Joint association pre-trilogue comments on the MiFID II / MiFIR Fundamental Review in relation to commodity derivatives

Brussels, 4 April 2023 | CMCE/EFET/Europex/FESE/FIA/ISDA (the "**Associations**") would like to provide comments aimed at preserving the well-functioning of European commodities markets for the upcoming agreement on a final MiFID/R legislative text. We refer, in particular, to the European Parliament's ECON report on MiFID/MiFIR (here for the Regulation and here for the Directive) in relation to commodities and commodity derivatives in advance of the MiFID/MiFIR trilogue process.

As a general remark, we understand that the current energy crisis has intensified the debate with respect to commodity derivatives after the publication of the European Commission's MIFIR and MiFID Review proposal. However, the recent market stress in energy derivatives has been caused by supply issues, in particular the disrupted supply of gas from Russia and requirements to fill gas storages. The energy crisis is still on-going and whilst we agree that it would be useful to consider any lessons learned once it has passed, we believe making major changes to the regime during a crisis and a period of increased volatility would exacerbate the strain on liquidity as well as market participants and could cause lasting damage to markets. Commodity markets are already being subjected to cumulative and frequent regulatory changes, e.g. a review of REMIT and market abuse requirements is conducted in parallel, as well as to implementation of the market correction mechanism, new LNG reporting and the price assessment. These changes put additional strain on firms' resources while already dealing with the energy crisis and its fallout. In addition, we do not believe that the amendments adopted by ECON in relation to commodities and commodity derivatives will address volatility nor will they reduce energy prices, but instead further impede the development of commodity markets in the EU and lead to competitive disadvantages for participants in EU commodities markets. We have set out our concerns in more detail below.

Executive Summary:

- We are concerned about the European Parliament's proposal to review the position limit regime and the ancillary activity exemption, as they were only recently reviewed;
- We support the scope-in of derivatives on emission allowances to the position management controls regime but are concerned about the proposal to include trading volume in the weekly position reports;
- A minimum holding period for agricultural, energy and emission allowance derivatives would negatively affect the functioning of these markets;
- We see no added value in a mandate for ESMA to define the principles for establishing the main technical parameters that regulated markets shall consider when establishing their circuit breakers; and
- We support the re-introduction of the hedging exemption for the own account exemption.

1. Position limits – Art. 57 par. 15 (new) MiFID II

In Art. 57 par. 15 of MiFID II, the EU Parliament proposed a potential review of the position limits regime. However, an assessment of the position limits regime based on criteria similar to those suggested in Compromise P has only recently taken place. A new assessment will not add any additional value.

ESMA and the European Commission only recently extensively reviewed the position limits regime in the context of the MiFID Quick-fix amendments. Prior to the final Level 1 amendments, ESMA issued a call for evidence, publicly consulted stakeholders, and issued the ESMA final report on position limits and position management of April 2020. The report explains the need for a nuanced application of the position limit regime, i.e. by applying limits to well-developed 'critical and significant' contracts but not to nascent or illiquid contracts. ESMA proposed in its final report of 19 November 2021 according changes to the RTS 21 on position limits and the co-legislators adopted the according CDR (EU) 2022/1302, which entered into force in August 2022. Hence, stakeholders and ESMA only recently and consistently argue that the application of position limits to all commodity derivatives would have adverse impacts on the functioning and development of niche markets and act as a barrier for new contracts. In this context, it should be noted that attractive commodity markets would also bolster the EU's strategic autonomy objectives.

Further, it should not be forgotten that non-critical or significant commodity derivatives are subject to position reporting and management, and other MiFID obligations such as transparency and transaction reporting. Therefore, any concerns about high market concentration can be detected by ESMA and NCAs, irrespective of MiFID prescribed position limits.

MiFID II's main aim is to safeguard market integrity. The ability of position limits to support this aim has been subject to extensive discussions among regulators, policymakers, and industry practitioners in recent years.

For example, ESMA in their final report from April 2020 mentioned above, noted in section 3.2 that rather than being the main objective, preventing market abuse is only an indirect potential consequence of the position limits regime. In the same section, ESMA stated that "the extent to which position limits contribute to preventing market abuse appears less apparent".

Recommendation 1: The Associations recommend deleting the changes to Art 57 par 15 and recital 10c of MiFID II, proposed by the EP.

