July 7, 2019

Subject: **ESMA70-156-1101 (Response to Call for Evidence on Position Limits in Commodity Derivatives)**

Author: **Iñaki Viggers San Mamés**

RESPONSE

This response advances the argument that position limits are justifiable only where an agent's solvency reveals his inability to maintain a position consistent with others' entitlements and foreseeable decisions pursuant to the terms of financial derivatives. This implies that (1) only *short* positions are amenable to a policy of position limits; and (2) the application of that policy shall be determined on a *case-by-case* basis entirely premised on the agent's solvency or liquidity.

Any implementation of position limits beyond the aforementioned criterion triggers the concern[1] best expressed by U.S. Commodity Futures Trading Commissioner Michael Dunn in the sense that "*at best position limits are a cure for a disease that does not exist, or at worst it's a placebo for one that does*".

Furthermore, imposing position limits tends to obfuscate the analysis and modeling required for a better understanding of the complexities in financial markets. That renders issues such as *price discovery* needlessly more difficult than in the absence of a generalized policy of position limits.

Altogether, position limits as currently devised by the EU authorities can only hinder the EU's status and leadership in the financial markets.

I. Position Limits Are Ineffective in Preventing or Addressing Market Abuse.

The ESMA indirectly concedes --in item 20 of the instant Call for Evidence-- that position limits are unavailing on the issue of preventing market abuse.

The ESMA conjectures that "*[p]osition limits may cap the financial gain a market participant could potentially make*" when incurring market abuse. But even that presumption is naive. For instance, a person who engages in insider trading can readily circumvent a position limits regime by coordinating with *straw buyers*. Whereas detecting concerted efforts to circumvent policy is costly and oftentimes futile, the potential distortions of price would be the same as in the absence of position limits.

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[1] US Commodity Futures Trading Comm'n, Transcript of Open Meeting on the Ninth Series of Proposed Rulemakings Under the Dodd-Frank Act, 9 (Jan. 13, 2011). Citation found on page 26 of "*From inception to today: the development of commodity position limits in the United States*", Deanna R. Reitmant and Sarah Nabors.
https://www.dlapiper.com/~/media/files/insights/publications/2019/01/mrs000119339-white-paper-on-cftc-position-limits---reitman-nabors---fin,-d-,,-d-,_.pdf

Furthermore, a position limits regime tends to impress on the rest of market participants the false and misleading notion of a *generalized sentiment* regarding the commodity at issue.

Indeed the scenario of (1) *one agent tending to a dominant position* conveys a different situation than the scenario of (2) *a multiplicity of [conspiring] agents simultaneously reaching the position limit*. Accordingly, each scenario leads external agents to reach opposite conclusions. The irony is that a position limits regime propitiates the latter scenario, the one which is more elusive and more misleading in regard to *generalized sentiment*.

II. A Position Limits Regime Hinders ***Orderly Pricing*** and ***Price Discovery***.

A multiplicity of agents pursuing one similar position --where each individual does so to the maximum extent allowed by such regime-- is much likelier to cause a *herd effect* than if everyone else identifies that only one entity seeks to attain a dominant position. To the rest of market participants it is irrelevant and unknowable whether there is a concerted effort among those agents to achieve that effect.

As mentioned above, the position limits regime will not dissuade insider trading. Instead, the regime will only prompt the insider trader to dissimulate his ulterior motive, thereby depriving external agents of an important clue with which to make sense of the course of commodity and/or derivative prices.

The Call for Evidence does not offer a rationale for the presumption that a position limits regime would enhance the "*rational relationship between consecutive prices*" or the "*accurate relationships between the price of a derivative and the underlying commodity and reasonable spreads between near and far dated contracts*" (item 24).

The matter of *consecutive prices* pertains more to properly scaling back a tick size regime than the attempt to prevent via position limits the formation of dominant positions.

In ESMA's prior consultation regarding tick size regime[2], the author of the instant response argued there[3] why the new tick size regime carries the effect of raising hedging costs. An understanding of consecutive prices --and therewith price discovery-- is impaired if policy imposes different tick sizes. That distortion can only be worsened by the introduction of additional constraints, now in the form of position

[2] https://www.esma.europa.eu/press-news/consultations/amendment-commission-delegated-regulation-eu-2017588-rts-11

[3] See Section III of the answer to Q2. https://www.esma.europa.eu/file/49145/download?token=a-CJCQ1Q

limits. Generally speaking, the introduction of constraints which are unnecessary and of limited value complicates the analysis, understanding, and modeling of financial markets.

As for the accuracy of relationships between reasonable spreads and the prices of the derivative and the underlying commodity, the Call for Evidence fails to explain how a hypothetical imbalance or inaccuracy would ensue. In fact, the principles of financial derivatives are clear in that an imbalance of that sort would be short lived because of the arbitrage opportunities that would ensue. This matter is immediate and more evident in the case of contracts approaching their expiration.

III. The Need for Position Management Controls Is Different from and Does Not Merit The Implementation of Position Limits.

The instant Call for Evidence conflates the matters of *position management controls* and *position limits*. Although the former contributes to preserving market health, it should not be conceived as a justification for generalizing position limits.

The importance of *position management controls* is the recurrent verification that a market participant maintains the ability to meet his potential *liabilities* pursuant to his position in unexpired contract(s). In the context of derivatives, only the parties holding *short* positions are at risk of insolvency, for the holders of long positions already disbursed whatever loss they might incur. Hence, the notion of position limits is outright pointless from the standpoint of liquidity and the solvency that *position management controls* intend to scrutinize and enforce.

Those controls tend to forestall both a spiral of losses (from the standpoint of each individual agent) and the contagion that would result when a cash-strapped participant defaults on his obligations pursuant to his contracts. However, this cornerstone ingredient of financial markets is unrelated to the essentially *one-size-fits-all* approach implied in the imposition of position limits.

CONCLUSION

One essential need in developed, competitive markets is the elimination of constraints which are of limited or questionable value. The author's opinion is that position limits are detrimental from the standpoints of financial modeling, compliance, and investor's decision-making.

The detriment from a position limits regime outweighs the alleged, blurry benefits that the policy maker may be tempted to attribute to it.