- Consultation Response -

Europex response to Commission consultation on the review of the MiFID II/MiFIR regulatory framework

Question 1. To what extent are you satisfied with your overall experience with the implementation of the MiFID II/MiFIR framework?

2 – Unsatisfied

Question 1.1 Please explain your answer to question 1 and specify in which areas would you consider the opportunity (or need) for improvements:

As already stated at earlier occasions, Europex fully supports the underlying policy objectives of MiFID II / MiFIR and the G-20 Pittsburgh commitments to "improve the functioning and transparency of financial and commodity markets and address excessive commodity price volatility". However, more than two years after the MiFID II / MiFIR framework started to apply, we believe that these objectives have not yet fully materialised as far as commodity derivatives markets are concerned, notwithstanding the heavy burden already imposed on the industry.

This concerns in particular the MiFID II position limits and position management regime as well as the MiFIR pre-trade transparency rules – both which we fully support in their spirit. However, we consider that their current calibration prevents any substantial increase in volumes traded on exchanges and cleared through CCP clearing houses, which would ensure a high level of security and transparency for these transactions.

We therefore consider it crucial that this review exercise is done with a view to ensure that the legislative framework becomes fit for purpose and supports the creation of an efficient high-quality ecosystem for energy commodity trading that fosters sustainable economic growth – notably in light of the new political, economic and climate reality.

Moreover, Europex would like to highlight that liquid, efficient, safe and transparent energy markets are an essential prerequisite for the successful fostering of the international role of the Euro and an increased global share of euro-denominated transactions in energy commodities. Energy markets traded in stable and reliable currencies, like the Euro, fulfil an important risk mitigation function and help limit costs for end-users as well as optimise overall socio-economic welfare. We therefore welcome the Commission's recognition of the

constraints posed by the (lack of flexibility of the) current position limit regime for commodity derivatives markets to allow Euro-denominated energy markets to emerge and grow.

With all this in mind – and in line with ESMA's proposal on this issue –, we suggest to refocus the position limit regime to better fit the legislative objectives and to address the unintended negative consequences we are currently experiencing. This can be best achieved by narrowing the scope of the regime to a more limited set of mature (critical) benchmark contracts relevant for the price formation in the underlying commodity.

Such a refocus of the position limit regime would make it more efficient, mitigate the unintended consequences and reduce the compliance burden for all concerned parties. Most importantly, in combination with an explicit hedging exemption for financial counterparties, such a targeted approach would allow new and nascent products to emerge and develop in line with the policy objective of the Directive as expressed in its implementing RTS 21: "Position limits should not create barriers to the development of new commodity derivatives and should not prevent less liquid sections of the commodity derivatives markets from working adequately". In light of the existing inflexible treatment of new, illiquid as well as liquid contracts, we appreciate ESMA's acknowledgement of the significant length of this review process and therefore support and call for urgent amendments to RTS 21 which we deem highly necessary to mitigate the existing negative impact of the current regime.

Importantly, while the scope of the position limit regime would indeed be reduced, all commodity derivative contracts would remain subject to the position reporting regime under Article 58 of MiFID II. In addition, these contracts will still be subject to position monitoring and position management measures by exchanges as well as well-established oversight practices by the exchanges' market supervision and market surveillance departments in accordance with the principles set out in the Market Abuse Regulation (MAR) and the Regulation on Wholesale Energy Market Integrity and Transparency (REMIT).

Further, it is important to ensure a level playing field for competing liquid commodity derivative contracts with the same physical underlying and the same characteristics. While not currently the case, the other months limit of the venue with the highest open interest should be applied identically to all competing liquid commodity derivative contracts. This is an efficient mechanism to ensure a level playing field between trading venues and there should be an urgent amendment to RTS 21 to implement this accordingly. In addition, in a future reviewed regime, the same rule should apply in case there are two or more competing critical contracts at different exchanges.

Finally, it is important to recognise that energy markets have specific characteristics and often suffer from a one-size fits all regulatory approach across all classes of financial instruments. MiFIR rightly recognises that certain exemptions can be granted to trading venues from the general requirement to publish pre-trade transparency data in order to preserve orderly price discovery processes and to allow, in particular, new and illiquid contracts to emerge and develop. However, as currently tailored, the pre-trade transparency regime at times limits pre-arranged trades in developing contracts from being submitted to exchanges for central clearing, thereby constraining the ability of market participants to hedge their commercial risk exposures on exchanges. Hence, we recommend a review of the currently ill-calibrated

waiver thresholds methodology in RTS 2. The aim of such an amended methodology should be to allow for pre-arranged trades in new and illiquid contracts to be brought to an exchange and subsequently familiarise commodity traders with the beneficial features of increased transparency and secure on-venue trading.

Question 69. Please specify to what extent you agree with the statements below regarding the experience with the implementation of the position limit framework and pre-trade transparency?

	1 disagree	2 rather not agree	3 neutral	4 rather agree	5 fully agree	N.A.
The EU intervention been successful in achieving or progressing towards improving the functioning and transparency of commodity markets and address excessive commodity price volatility.	x					
The MiFID II/MiFIR costs and benefits with regard to commodity markets are balanced (in particular regarding the regulatory burden).		x				
The different components of the framework operate well together to achieve the improvement of the functioning and transparency of commodity markets and address excessive commodity price volatility.	x					
The improvement of the functioning and transparency of commodity markets and address excessive commodity price volatility correspond with the needs and problems in EU financial markets.	x					
The position limit framework and pre- trade transparency regime for commodity markets has provided EU added value.		x				

Question 69.1 Please provide both quantitative and qualitative elements to explain your answer and provide to the extent possible an estimation of the benefits and costs. Where possible, please provide figures broken down by categories such as IT, organisational arrangements, HR etc.

