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| Reply Form to the Call for Evidence |
| Position limits and position management in commodity derivatives |

**Responding to this paper**

ESMA invites comments on all matters in this paper and in particular on the specific questions summarised in Annex 1. Comments are most helpful if they:

* respond to the question stated;
* indicate the specific question to which the comment relates;
* contain a clear rationale; and
* describe any alternatives ESMA should consider.

ESMA will consider all comments received by **5 July 2019.**

All contributions should be submitted online at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading ‘Your input - Consultations’. Please follow the instructions given in the document ‘Reply form for the call for evidence on position limits and position management controls in commodity derivatives’ also published on the ESMA website.

**Instructions**

In order to facilitate analysis of responses to the Call for Evidence, respondents are requested to follow the below steps when preparing and submitting their response:

1. Insert your responses to the questions in the Call for Evidence in the present response form.
2. Please do not remove tags of the type <ESMA\_QUESTION\_PLPM\_1>. Your response to each question has to be framed by the two tags corresponding to the question.
3. If you do not wish to respond to a given question, please do not delete it but simply leave the text “TYPE YOUR TEXT HERE” between the tags.
4. When you have drafted your response, name your response form according to the following convention: ESMA\_PLPM\_nameofrespondent\_RESPONSEFORM. For example, for a respondent named ABCD, the response form would be entitled ESMA\_PLPM\_ABCD\_RESPONSEFORM.
5. Upload the form containing your responses, in Word format, to ESMA’s website ([www.esma.europa.eu](http://www.esma.europa.eu) under the heading “Your input – Open consultations” 🡪 “Call for Evidence on Position limits and position management in commodities derivatives”).

**Publication of responses**

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA’s rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA’s Board of Appeal and the European Ombudsman.

**Data protection**

Information on data protection can be found at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading [Legal Notice](http://www.esma.europa.eu/legal-notice).

**Who should read this paper**

All interested stakeholders are invited to respond to this consultation paper. This consultation paper is primarily of interest to trading venues, investment firms and non-financial counterparties trading in commodity derivatives, but responses are also sought from any other market participant including trade associations, industry bodies and investors.

**General information about respondent**

|  |  |
| --- | --- |
| Name of the company / organisation | London Metal Exchange |
| Activity | Regulated markets/Exchanges/Trading Systems |
| Are you representing an association? |  |
| Country/Region | UK |

**Introduction**

***Please make your introductory comments below, if any***

<ESMA\_COMMENT\_PLPM\_1>

The LME supports the underlying policy objectives of the position limits regime which was introduced through the MiFID II legislation. These objectives fulfil the commitments made during the 2009 meeting of the G20 in Pittsburgh, which pledged to “improve the regulation, functioning and transparency of financial and commodity markets to address excessive price volatility”. The ten year anniversary of that commitment, combined with the obligation on ESMA to prepare advice to the European Commission’s report on the impact of position limits and position management controls on commodity derivatives markets, presents an appropriate opportunity to review and assess the efficacy of the regime and consider the manner in which it may be appropriate to improve or revise it.

The LME worked closely with the FCA during the implementation phase of the position limits regime and provide it with all required data to enable limits that were set at appropriate levels and in line with existing market practice. As a result, the direct impact of the limits on the LME’s mature and liquid contracts was limited and members did not generally report any prejudicial impact on their normal trading patterns. Nor did the LME identify any unusual trading pattern or volume changes which could be attributed to the implementation of the new rules.

However, this is not the case for the LME’s nascent and illiquid contracts where the prescribed limits are set at such a level that they would present a significant barrier to the growth and success of such contracts. It is well understood that it takes time to build up liquidity and volume in new contracts and the most deleterious effects of these limits have only been avoided through the discretionary action taken by the FCA to introduce unspecified “TBA” limits. This has permitted LME’s nascent and illiquid contracts to be traded without the limitations that would otherwise have been imposed and which the LME believes would have caused trading on those contracts to have ceased or significantly reduced. This has enabled physical market users to hedge their physical exposures when otherwise they might not have been able to. The LME therefore strongly supports broader industry calls for a review of the manner in which position limits are determined and applied to nascent and illiquid contracts.

