 19/12/2016]

What is the definition of lot for energy products?

Answer 2

In derivatives markets where the underlying asset is electricity, natural gas (gas) or liquefied natural gas (LNG) and there is no concept of a standardised lot as a unit of trading the following approach should be used:

Delivery period: the period over which the contract is delivered (physically or by cash settlement vs spot prices). These periods may be annual (calendar), quarterly, monthly, weekly (whole week, labour week and weekend) or daily. For gas and LNG derivative contracts the units of time for delivery are typically days.

Unit of registration: Generally, it is 1 Megawatt MW, but there are ISINs whose unit of registration is a multiple or a proportion of MW (e.g. 0.1 MW)

Product type: For most power derivatives the underlying is delivered as a fixed quantity per hour during a defined number of hours (“relevant hours”) in the relevant days of the delivery period. There are two main product types for power derivatives:

- **Base Load:** Relevant hours are 24 per day, as the underlying asset is delivered from the first hour of the day (0:00 to 00:59 hours) until the last hour of the day (23:00 to 23:59 hours) of relevant days included in the delivery period.
- **Peak Load:** Relevant hours are different in different jurisdictions and are usually specified as part of the day (for example, 12 hours where an underlying asset is delivered from the ninth hour of the day (08:00:00 to 08:59:00 hours) until the twentieth hour of the day (19:00 to 19:59 hours) of every Monday, Tuesday, Wednesday, Thursday and Friday (relevant days) included in the delivery period).



Nominal/multiplier of a contract: the implicit multiplication of the deliverable underlying in the contract. For power contracts, it is in MWh.

For Power derivatives

Nominal = Unit of registration * number of relevant days (in delivery period) * relevant hours (per day)

For Gas and LNG derivatives

Nominal = Unit of registration * number of relevant days (in delivery period)

Where a lot is not defined for energy contracts, according to Article 9 of RTS 21, a lot should be the minimum quantity tradable of that commodity derivative, calculated as nominal * minimum number of contracts to be included in a trade.

Typically, for power base load contracts the lot is 24 MWh as the minimum amount tradable is one daily contract of 1 MW. Similarly, for peak load contracts, a lot is equal to the number of hours in the peak load period (e.g. 12 MWh).

For gas and LNG, a lot will be 1 MWh, except for gas derivatives where the number of contracts traded as a unit is above this size.

Question 3 [Last update: 19/12/2016]

What is a lot in the case of Economically Equivalent OTC contracts (EEOTC)?

Answer 3

A significant number of OTC contracts are specified by reference to a quantity of the underlying commodity and not the standardised lot sizes of an exchange-traded derivative. Where an OTC contract is not defined in standardised lots the size of the contract should be calculated as a multiple of the standard unit of trading used by the trading venue for the commodity derivative to which the OTC contract is equivalent.

Question 4 [Last update: 19/12/2016]

Should positions with different maturities for other months' limits be netted?

Answer 4



Yes. Persons must determine their net position for each commodity derivative for the other months' limit, as indicated in Article 3(4) of RTS 21⁸.

They should sum (or net, as appropriate) all individual positions across the curve excluding those positions in the spot month for that commodity derivative.

Question 5 [Last update: 19/12/2016]

How should non-EU entities with positions above the limits be treated? Do they have access to exemptions, and if so, when and how do they apply to the relevant NCA?

Answer 5

A non-financial entity from outside the EU (European Union) may apply for an exemption in the same manner as an EU firm would. The rules and procedures are laid down in RTS 21.

Question 6 [Last update: 19/12/2016]

How do limits apply to long and short positions?

Answer 6

Position limits apply to net positions regardless of whether the net position is long or short. When calculating their positions, a person needs to aggregate their long and short holdings in spot contracts towards the spot month limit. They separately need to aggregate all their long and short positions for all other months towards the other months' limit.

Question 7 [Last update: 19/12/2016]

Are securitised derivatives considered to be commodity derivatives under MiFID II? How does ESMA differentiate between ETCs and securitised derivatives?

Answer 7

“Securitized derivatives” are transferable securities whose value is based upon underlying assets. However, neither MiFID I (incl. level 2 thereof), nor MiFID II/MiFIR contain a specific definition of these instruments.

⁸ Please note that, for ease of reference, RTS have been numbered in this document in accordance with the numbering used in the package sent by ESMA to the Commission in September 2015 (ESMA/2015/1464). Readers are nevertheless invited to consult the Commission and European Parliament websites for updated versions of those RTS



Where the underlying asset of securitised derivatives is one or more commodities, these instruments are caught by the definition of “transferable securities” in Article 4(1)(44)(c) of MIFID II and are commodity derivatives under Article 2(1)(30) of MiFIR.