Quantitative elements for question 69.1:

	Estimate (in €)
Benefits	
Costs	Both the one-off implementation and the annual maintenance costs are estimated at a 1-digit million EUR figure each. This includes internal and external resources in terms of IT projects, technical requirements, compliance, reporting and surveillance costs. This assessment relates to one exemplary exchange. The total costs for the industry should thus be multiplied by the number of actors as this has to be done individually and there is very little to no synergy in implementing the requirements. Furthermore, this exchange-based assessment does not include the implementation costs for market participants, which in total is likely to be an even higher number than for exchanges due to the substantially higher number of actors. Most importantly, however, this cost assessment does not include the costs of the slowed-down growth of commodity derivatives markets in Europe because of the hampering effects of MiFID II / MiFIR. This is estimated to be by far the biggest cost of the regime, though it is difficult, if not impossible, to quantify exactly. [Please refer to our response to Q69.1 below for a more extensive qualitative explanation.] As stated above, an exact cost assessment is very difficult to realise. However, when taking the direct costs into account, the overall cost of the two regimes should be assumed between 50 million to 100 million EUR and when also looking at the indirect costs, a loss of 250 million to 500 EUR seems most realistic.

Qualitative elements for question 69.1:

Europex agrees with the overall objectives of MiFID II / MiFIR to “improve the functioning and transparency of commodity markets and address excessive commodity price volatility”. However, we believe that these objectives have not fully materialised with the implementation of the position limit and pre-trade transparency regimes. In fact, we consider that the MiFID II position limit regime has impaired the development of commodity markets in Europe without providing tangible benefits.

The establishment of and compliance with MiFID II / MiFIR, has proven to be a burdensome and costly process. This is particularly true for the implementation of the extensive reporting and transparency requirements. In addition, and contrary to the general intention of EU financial services policy to bring more trading onto regulated markets to increase safety,

efficiency and transparency, the regimes have slowed down the growth of European energy derivatives markets.

Commodity derivatives are by nature global products that are traded in a highly competitive environment. The introduction of the position limit regime has thereby negatively impacted the EU's competitive position compared to other jurisdictions.

In the following, we distinguish between (1) costs based on a slowed-down increase in trading activity in energy commodity derivatives inside the Union and (2) a more comprehensive approach, whereby costs are estimated based on extrapolation, including the potential development of a benchmark contract in the EU, its wider economic purpose and benefits to the real economy.

In the first category of indirect economic impact, we would like to highlight three main areas where the position limit regime has had clear negative consequences in terms of a slowed-down increase in trading activity in energy commodity derivatives in Europe.

Firstly, the position limit regime had a twofold material negative effect on a) exchange-traded new and illiquid contracts and b) the ability of exchanges to develop new benchmark contracts in the EU. While the position limit regime has worked well for mature benchmark contracts, it has introduced adverse effects on the development of new, illiquid and liquid non-benchmark contracts.

In addition, as far as liquid competing contracts are concerned, Europex believes that the regime may contribute to pushing liquidity to the exchange with the highest open interest, if materially different position limits apply to contracts with the same physical underlying and same characteristics listed by competing exchanges. This has a negative effect on the level playing field between trading venues.

Secondly, the position limit regime results in significant costs in terms of lost opportunity when exchanges decided to launch contracts in other jurisdictions, which may otherwise be offered for trading inside the EU. Large exchange groups can launch new contracts in varying locations depending on, amongst other factors, a favourable regulatory environment for commodity trading.

Thirdly, to remain competitive, a substantial number of commodity derivative contracts have been transferred to other jurisdictions due to the restrictive nature of the MiFID II position limit regime.

In the second category of costs, relating to the negative impact of the position limit regime on the business climate in Europe, the regime has significantly reduced the chances that additional benchmark commodity derivative contracts develop inside the EU. The subsequent costs are far greater than merely the absence of the associated trading activity. The unavailability of such a benchmark commodity derivative contract and the lack of liquidity also affect the real economy, including the limitations to effective risk management and increased costs for energy trading due to wider bid-ask spreads.

Against this background, Europex sees clear merits in limiting the application of the regime to a more restricted set of important critical “benchmark” commodity contracts. Due to overly restrictive (de minimis) limits and a lack of flexibility in the current regime, market participants have been discouraged from on-venue trading which negatively impacts the orderly pricing of contracts as well as the general transparency in the market. We believe that a reduction of the regime’s scope to mature, critical contracts together with an extended hedging exemption will solve these concerns. A simplified and more targeted regime would be easier to implement and enforce and would ultimately help to achieve the initial policy objective.

Additionally, we believe a more tailor-made pre-trade transparency regime would foster liquidity and competitiveness in European commodity markets. Therefore, it is important to understand that commodity markets have specific characteristics and conseuqently often suffer from a one-size fits all regulatory approach across all financial instruments. As currently tailored, the regime limits pre-arranged nascent contracts from being submitted to exchanges for central clearing, constraining the ability of market participants to hedge their commercial exposures on exchanges.

Our responses to Q70 on the position limit regime and to Q76 on the pre-trade transparency regime, together with our separate responses to ESMA’s complementary consultations provide additional examples on the current functioning and shortcomings of the two regimes.

In this context, we explicitly welcome the European Commission’s recognition of the role of European commodity markets in strengthening the role of the Euro and Euro-denominated products. More proportionate and efficient position limit and pre-trade transparency regimes would significantly contribute to the competitiveness of globally-connected European energy markets.

1. Position limits for new and illiquid commodity markets

The lack of flexibility of the position limit framework for commodity hedging contracts (notably for new contracts covering natural gas and oil) is a constraint on the emergence of euro-denominated commodity markets that allow hedging the increasing risk resulting from climate change. The current de minimis threshold of 2,500 lots for those contracts with a total combined open interest not exceeding 10,000 lots, is seen as too restrictive especially when the open interest in such contracts approaches the threshold of 10,000 lots.

Question 70. Can you provide examples of the materiality of the above mentioned problem?

Yes, I can provide 1 or more example(s)

Please provide example(s) of (nascent) contracts where the position limit regime has constrained the growth of the contract:

Underlying cause of the constraint (A/B/C)*:

*Note: 1 The underlying cause of the constraint is due to (A) the position limit becoming too restrictive as open interest increases, (B) an incorrect categorisation under the position limits framework or (C) the underlying physical markets are not efficiently reflected.