In relation to the position management controls introduced under MiFID II; the LME already enjoyed established and respected position management controls on its market before the introduction of MiFID II. These controls have been, and remain, a fundamental tool in managing the market to ensure it remains orderly and in protecting against abusive squeezes and other types of market abuse. The established position management controls were able to continue under the MiFID II regime and, as such, the LME believes that the current position management requirements are appropriate and do not necessitate review or revision.

<ESMA\_COMMENT\_PLPM\_1>

**Questions**

1. : In your view, what impact, if any, did the introduction of position limits have on the availability and liquidity of commodity derivative markets? What are in your views the main factors driving this development, e.g. the mere existence of a position limit and position reporting regime, some specific characteristics of the position limit regime or the level at which position limits are set? Please elaborate by differentiating per commodity asset class or contract where relevant and provide evidence to support your assessment.

<ESMA\_QUESTION\_PLPM\_1>

In relation to its mature and established contracts, the LME has not identified any impact on availability and liquidity of contracts traded on its market nor has any such impact been reported by members. Whilst the obligations introduced under MiFID II (including those on position limits and position reporting) required firms and markets to undertake considerable preparatory work, since their introduction there has been little direct impact.

The introduction of position limits to nascent and illiquid contracts (and consequent impact on market operators’ ability to maintain or grow liquidity), has, however, caused considerable concern to the LME market and we share the concerns expressed by industry groups that the default limits are overly restrictive. The potential threat to the liquidity and success of such contracts on the LME market was only avoided through the discretionary action taken by the FCA to introduce “TBA” limits which permitted continued and uninterrupted trading by market participants enabling them to continue to manage their risk confidently and efficiently.

<ESMA\_QUESTION\_PLPM\_1>

1. : Have you identified other structural changes in commodity derivative markets or in the underlying markets since the introduction of the MiFID II position limit regime, such as changes in market participants? If so, please provide examples, and where available data, and differentiate per commodity derivative asset class where relevant.

<ESMA\_QUESTION\_PLPM\_2>

1. The LME has not identified any other structural changes to its market since the introduction of the MiFID II position limit regime.

<ESMA\_QUESTION\_PLPM\_2>

1. : Do you consider that position limits contribute to the prevention of market abuse in commodity derivatives markets? Please elaborate by differentiating per conduct, per commodity asset classes or contract where relevant and provide evidence to support your assessment when available.

<ESMA\_QUESTION\_PLPM\_3>

The position limit regime forms part of a coherent set of legislation aimed at preventing and detecting abusive behaviours within the commodity derivatives markets. The LME believes that it is this legislative combination (made up of the Market Abuse Regulation, position management controls of individual market operators, position limits and position reporting) that collectively contributed towards greater controls and prevention of market abuse of commodity markets.

However we consider National Competent Authorities are likely to be better placed to assess the direct impact of the position limits regime (in isolation) on the prevention of market abuse.

<ESMA\_QUESTION\_PLPM\_3>

1. : In your view, what impact do position limits have on the orderly pricing and orderly settlement of commodity derivative contracts? Please elaborate by differentiating per asset class or per contract where relevant and provide evidence to support your answer when available.

<ESMA\_QUESTION\_PLPM\_4>

The LME has not seen any evidence, and therefore does not believe that the position limit regime has had an impact on orderly pricing and orderly settlement of commodity derivative contracts. However, given that the regime was introduced only 18 months ago, it may be too premature to undertake a comprehensive assessment of its impact.

<ESMA\_QUESTION\_PLPM\_4>

1. : More generally, and beyond the specific items identified above, what would be your overall assessment of the impact of position limits on EU commodity derivatives markets since the application of MiFID II?

<ESMA\_QUESTION\_PLPM\_5>

In relation to mature and liquid contracts the LME has not identified any material impact of the position limit regime on its market. There has been some anecdotal evidence from member firms that certain contracts are traded off-exchange where they would otherwise have been traded on-exchange, however the LME has not identified any significant changes in its trading volumes attributed to the position limits regime.