Exchange traded commodities (ETCs) are debt instruments which are within the scope of Article 4(1)(44)(b) of MiFID II and are classified as such in RTS 2. Therefore, they are outside the definition of commodity derivatives in Article 2(1)(30) of MiFIR and the position limits regime does not apply to them.

ESMA is aware that market practices in differentiating between ETCs and securitised derivatives are neither clear nor uniform and presents the following guidance to allow for a correct classification of instruments in practice.

In RTS 2 ETCs are described as debt instruments issued against a direct investment by the issuer in commodities or commodity derivative contracts. The price of an ETC is directly or indirectly linked to the performance of the underlying. An ETC passively tracks the performance of the commodity or the commodity indices to which it refers.

In addition, ESMA considers that ETCs typically have the following features:

- a primary market exists which is accessible only to authorised market participants permitting the creation and redemption of securities on a daily basis at the price set by the issuer;
- they are not UCITS and therefore unlike an ETF can have an exposure profile not in compliance with the UCITS diversification requirements;
- they are traded on- and off-venue in significant volumes;
- the price is aligned, or multiplied by a fixed leverage of the price of the underlying commodity;
- a management fee is charged by the issuer;
- they may be issued by non-banking institutions;
- they do not have an expiry date;
- they may have a strict regime of capital segregation, usually through the use of special purpose vehicles;
- they are often aimed at professional investors.

In comparison, the term ‘securitised derivatives’ describes a much wider set of financial instruments that can have a large variety of features among them the following typical features:

- they can have commodities as underlying but also many financial instruments or they can be linked to strategies, indices or baskets of instruments;



- they can passively track the performance of the underlying but they can typically also apply leverage, can have an option structure or also have a lower risk profile than the underlying by, for example, offering capital protection;
- they are traded on venue or OTC by the issuer directly or via intermediaries;
- the issuers' costs and compensation are factored into their price;
- they have an expiration date;
- they provide an issuer credit risk exposure;
- they are often aimed at retail clients.

Question 8 [Last update: 19/12/2016]

Are the net positions held by clearing members usable for the purposes of determining the positions of their clients for the application of position limits under Article 57?

Answer 8

No. Central counterparties determine net positions at the level of their clearing members, which usually encompass the long and short position of many different clients unless held in individually segregated accounts. A CCP may also see positions only for those contracts for which it provides a central counterparty service and not the EEOTC positions or any held at a CCP subject to interoperability. Position limits apply at the level of the individual person, and net positions held at clearing level must therefore be disaggregated.

Question 9 [Last update: 19/12/2016]

Will there be a different position limit for options and futures? If so, how should options be converted into futures for the application of position limits?

Answer 9

No, separate limits will not be set for futures and options on the same commodity derivative.

Futures and options are fungible in terms of their economic effect at expiry if an option expires in the money with the respective future expiring at the same time. During the life of an option contract, the probability it will expire in the money is reflected in its delta value, with an option that is more likely to be in the money having a higher delta value.

Option positions should therefore be converted into positions in their respective future contracts positions on the basis of the current delta to arrive at a delta equivalent futures



position. Long delta equivalent positions on calls and short delta equivalent positions on puts should be added to long positions on futures. Short delta equivalent positions on calls and long delta equivalent positions on puts should be added to short positions on futures.

If available, position holders should use the delta value published by the trading venue or the CCP to report their positions in options.

In the absence of a published delta value, position holders may use their own calculation. Position holders should be able to demonstrate, on demand, to the National Competent Authority responsible for the application of the position limit that their calculations correctly reflect the value of the option.

The open interest of futures should be used for both futures and options on the same underlying.

Question 10 [Last update: 29/03/2017]

How is the position limits regime applied to the various underlyings listed in Annex I, Section C(10) of MIFID II?

Answer 10

Section C(10) of Annex I of MIFID II covers a number of different types of commodity derivatives. For these instruments the following approaches should be taken:

Position limits should be applied to **freight rate** derivatives (wet and dry freight) based on the open interest both in the spot month and in the other months.

Position limits should be applied to derivative contracts relating to **indices** if the underlying index is materially based on commodity underlyings as defined in Article 2 No. 6 of Commission Delegated Regulation of 25 April 2016. ESMA considers that the underlying index derivative is materially based on commodities if such commodities have a weighting of more than 50% in the composition of the underlying index. The spot and the other months' limits should be based on open interest only, in accordance with Article 13(1) of [draft RTS 21], as no single measurable deliverable supply can be determined for the commodities contained within the index.

A commodity derivative contract in the legal form of a "spread" or "diff" contract is a contract that is cash-settled and whose value is determined by the difference between two reference commodities which may vary in type, grade, location, time of delivery, or other features. Whilst having multiple commodity values underlying it, the commodity derivative is available on a trading venue as a single tradable financial instrument. A spread contract is different to a spread trading strategy, when two or more commodity derivative contracts may be traded together in order to achieve a certain economic effect. Such a strategy may be executed by a single action in a venue's trading systems, but it remains composed of separate and legally distinct commodity derivatives which are executed as trades simultaneously.