The position limit regime in its current form has a substantial impact on the development of new and nascent products as well as on the further growth of existing commodity derivatives markets. We observed a clear stagnation in markets which we believe would have developed into more liquid markets otherwise. We largely agree with the three underlying causes of constraints as indicated in this question: a) the de minimis rule of 2,500 lots becomes too restrictive when a contract comes close to 10,000 lots of open interest (OI); b) an incorrect categorisation caused by a slow pace by which a contract is considered liquid and hence receives a bespoke limit, or a flawed liquidity assessment following lot sizes that do not reflect market realities; and c) the lack of flexibility for NCAs to deal with special circumstances occurring in the underlying markets. To avoid that excessive speculation affects prices in an adverse manner, it is sufficient to only consider those contracts that are relevant for the price formation in the underlying commodity. In other words, this concerns mature contracts which serve as a benchmark for the respective commodity market.

Finally, we would like to highlight that the hedging exemption is currently only available to non-financial entities, even though financial entities engage in genuine hedging activities on behalf of their clients. This rule damages further growth of commodity derivatives markets and should therefore be revised.

[Please refer to our complementary responses to ESMA's call for evidence and ESMA's consultation paper on the MiFID II review report on position limits and position management for more details.]

Increasingly restrictive standardised limit - A

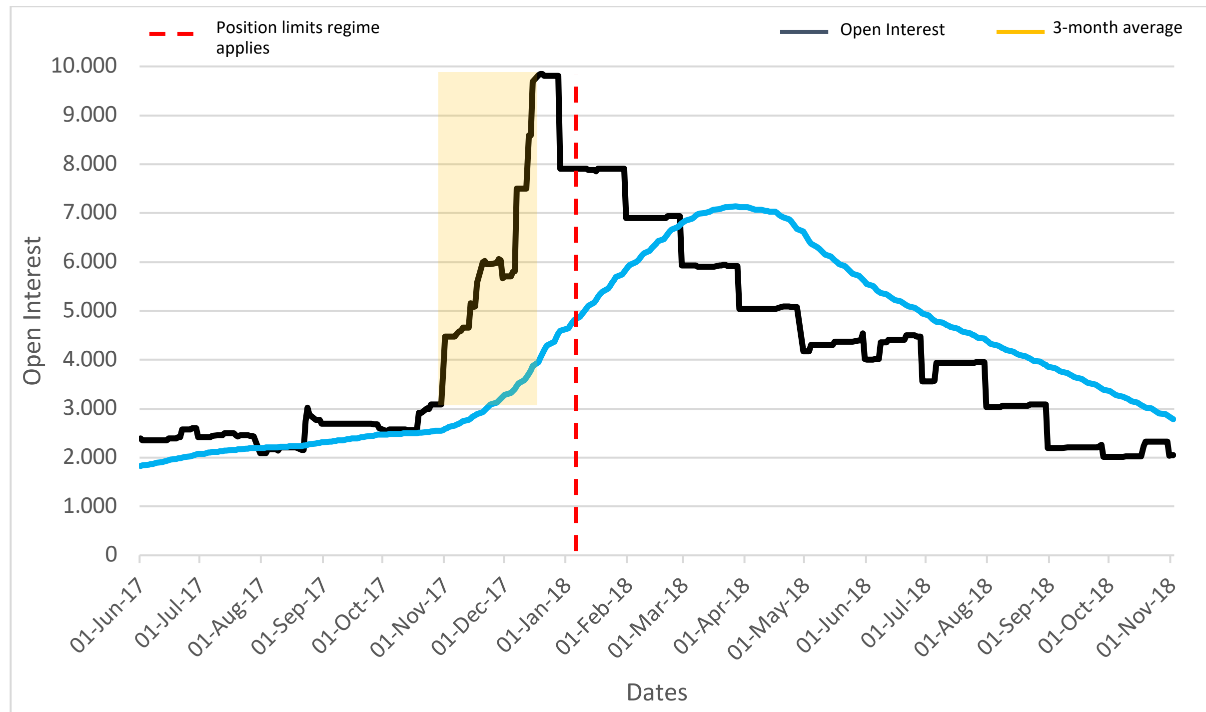
Contracts classed as 'illiquid' under the current position limit framework receive a standardised limit of 2,500 lots and thereby are effectively given a highly restrictive limit (resembling a baseline limit of 25 percent of open interest) when open interest increases to close to 10,000 lots.

And while in theory in line with ESMA's Q&A on 'commodity derivative topics', National Competent Authorities (NCAs) can use different derogations for illiquid markets which have an open interest between 5,000 and 10,000 lots. These remain difficult to apply in practice and are often not sufficient to mitigate the negative impact of disproportionately low position limits in fast growing markets.

Once the limit is reached, participants withdraw from the market, often switching to another trading venue outside of the MiFID II / MiFIR regime, thereby leaving the competent authority

no time to adjust the limit upwards. As an example, this effect has impaired the development of the Euro-denominated Italian Punto di Scambio Virtuale (PSV) Gas Futures contract offered for trading on ICE Endex.

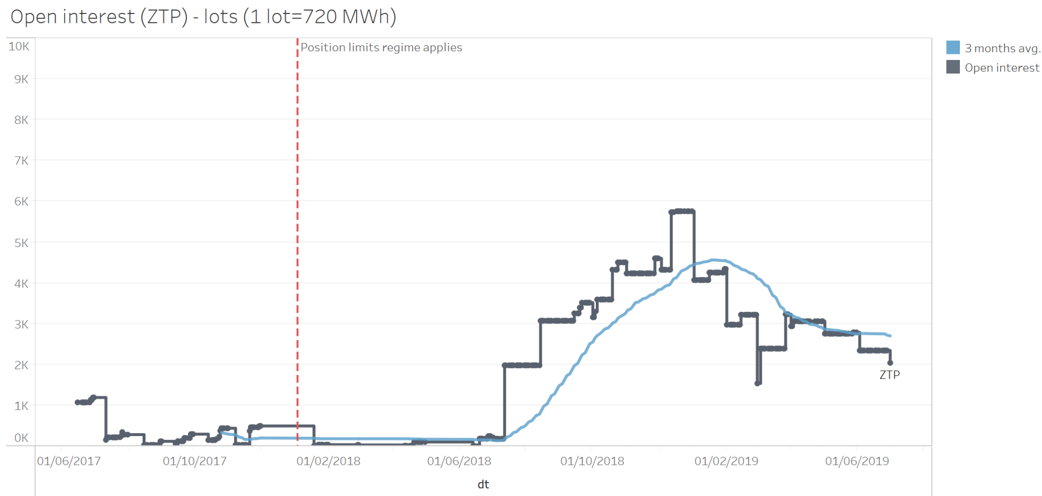
Figure 1 – Position limit regime hindering growth in ICE Endex Italian PSV Gas Futures