In relation to nascent and illiquid contracts, we consider the position limit regime, as currently calibrated, poses a material threat to the successful introduction of new contracts and limits their ability to thrive. This, in turn, impacts physical users being able to confidently hedge their physical exposures in those markets. We consider the prescribed limits are too restrictive and do not fully cater for the patterns of growth witnessed in commodity markets. For example, the LME Gold contract saw open interest exceed 10,000 lots within the first week of trading. However as there were only a limited number of participants, they faced a material risk of breaching the imposed limits because, by definition, there was a higher likelihood of a position being large in a market with few participants. If position limits are introduced after a contract’s open interest exceeds 10,000 lots then ESMA prescribes that the limit must be a maximum of 50% of open interest. In a nascent market it is common to have one or two key participants housing risk, holding positions and making markets. This can easily lead to scenarios where they hold more than 50% of open interest in the early stages of growth before the market diversifies its participant base. For LME Gold this potential risk lead to a number of participants considering withdrawing from the market, reducing positions, ceasing trading or providing liquidity. Potential breach of the position limit regime was also a concern cited by prospective new participants. This, in turn, would have prevented those participants from managing their risk through a transparent orderbook with the benefits of central clearing.

This effect was avoided through the discretionary action of the FCA which imposed “TBA” limits on affected contracts meaning that trading could continue without interruption and no participants felt compelled to withdraw their participation. However, this temporary situation does not offer sufficient comfort or certainty and as such the LME supports calls a review of the position limits applicable to new and illiquid contacts to ensure participants can continue to access markets that are growing in nature but in which they need to manage risk. Current participants and prospective participants require clarity on position limits before trading new contracts and establishing positions.

<ESMA\_QUESTION\_PLPM\_5>

1. : Do you consider that position management controls have an impact on the liquidity of commodity derivatives markets? If so, please elaborate, differentiating per commodity derivative trading venues or contract where appropriate.

<ESMA\_QUESTION\_PLPM\_6>

The experience of the LME in relation to position management controls is that they ensure fair and liquid markets by managing, rather than limiting, the position that participants are able to hold. As such these controls permit the market to trade without fear of a sudden change in availability.

<ESMA\_QUESTION\_PLPM\_6>

1. : Do you consider that position management controls adopted by commodity derivative trading venues have a role on the prevention of market abuse? If so, please elaborate, differentiating per commodity derivative trading venues or contract where appropriate.

<ESMA\_QUESTION\_PLPM\_7>

Position management requirements play a significant part in preventing market abuse on commodity derivative markets. It has been the experience of the LME that its own position management regime, introduced in 1998, has been instrumental in preventing market abuse. The position reporting requirements that the LME imposes in its members takes a holistic view of a member’s position and includes physical holdings as well. This means that potential abuse, for example through a “squeeze”, created through a position held on and off-market can be detected and prevented.

<ESMA\_QUESTION\_PLPM\_7>

1. : Do you consider that position management controls adopted by commodity derivative trading venues have a role on orderly pricing and settlement conditions? If so, please elaborate, differentiating per commodity derivative trading venues or contract where appropriate.

<ESMA\_QUESTION\_PLPM\_8>

The LME considers that position management controls do have a role in maintaining orderly pricing and settlement conditions. It achieves this through ensuring a fair market and that no participant can influence the price by holding a disproportionately large position.

<ESMA\_QUESTION\_PLPM\_8>

1. : If you are a commodity derivative trading venue, please explain how you have been exercising your position management controls since MiFID II application. In particular, how frequently did you ask further information on the size or purpose of a position, on beneficial owners or assets and liabilities in the underlying commodity under Article 57(1)(b) of MiFID II, require a person to terminate or reduce a position under Article 57(1)(c) of MiFID II, require a person to provide liquidity back into the market under Article 57(1)(d) of MiFID II or exercise any of your additional position management controls?

<ESMA\_QUESTION\_PLPM\_9>

In order to ensure that the price discovery process is not unduly influenced by the existence of a position, which can include the holding of warrants, the LME has in place arrangements to ensure that positions held on the market are subject to ongoing monitoring. Members are required on a daily basis to report end of day positions to the LME. Where a dominant position (as defined by the rules) exists, the LME will require that member to “lend” that position back into the market at a set premium in order to let short position holders exit their position without fear of an abusive squeeze. The LME Rules also require members to inform the LME of financing arrangements and to whom those arrangements give effective control over warrants.