As a spread contract has no single commodity at a specific place or time as the underlying, it is not possible to link it to a single physical deliverable supply against a contractual obligation to physically settle the trade. It is for this reason all spread contracts are cash-settled and not physically settled.

Therefore, spread contracts should be treated for the application of the ESMA methodology in the same manner as C10 commodity derivatives which do not have a physical underlying, such as weather derivatives. The open interest figure for the commodity derivative itself should be used as the baseline for both the Spot Month limit and the Other Months' limit

For other derivatives listed in Section C10 of Annex I of MiFID II and in Article 8 of Commission Delegated Regulation of 25 April 2016, ESMA is not expecting the setting of any position limits as the underlyings of such derivatives are not considered to be commodities as defined in Article 2 No. 6 of Commission Delegated Regulation of 25 April 2016.

Question 11 [Last update: 29/03/2017]

Can a hedge exemption be netted against positions in derivatives which are not objectively measurable as reducing risks directly related to that person's commercial activity?

Answer 11

No. Once an exemption has been granted and positions are approved as risk-reducing in accordance with Article 8 of draft RTS 21, those positions fall outside the position limit regime. Otherwise, the benefit of a risk-reducing position would be double-counted, by first being excluded from the limit and then being used to offset a speculative exposure.

Question 12 [Last update: 29/03/2017]

What is the meaning of the 'single fungible pool of open interest' in Art 5.1(b) of RTS 21? Does it refer only to those commodity derivatives cleared in the same central counterparty?

Answer 12

Commodity derivatives with a single fungible pool of open interest would include those cleared by the same central counterparty (CCP) and those in interoperable CCPs which may be closed out against each other. It would also include other commodity derivatives with delivery obligations which are fungible and can be closed out against each other (for example, through the operational netting provided by a transmission system operator).

Question 13 [Last update: 29/03/2017]

How should contracts that have a high variability of open interest during the year be treated (i.e. minimum open interest is below 10,000 lots but maximum above it)?



Answer 13

Article 15 of RTS 21 states that new and illiquid contracts for which the total combined open interest in spot and other months' contracts does not exceed 10,000 lots for a consecutive three-month period are assigned a position limit of 2,500 lots. Therefore, any contract with a high variability would have to exceed the threshold of 10,000 lots of open interest on a daily basis based on end-of-day figures for three consecutive months before an individualised position limit has to be set for that contract.



3 Ancillary activity [Last update: 19/12/2016]

Question 1 [Last update: 19/12/2016]

Do all legal entities that deal in commodity derivatives within a financial group need to be individually authorised as investment firms?

Answer 1

Yes. Under Article 2(1)(j), the exemption for trading in commodity derivatives only applies when the main business of the group is considered on an overall basis not to be the provision of investment services within the meaning of this Directive or banking activities under Directive 2013/36/EU.

Therefore, all entities within a group which cannot be considered as a non-financial group are required to obtain authorisation as an investment firm under MiFID II if they wish to trade commodity derivatives.

Question 2 [Last update: 19/12/2016]

Does trading activity in C6 contracts which takes place on OTFs after 3 January 2018 need to be counted towards the ancillary thresholds prior to that date?

Answer 2

We differentiate between wholesale energy products categorised as C6 within the REMIT scope (derivatives with electricity and natural gas as underlying traded on an OTF that must be physically settled), C6 energy derivatives contracts (those with coal or oil as underlying traded on an OTF that must be physically settled) and the rest of C6 instruments.

Financial instruments under MiFID I which will also be financial instruments within C6 under MiFID II should count towards the trading activity and assessed against the ancillary thresholds.

C6 with coal or oil as underlying and the rest of C6 instruments count throughout the calculation period to determine market size, as OTC instruments until January 3, 2018 and as OTF on-venue instruments after that. For C6 instruments with coal or oil as underlying traded on OTFs this assessment is based on them only being exempted from certain EMIR obligations for a transitional period while they are being classified as financial instruments throughout the period. The same applies to the computation of positions by non-financial corporates.



Question 3 [Last update: 19/12/2016]

Since elements of the ancillary activity tests are to be calculated on a group level, is only the parent undertaking obliged to notify its NCA for the whole group or do the subsidiary undertakings also have to notify their local NCA?

Answer 3

The ancillary exemption applies to persons. Notification to the relevant NCA for that person is a condition for using the exemption. Therefore, any person that is party to a commodity derivative will need to notify its relevant NCA. This also applies to persons who are part of a group. It is not possible for a group to apply for an exemption on behalf of all the entities that the group contains.