Source: ICE Endex

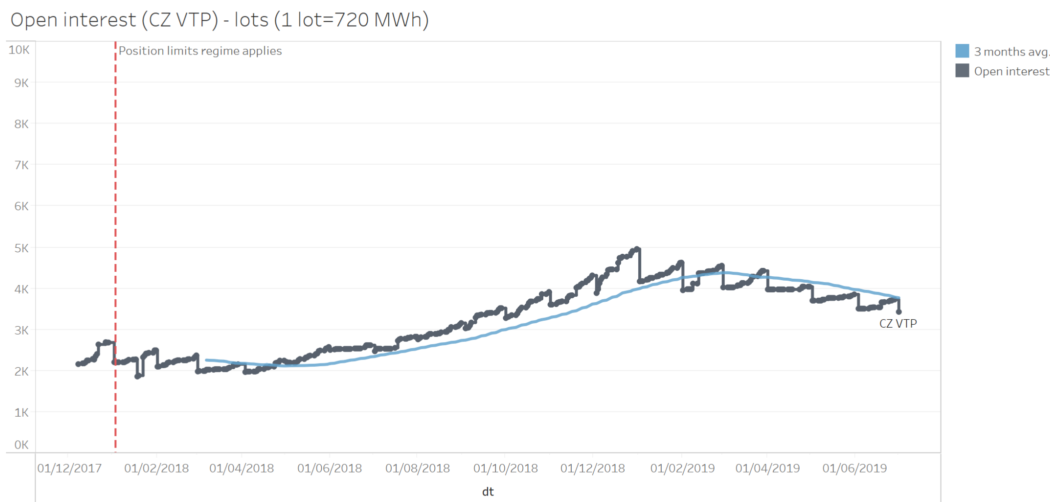
Two other examples, from EEX Group, illustrate the negative impact of the 2,500 lots limit in combination with the lack of a hedging exemption for financial counterparties. Both, the EEX Zeebrugge Trading Point (ZTP) and the Czech Virtual Trading Point (CZ VTP) Gas Futures, took off in the course of 2018, but then declined when the 2,500 lots limit became too restrictive. With only ten to twelve market participants registered to trade and only one or two very active market participants being responsible for most of the volumes - a perfectly normal situation for a new contract -, the position limit put a clear halt to the further development of the contract. While some participants are eligible for the hedging exemption, other important participants are investment firms and cannot benefit from this exemption, meaning that they have no other option than to stop trading and look for other contract alternatives.

Figure 2 - Position limit regime hindering growth in EEX ZTP Gas Futures



Source: EEX

Figure 3 - Position limit regime hindering growth in EEX Czech VTP Gas Futures



Source: EEX

Another important challenge is the level playing field between a benchmark contract and competing liquid contracts with the same physical underlying and same characteristics traded at different exchanges. Growing liquidity in these competing non-benchmark contracts has proven difficult and is often due to much higher position limits set in "other months" for the benchmark contracts than for the second or third most liquid contracts at competing exchanges. When position limits are materially different, there is a risk that traders and market makers will seek to trade on the most liquid market only; in other words, where they have a lower risk of breaching the position limit. This may clearly prevent the development of liquidity at smaller venues and also reduces the options available to market participants to manage their risks at other exchanges than the exchange on which the benchmark contract

is traded. This is the case, for instance, of the German power contract listed by Nasdaq which competes with the substantially more liquid EEX contract.

Further, it is important to still ensure a level playing field under the reviewed critical contract regime for competing contracts with the same physical underlying and the same characteristics. Whenever two or more contracts are deemed 'critical', the other months limit of the venue with the highest open interest should be applied identically to all competing critical contracts.

Inflexible categorisation of markets and recalibration of position limits - B

In order to provide for a workable regime for growth markets, NCAs need to be able to process near instant updates of the categorisation of markets and readjust the applicable limits as open interests in a market increases. This is especially true for markets that experience strong increases in open interest in a short period of time. Markets with initially relatively low levels of open interest can develop into liquid markets in a matter of weeks or months. In order for a limit not to impede the development of fast growing markets it is important to recognise that:

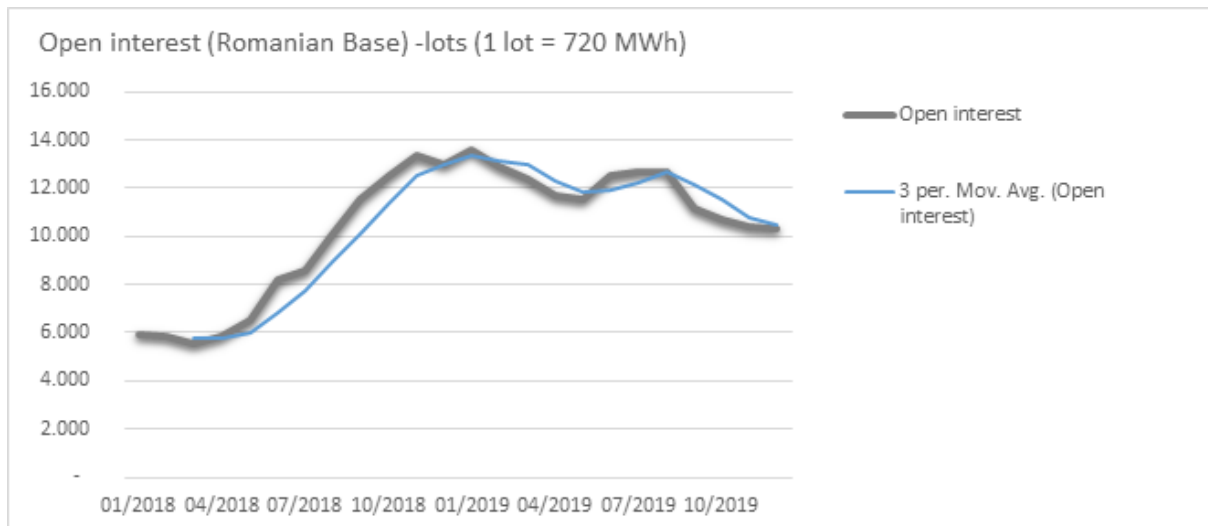
a) The growth of open interest requires a timely reclassification of a market under the position limit regime (e.g. from 'illiquid' to 'less liquid') in order to allow the position limit to be adjusted to a more appropriate level, before it becomes unnecessarily restrictive.