Limits on positions are published by the LME which apply to all prompt dates. Whilst a large position is not automatically considered abusive the intended purpose of the position management rules is to ensure that where such positions are held by market participants, the ongoing management of those positions does not have an undue influence upon the market.

Where a limit is exceeded the LME may request further information and has powers under its rules to give directions in respect of that position (for example to reduce or close it as necessary). On a daily basis the LME also monitors accountability levels. These are thresholds which are set below the LME-published limits and which could be anywhere along the forward curve. If a member holds a position that exceeds the accountability level threshold, the LME is permitted to request further information in relation to the nature and purpose of the position.

Where appropriate, the LME may also take such action, through the Special Committee (a committee to whom the directors have delegated certain emergency powers), as it deems appropriate to ensure that no position holder is able to exercise an undue influence on the market.

<ESMA\_QUESTION\_PLPM\_9>

1. : Do you have any general comment on the position limit regime and associated position reporting introduced by MiFID II?

<ESMA\_QUESTION\_PLPM\_10>

The direct impact of the regime on mature and liquid contracts was limited and members did not generally report any prejudicial impact on their normal trading patterns. However, this is not the case for the LME’s nascent and illiquid contracts where the prescribed limits have been shown to introduce a potentially significant barrier to the growth and success of such contracts. In particular, these limits could be very detrimental to contracts below the deminimis threshold, or those which are liquid (i.e. have open interest above 10,000 lots) but which have only a limited number of active market participants. Ultimately this will adversely impact the growth and development of markets that are designed to enable users to hedge their physical risk confidently and with the benefits of central clearing. The LME therefore proposes a wholesale review of the application of the position limit regime to nascent and illiquid contracts. The LME suggests that the regime would not begin to apply until a deminimis threshold of open interest has been reached. This threshold would vary depending on the underlying commodity, the notional value of the contract and the size of the relevant market but would be set at such a level whereby the position limits would be relevant when positions could feasibly influence the price volatility of the underlying commodity.

<ESMA\_QUESTION\_PLPM\_10>

1. : In your view, how will EU commodity derivatives markets be impacted by the UK leaving the EU? What consequences do you expect from Brexit on the commodity derivatives regime under MiFID II?

<ESMA\_QUESTION\_PLPM\_11>

Following the UK’s withdrawal from the EU, the position limit regime under EU MiFID will no longer apply to contracts traded on the LME. However, market participants may nonetheless be impacted by domestic legislation in force in the UK in relation to their activity on the LME. Accordingly this could introduce a dual monitoring and reporting obligation for such firms.

<ESMA\_QUESTION\_PLPM\_11>

1. : Taking into consideration the intended purposes of position limits, do you consider that they deliver the same benefit across all commodity asset classes and across all types of commodity derivatives? Please explain.

<ESMA\_QUESTION\_PLPM\_12>

N/A

<ESMA\_QUESTION\_PLPM\_12>

1. : Would you see benefits in limiting the application of position limits to a more limited set of commodity derivatives? If so, to which ones and on which criteria?

<ESMA\_QUESTION\_PLPM\_13>

The position limit regime introduced under MiFID II encompasses a significantly broader range of commodity derivative contracts than comparable regimes introduced in alternative jurisdictions which were also established in order to fulfil the G20 commitments. Accordingly, it would be appropriate for the EU to review whether a regime that includes such a wide-range of commodity contracts remains appropriate or whether the underlying policy objectives could still be met if position limits were to apply to a more limited subset of contracts. For example, the LME supports industry proposals to limit the scope of the regime to key benchmark contracts or to those contracts considered “important, critical derivative contracts”. The CFTC in the US took the latter approach and it may be appropriate to align the two regimes in this way.

<ESMA\_QUESTION\_PLPM\_13>

1. : More specifically, are you facing any issue with the application of position limits to securitised derivatives? If so, please elaborate.