b) The calculation of open interest in a market for the purpose of setting a position limit needs to adequately capture the period of growth of open interest. It is therefore essential that an appropriate methodology for calculating open interest is used. Applying a randomly selected period with an inappropriate duration could lead to inapt results and relatively frequent requests to amend the newly established limit as it could be reached with only a few transactions in a fast growing market.

In practice it has proven impossible for NCAs to reclassify markets and recalibrate the applicable limits in a manner that would prevent a negative impact on the development of fast growing markets. Indeed, the underlying causes of Constraints A and B are strongly correlated and exacerbate the problems experienced with the position limit regime in its current form.

By way of example: for some power contracts that became liquid after MiFID II started to be applied, the time between the contracts exceeding 10,000 lots of open interest during three consecutive months and the contracts receiving a bespoke limit amounted to two to three months on average. This reflects the lack of flexibility in the rules for NCAs and the definition of a liquid contract. It also highlights the slow pace in which the bespoke limits are set and hurts new and nascent markets. Figure 4 (Annex I) showcases the example of the EEX Romanian Base Power contract which became liquid in June 2019 but has yet to receive a bespoke limit.

Figure 4 - Impact of slow pace with which the EEX Romanian Power Base contract is being reclassified from illiquid to liquid



Source: EEX

Question 71. Please indicate the scope you consider most appropriate for the position limit regime:

	Most appropriate	Neutral	Least appropriate
Current scope			x
A designated list of 'critical' contracts similar to the US regime	x		
Other			

Question 71.1 Please explain your answer to question 71:

Europex believes that to effectively overcome the negative impact of the current regime on new, illiquid and liquid commodity derivatives a more fundamental review, i.e. a Level 1 change, is needed. We consider that to solve the issues we have outlined in our responses to this consultation as well as to ESMA's call for evidence and ESMA's consultation paper on the MiFID II review report on position limits and position management, we need to move towards a more proportionate and efficient position limit regime. This can be achieved by refocusing on a more limited set of important, critical commodity derivative contracts.

Ultimately, this will allow the regulatory framework to meet the intended policy objectives and meet the overall aim of MiFID II to "improve the functioning and transparency of commodity markets and address excessive commodity price volatility".

First, we have extensively demonstrated in our response to the ESMA call for evidence and the subsequent ESMA consultation that the MiFID II position limit regime neither contributed to the prevention of market abuse nor to the improvement of orderly pricing and settlement. However, to avoid that excessive speculation adversely affects commodity prices, it is sufficient to consider only those contracts that are relevant for the price formation in the underlying commodity. This means mature and indeed critical contracts which serve as a price benchmark for the respective market. The same approach is also taken in the US position limit regime. This view is similarly shared by ESMA which, in its recent MiFID II review report on position limits and position management, acknowledges that "the scope of position limits should be limited to commodity derivatives where position limits can play of 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."

Second, while the scope of the position limit regime would indeed be reduced, all commodity derivative contracts would still remain subject to the position reporting regime under Article 58 of MiFID II. In addition, these contracts will still be subject to position monitoring and position management measures by exchanges and well-established oversight practices by the exchanges' market supervision and market surveillance departments in accordance with the principles set out in the Market Abuse Regulation (MAR) and the Regulation on Wholesale Energy Market Integrity and Transparency (REMIT).

Third, new and illiquid products constitute a minor share of commodity markets. Such contracts are unlikely to influence price movements in the underlying physical commodity markets. 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 onto regulated venues would contribute to a more transparent and safer trading environment.

Fourth, we support ESMA's proposal for a more pragmatic approach towards competing contracts on different venues. In combination with a reduced scope of the position limit regime, this will prevent potential competitive disadvantages between EU exchanges. Indeed, the definition of "same contract" does not reflect the commodity derivatives markets' reality. Instead, the open interest figure which serves as a basis for setting the other months' limit should be provided by the trading venue with the higest average open interest over a certain period, i.e. one year. The position limit of the most liquid commodity derivative contract should be applied identically to competing contracts that are deemed liquid and have the same physical underlying. Such an approach would prevent any discrimination of the MiFID II position limit regime towards trading venues with lower open interest in a competing contract.

Fifth, while we explicitly support the move to a more focused position limit regime, we are aware of the time horizon of the necessary legislative amendments to achieve this. Given that the position limit regime in its current form continues to have a negative impact on new, illiquid and liquid contracts, we strongly support ESMA in its recommendation of a two-tier approach whereby Level 2, notably Article 15(2), is amended immediately, while the more fundamental reform is dealt with as part of the Level 1 review.

For this short-term relief, we would like to highlight two important technical aspects on which we have made proposals before:

a) To facilitate the growth of fast-moving contracts of both illiquid and liquid contracts, we would like to recall our support for the introduction of a forward-looking model in which the position limit is calculated based on an extrapolation of the market's historical development of open interest in the case of other months' contracts and deliverable supply in the case of spot month contracts. This approach would be particularly well suited to accommodate for periods of strong market growth and should not only apply to setting the limits but also to classifying contracts as liquid or not.

b) In case of competing liquid contracts with the same physical underlying at different exchanges, the open interest of the most liquid market should serve as the basis for setting the other months' limit for all concerned exchanges. This will prevent position limit based competition between trading venues and will provide adequate choice to market participants.

Question 72. If you believe there is a need to change the scope along a designated list of 'critical' contracts similar to the US regime, please specify which of the following criteria could be used.

Open interest

Threshold for open interest:

Europex recommends that a contract should have at least 300,000 lots of open interest on average over one year to qualify as 'critical'.

Number of affected contracts in the EU for open interest:

Based on 2019 (pre-Brexit) figures, more than twenty commodity derivative contracts (electricity, oil and natural gas) were affected. Please note that this does not take into account metals and agricultural contracts.

Please explain why you consider that the open interest is a criterion that could be used:

Exchanges use various criteria to assess the liquidity of a market. They include, inter alia, open interest, share of open interest versus deliverable supply, number of active trading participants, churn ratio (for physically settled contracts), share of screen execution and average trading horizon. However, based on internal assessments, Europex has come to the conclusion that these parameters are highly correlated and therefore open interest is

sufficient to determine whether a contract qualifies as a 'critical' or not. Hence, it would be redundant to set additional parameters. We would nevertheless not oppose adding "underlying asset" as an additional factor.

Europex considers a commodity derivative contract to be 'critical' once it has developed into a highly liquid instrument with open interest levels that imply that all the various more detailed liquidity criteria have been met. Furthermore, the price signal of a critical contract should be broadly recognised in the wider market as a relevant benchmark price for its underlying commodity.

Based on the criteria that exchanges use to determine which markets should be considered mature and developed, Europex recommends that a contract should have at least 300,000 lots of open interest on average over one year to qualify as 'critical'. Most importantly, we believe this focused approach would stimulate the development of European benchmark contracts.

This approach would produce an outcome broadly comparable with the US regime for position limits, whereby we expect more than 20 commodity derivative contracts offered for trading in Europe to be classed as critical (see table below). Please note that Europex has merely provided examples of energy derivative contracts above the thresholds for critical contracts. Metals and agricultural contracts have not been taken into account and should add a considerable amount of additional critical contracts.

Trading venue offering the product	Type	Product name
EEX AG	Electricity	Phelix DE-Futures
EEX AG	Electricity	Italian Base
Nasdaq Oslo ASA	Electricity	Nordic Power
ICE Futures Europe	Oil	Brent Crude Futures
ICE Futures Europe	Oil	WTI Crude Futures
ICE Futures Europe	Oil	Low Sulphur Gasoil Futures
ICE Futures Europe	Oil	Crude Diff - Dated Brent vs Brent 1st Line Future
ICE Futures Europe	Oil	Brent 1st Line Future
ICE Futures Europe	Natural Gas	UK Natural Gas Futures
ICE Endex	Natural Gas	TTF Gas Futures
EEX AG	Natural Gas	EEX Regulated Market Futures TTF

Please explain why you consider that the type and variety of participants is a criterion that could be used:

In relation to the 'type and variety of market participants', we consider this indicator to normally be highly correlated with open interest. In the interest of transparency and simplicity of the regime, we therefore recommend that this not made a separate criterion.

However, if the Commission wishes to take the type and variety of market participants into account, we recommend that, in addition to meeting the threshold for open interest, there would be at least 50 actively trading market participants in a contract on average over a one year period for such a contract to be considered 'critical'. This number of market participants is also a factor to be considered by NCAs when setting position limits under the implementing legislation of Article 57 of MiFID II. To qualify as critical a contract would have to meet both the thresholds for open interest and actively trading participants.

Question 72.1 Please explain your answer to question 72:

As specified above, open interest is the most important indicator for exchanges to determine whether an instrument is highly liquid and mature. When assessed against market reality, it shows the potential of an instrument to serve as a benchmark contract for the underlying commodity. Therefore, assessing contracts against open interest would give an appropriate indication of which contracts are mature enough to serve as mature benchmark products, and would allow the development of more European critical contracts over time.

ESMA rightly points out in its review report that, in a post-Brexit environment, a more limited amount of benchmark commodity derivative contracts will reside inside the European Union. However, we would like to urge the Commission and the co-legislators to refrain from artificially classifying contracts as critical. This would hinder the development of genuinely non-critical energy derivative contracts in the European Union and thereby, at best, maintain the status quo. Rather than designing thresholds to cover a wider range of contracts, European policy-makers should ensure that the EU financial services legislation is proportionate and effective, so that exchanges are able to develop new commodity derivative contracts inside the European Union and can compete on a global basis. A reduced scope to genuine 'critical' mature contracts, identified by using 300,000 lots open interest as a reference minimum threshold, would allow Euro-denominated commodity derivative contracts to develop into European and global benchmark contracts.

In case the Commission may wish to take more criteria into account, this needs to follow the strict logic of the overarching purpose for the review, i.e. refocusing the scope of the position limit regime to critical contracts only and to allow euro-denominated energy derivatives to develop into global benchmark contracts. For this purpose, we believe taking a two-tier approach would be most appropriate. The open interest figure, on average, over one year should thereby serve as a strict minimum threshold to qualify contracts for the regime. This gives NCAs and ESMA the opportunity to, in a second step, assess the 'critical nature' of these highly liquid contracts and set bespoke limits based on a deeper market understanding. This

was previously impossible due to the enormous number of contracts for which limits needed to be defined. Such an approach ensures that only mature products that are able to function well under the position limit regime receive an appropriate limit and 'critical' status, while nascent contracts are given the opportunity to further develop.

This second determination step should take into account whether the price signal of a 'critical' contract is broadly recognised in the wider market as a relevant benchmark price for its underlying commodity. Thereby, it is particularly important to consider the existence of non-EU derivatives markets with the same underlying commodity. If a market has developed elsewhere for the same underlying commodity, there is a risk that the non-EU market attracts the liquidity of the EU-based market.