<ESMA\_QUESTION\_PLPM\_14>

N/A

<ESMA\_QUESTION\_PLPM\_14>

1. : Do you consider that there would be merits in reviewing the definition of EEOTC contracts? If so, please explain the changes you would suggest.

<ESMA\_QUESTION\_PLPM\_15>

The LME supports on-exchange trading of commodity derivatives and recognises the balance that was sought in crafting the definition of EEOTC contracts, to ensure that trading OTC could not be used in order to circumvent the requirements of the regime whilst allowing for netting of OTC contracts that were genuinely equivalent. The LME notes that very few contracts have been identified as fulfilling the EEOTC definition, however this is not demonstrative of a need to change the definition and the LME believes that it would introduce unnecessary confusion and potential disruption should the definition be reviewed at this stage.

<ESMA\_QUESTION\_PLPM\_15>

1. : In your view, would there be a need to review the MiFID II position limit exemptions? If so, please elaborate and explain which changes would be desirable.

<ESMA\_QUESTION\_PLPM\_16>

The LME has not been made aware of material concerns associated with the exemption regime. However, in order to ensure that this regime benefits those for which it was intended to be relied upon, it may be appropriate to extend the exemption to cover financial firms holding a position against a non-financial client firm, which is itself hedging its position for commercial purposes.

<ESMA\_QUESTION\_PLPM\_16>

1. : Would you see merits in the approach described above and the additional flexibility provided to CAs for setting the spot month limit in cash settled contracts? Please explain.

<ESMA\_QUESTION\_PLPM\_17>

The LME believes that CAs are able to exercise discretion in a way that ensures that specific requirements can be appropriately tailored to the needs of the relevant market. Accordingly the LME supports increased discretion for domestic CAs in setting the spot month limit in cash settled contracts.

<ESMA\_QUESTION\_PLPM\_17>

1. : Would you see benefits to review the approach for setting position limits for new and illiquid contracts? If so, what would you suggest?

<ESMA\_QUESTION\_PLPM\_18>

The LME strongly supports a review of the existing regime in place for new and illiquid contracts.

In the first instance the LME would support a wholesale review of the breadth of the position limit regime and supports industry calls for a reduction in its scope so that it covers only key benchmark contracts. This would automatically exclude new and illiquid contracts and reduce some of the unintended consequences we have set out in this submission.

However, should the current scope of the position limit regime be retained, then the prescribed limits for new and illiquid contracts should be revised away from their current levels which are set at such a level that they inhibit trading on new contracts and limit the potential growth of such contracts; in turn restricting market users’ ability to manage risk effectively. In particular, the default limits could be very detrimental to contracts below the deminimis threshold, or those which are liquid (i.e. trade above 10,000 lots) but which have only a limited number of active market participants.

The LME therefore proposes a suspension of any position limits up until trading has reached a predetermined deminimis threshold which would be based on the size of the underlying physical commodity market. This threshold would be calculated based on the open interest that would be required to be feasibly relevant to price volatility of the underlying commodity.

<ESMA\_QUESTION\_PLPM\_18>

1. : Would you see merits in a more forward-looking approach to the calculation of open interest used as a baseline for setting position limits? Please elaborate.

<ESMA\_QUESTION\_PLPM\_19>

A more forward looking approach would be more likely to give a more accurate view of the market and predict appropriate limits for the future prompt dates.

<ESMA\_QUESTION\_PLPM\_19>

1. : In your view, are there other specific areas where the methodology for calculating the position limits set out in RTS 21 should be reviewed? If so, what would you suggest, and why?

<ESMA\_QUESTION\_PLPM\_20>

N/A

<ESMA\_QUESTION\_PLPM\_20>

1. : How useful do you consider the information on position management controls available on ESMA’s website?

<ESMA\_QUESTION\_PLPM\_21>

This information is useful.

<ESMA\_QUESTION\_PLPM\_21>

1. : Do you consider that there is a need to review the list of minimum position management controls to be implemented by commodity derivatives trading venues under Article 57(8) of MiFID II? If so, please explain the changes you would suggest.

<ESMA\_QUESTION\_PLPM\_22>

The position management regime under MiFID II functions well and the LME does not believe that it requires revision.

<ESMA\_QUESTION\_PLPM\_22>