We explicitly welcome ESMA's recommendation in the Review Report on position limits and position management that further work and consultation will need to be undertaken. This will allow for more timely adjustments as required by market developments. In order to achieve this, it is of utmost importance that ESMA consults all relevant actors in the identified commodities' value chain.

ESMA has questioned stakeholders on the actual impact of position management controls. Stakeholder views expressed in the ESMA consultation appear diverse, if not diverging. This may reflect significant dissimilarities in the way position management systems are understood and executed by trading venues. This suggests that further clarification on the roles and responsibilities of trading venues is needed.

Question 73. Do you agree that there is a need to foster convergence in how position management controls are implemented?

2 - Rather not agree

Question 73.1 Please explain your answer to question 73:

Europex supports the current regime where trading venues have a substantial responsibility for position monitoring and control.

Some trading venues have operated sophisticated position management regimes already before MiFID II. These regimes generally include:

1. Accountability levels above which members are required to report certain information to the exchange (e.g. their positions in a specific contract and the beneficiaries thereof);
2. Position, expiry and delivery limits indicating the maximum positions that can be held by members in a specific contract at a given time;
3. Exchange rules providing powers to the exchange to:
   - Request information from members as to the purpose of the positions they hold in a specific contract;

- Order members to decrease their position;
- Discipline members that do not comply with the above.

Furthermore, these regimes would be operated by compliance teams with sufficient staff and technologically advanced tools to monitor, on a daily basis, the open interest in contracts admitted to trading, the positions held in those contracts by exchange members and the activity in physical markets underlying the commodity derivatives admitted to trading.

For example, the compliance team monitoring positions in a crude oil contract may compare these positions with the activity in the underlying physical market and the direction of travel of oil barges in the relevant geographical area. If these movements are not coherent with positions held or if the positions are considered excessive given the activity in the underlying market, the compliance team may decide to open an inquiry with regard to the entered positions and take further action if the response is not satisfactory.

These 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 and underlying markets of contracts it admits to trading. There is no 'one size fits all' position management regime.
Against this backdrop, the majority of Europex members do not believe that the design of position management regimes should be codified in Level 2 technical standards.

Question 74. For which contracts would you consider a position limit exemption for a financial counterparty under mandatory liquidity provision obligations?

This exemption would mirror the exclusion of the related transactions from the ancillary activity test.

	Yes	No	N.A.
Nascent	x		
Illiquid	x		
Other			

Question 74.1 Please explain your answer to question 74:

Europex fully supports a position limit exemption for financial counterparties under mandatory liquidity provision obligations, similar to the one outlined in Article 2(4) of MiFID II. However, such an exemption should not be limited to financial counterparties only. Very often, if not in most cases, non-financial counterparties fulfil mandatory liquidity obligations. For this case, too, a position limit exemption should be granted. However, we would like to reiterate that reducing the regime's scope to critical contracts receives our highest priority and would solve the problems posed by the position limit regime in the most efficient manner.

This is particularly necessary for new contracts that need financial or non-financial entities to incentivise trading in the contract, at least if the position limit regime continues to include the restrictive 2,500 lots limit on new and illiquid contracts. If no such exemption is available and the 2,500 lots limit continues to apply, exchanges have to contract a 'panel' of liquidity providers to ensure that none of these firms exceed the 2,500 lots limit. In nascent markets it is highly possible that there may not be the required number of counterparties to build such a 'panel' and even where this is the case, it adds significant costs for the exchange.

In order to avoid such a situation, Europex recommends that the position limit regime includes an explicit exemption based on the same conditions as the liquidity provision exemption outlined in Article 2(4) of MiFID II and the ESMA Q&A on MiFID II / MiFIR commodity derivative topics. This exemption should be implemented similarly to the hedging exemption under the position limit regime.

Question 75. For which counterparty do you consider a hedging exemption appropriate in relation to positions which are objectively measurable as reducing risks?

	Yes	No	NA
A financial counterparty belonging to a predominantly commercial group that hedges positions held by a non-financial entity belonging to the same group	x		
A financial counterparty	x		
Other			

Please specify for other which counterparties you consider a hedging exemption appropriate:

Europex fully supports the introduction of a hedging exemption for financial counterparties. At the same time, we disagree that the exemption should only cover financial counterparties that are part of a 'real-economy' conglomerate.

Europex does not agree with ESMA's view that the compliance monitoring of such exemptions by regulators would not be possible or efficient. In fact, exchanges have been operating internal position management systems allowing for exemptions from limits of positions held for genuine hedging purposes by market participants, regardless of their regulatory status and nature of their business. We believe that a similar system, inclusive of all financial counterparties, could be operated by financial regulators across the EU.

Question 75.1 Please explain your answer to question 75:

Europex fully supports the introduction of a hedging exemption for financial counterparties.

At the same time, Europex disagrees with ESMA's view that the compliance monitoring of such exemptions by regulators would not be possible or efficient. In fact, exchanges have been operating internal position management systems allowing for exemptions from limits of positions held for genuine hedging purposes by market participants, regardless of their regulatory status or nature of business. We believe that a similar system, inclusive for financial counterparties, could be operated by financial regulators across the EU, all the more given the amount of information NCAs receive about the activities of such entities.

Question 76. Do you consider that pre-trade transparency for commodity derivatives functions well?

2 - Rather not agree

If you do not consider that pre-trade transparency for commodity derivatives functions well, please (1) provide examples of markets where the pre-trade transparency regime has constrained the offering of niche instruments or the development of new and/or fast moving markets, and (2) present possible solutions including, where possible, quantitative elements:

Europex fully agrees with the objectives of MiFID II / MiFIR and the G20 Pittsburgh commitments to "improve the functioning and transparency of financial and commodity markets and address excessive commodity price volatility". We therefore support the aim and implementation of the pre-trade transparency regime. However, we consider that their current calibration prevents any substantial increase in volumes traded on exchanges and cleared through CCP clearing houses, which would ensure a high level of security and transparency for these transactions.

Energy commodity derivatives in particular are negatively impacted by the inappropriately designed regime. Many relatively illiquid energy commodity products, in their development phase, offered by various energy exchanges have been wrongly classified as liquid and made subject to excessive Large In Scale (LIS) thresholds.

These include products such as ICE Endex TTF Options which have the potential to become euro-denominated benchmarks. Furthermore, over a hundred oil products traded on ICE Futures Europe have been wrongly classified due to insufficiently granular segmentation criteria.

Europex therefore recommends that both Level 1 and Level 2 provisions are revised:

Level 1

First, we recommend that the hedging exemption available in Article 8(1) of MiFIR is extended to cover all market participants managing risks arising from activity in the physical market,

including financial counterparties. Such a solution would allow exchanges to build liquidity in the order book and to continue without jeopardising the ability of commodity derivatives markets to fulfil their function.

Level 2

Secondly, such a change should be combined with amendments in RTS 2 which would remove the current factors leading to inappropriate thresholds. We are of the view that the methodology should be amended in line with the following recommendations:

1) Deletion of the price factor from the calculation of IL and LIS thresholds

The inclusion of price in the calculation of LIS and IL threshold values can lead to misinterpretations and, indeed, confusion when measuring liquidity in instruments that are not natively defined in notional value. A

This can result in situations like the following:

a) Price movements occurring in the same direction as changes in liquidity exaggerate the liquidity changes;
b) Price movements which occur in the opposite direction mute the change in liquidity; and
c) Price movements without a change in liquidity make liquidity appear more volatile than it actually is.

Liquidity should therefore not be measured by using the notional value of transactions.

Applying notional value as per, for example, the ADNA (Average Daily Notional Amount) across all asset classes is likely to introduce a significant amount of 'noise' to an analysis of market liquidity. Moreover, market players typically hedge their production and consumption by trading in lots and not in notional value. Thus, we recommend that any liquidity analysis is normalised to a base quantity unit that is native to the asset class. For commodities, this will typically be a specific unit of measure (e.g. barrels, tons, MW, etc.).

2) Sufficiently high daily number of trades for a market to be liquid

In order for a market to be considered liquid, a sufficiently high number of trades should be executed on each trading day. We recommend that the threshold should be set at the median of 100 transactions per day instead of the current average of 10. Considering the fact that liquidity is the ability to find a counterparty in a relatively short period of time within a given trading day, a threshold of 100 trades per day has the practical implication that it represents an average of approximately 1 trade every 5 minutes on an 8-hour trading day. In contrast, a threshold of 10 trades represents just 1.25 trades per hour.

For the same reason, a median is proposed as the minimum instead of a mean. The mean can simply be an alternate view of the sum count of trades per year.

3) Trade frequency and standard size rather than volume as liquidity indicators

By way of example: consider two instruments. Instrument 1 is traded on average once per day for 100,000 units and Instrument 2 is traded on average 10,000 times per day for 10 units. In both cases, the average volume will be 100,000 units per day. However, it would be very difficult to categorise Instrument 1 as liquid, whereas Instrument 2 can be considered to be very liquid for trade volumes of approximately 10 units.

We therefore recommend that trade frequency and standard size, excluding unrelated vectors such as price and currency, are both measured to determine liquidity.

4) Counterintuitive effects of a percentile-based approach

A percentile-based approach can lead to significant counterintuitive effects, which is important to keep in mind when setting LIS thresholds.

Any approach similar to the existing one using a central or percentile-based measure will result in:

a) A low standard size for high liquidity instruments;
b) A high standard size for low liquidity instruments;
c) A low LIS for high liquidity instruments;
d) A high LIS for low liquidity instruments.

The above results are counterintuitive and imply that the instrument with lower liquidity can support higher LIS levels than the high-liquidity instrument – when in fact the opposite is true. While the low liquidity instrument does typically trade in a higher size, the overall size of this market and trade frequency is dwarfed by the higher liquidity of the market. Therefore, setting a low LIS for high liquidity markets and a high LIS for low liquidity markets based on the standard trade size in either mean, median or mode terms is detrimental for the development of low liquidity markets. There is indeed a clear need for a more tailored approach or a scaled approach based on variations in distribution.

Question 76.1 Please explain your answer to question 76:

In sum, the pre-trade transparency regime should take into account the fact that non-equity markets are fundamentally different from equity markets and that there are significant differences across the underlying non-equity markets themselves. It is, for example, important to understand that commodity derivative markets have specific characteristics and, consequently, often suffer from a one-size fits all regulatory approach to financial instruments. Therefore, against the background of this targeted MiFID II/MiFIR review, we believe that transparency requirements could benefit from a more tailored approach to commodity markets.

MiFIR rightly recognises that certain exemptions can be granted to trading venues from the general requirement to publish pre-trade transparency data to preserve orderly price discovery processes and to allow in particular illiquid and nascent markets to develop.

The current shortcomings of the regime have, in some cases, prevented market participants from moving to transparent and regulated venues and central clearing.

Question 94. Have you detected any issues beyond those raised in previous sections that would merit further consideration in the context of the review of MiFID II/MiFIR framework, in particular as regards to the objective of investor protection, financial stability and market integrity?

Please explain your answer:

We would like to express our concerns regarding the impact of Brexit on the MiFID II framework for commodity derivatives and, in particular, on the ancillary activity exemption in Article 2. Once the UK will stop applying the MiFID II framework, the total trading activity in financial instruments in the remaining EU-27 will decline. Hence, if the thresholds of the ancillary activity test, and more specifically of the market share test therein, are not adapted early enough, trading activity in financial instruments in the EU-27 might be reduced significantly. We therefore strongly encourage the Commission to use the opportunity of the upcoming MiFID II / MiFIR review to amend the ancillary activity exemption and the criteria thereof. We explicitly welcome and support the proposal from ESMA to reconsider the quantitative test approach set out in Article 2(4) of MiFID II for eligibility to the ancillary activity exemption following the UK's scheduled regulatory departure from the EU by the end of the year.

About

Europex is a not-for-profit association of European energy exchanges with 29 members. It represents the interests of exchange-based wholesale electricity, gas and environmental markets, focuses on developments of the European regulatory framework for wholesale energy trading and provides a discussion platform at European level.

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