2. Emission allowances under the position management regime and weekly position reports – amended Art. 57 par. 8 MiFID II and Art. 58 par. 1

In an amendment to Article 57(8) of MiFID II the EU Parliament proposes to scope-in derivatives on emission allowances to the position management controls regime. The Associations support this amendment as it would implement one of the recommendations of the ESMA final report on emission allowances and associated derivatives (link). Whilst position management applies to a variety of contracts, emission allowances are not part of the commodity derivatives definition hence position managements in accordance with Article 57 of MiFID II cannot be applied. The amendment closes this gap and allows trading venues to effectively apply position management controls to emission allowances.

The Associations further support the requirement to make public two weekly position reports, one of which is excluding options, and send both reports to the National Competent Authority and ESMA. However, we do not support to include in these reports "the total trading volume per day, expressed as the number of derivatives contracts bought or sold in a given trading day, for each category". These reports are position reports and not transaction reports and market operators do not possess such information at end beneficiary level.

Recommendation 2: The Associations support the changes to Art. 57 (par. 8.) and Art. 58 (par. 1) as proposed by the EP, except for the new requirement for weekly position reports to include "the total trading volume per day, expressed as the number of derivatives contracts bought or sold in a given trading day, for each category".

3. Ancillary Activity Exemption – amended Art. 2 (4), sub-para. 1 and 2 of MiFID II

The amendments to Art. 2 (4), sub-para. 1 of MiFID II introduces the requirement for the Commission to produce a Delegated Act specifying when non-financial companies' activities are 'to be considered ancillary to the main business at a group level', also referred to as Ancillary Activity Exemption (AAE), taking into account four criteria.

The AAE was only recently reviewed and amended by the EU co-legislators in the 2021 MiFID II quick fix, as part of the recovery package after a volatile market period caused by the Covid pandemic. The review consisted in a Level 1 proposal by the Commission, as well as trilogue discussions between the Council and Parliament, during which the amendments to the AAE were carefully calibrated by co-legislators. Following this Level 1 legislation, the co-legislators adopted the according CDR (EU) 2021/1833 establishing the tests to define ancillary activities, which entered into force in November 2021.

Further, we are also very concerned that the amendment proposals for Art. 2 par. 4 subpar. 2 suggest changes to the parameters of the test without having conducted a review of the impact of new criteria on the market. This seems at odds with the proposed new Recital 10(a), in which the Parliament requests that the Commission review the ancillary activity exemption and how this rule has affected liquidity in and the orderly functioning of commodity markets.

We are also concerned that the proposed new Recital 10(a) seems to request that "the biggest entities are duly licenced and supervised as investment firms for their trading and investment service provision activities" without specifying what "biggest" means and without considering the business of such firms within their group activities and the impact a blanket licencing requirement based on size would have on the ability of commodity firms to continue to provide their services throughout the supply chain, add liquidity to markets and to end-consumers. Also, the Recital seems to neglect that commodity firms are distinguishable from banks and financial institutions and that commodity markets have special characteristics that are not catered for by the regime for financial firms. We further note that the biggest commodity firms may not necessarily pose the most risks as they can be better resourced and capitalised than smaller firms.

This recent MiFID II Quick-Fix legislation substantially reduced compliance burdens as it simplified the MiFID II commodity regime and allows European companies to cover their commercial risks, whilst safeguarding the transparency and integrity of commodity markets. The proposed amendments to the AAE would negate this positive impact of the MiFID II Quick-Fix changes in a market situation where energy market participants face even greater challenges caused by the ongoing energy crisis. The suggested changes would not solve the causes of the ongoing energy crisis, neither would they help energy firms to overcome this crisis. On the contrary, the consequential imposition of an investment firm licensing requirement on energy firms and their consequential status as financial counterparty would have rather exacerbated the energy crisis, in particular the (cash) liquidity stress of firms. We have in the past set out the consequences for a non-financial firm that would need to become authorised, which are not only very onerous and costly but also attract additional regulatory consequences, e.g. margin, clearing and capital requirements. We fear that proposing changes to the regime during stressed market conditions, will lead to significant negative consequences for commodity markets, such as a further reduction in liquidity. For further explanations we refer to the EFET paper on the AAE review (see link).

Recommendation 3: The Associations recommend deleting Art. 2 par. 4 subpar. 2 and Recital 10a of MiFID II, proposed by the EP.

4. **Minimum holding period for agricultural, energy and emission allowance derivatives -** new Article 52 par. 15(a) and new Recital 32(a) of MiFIR

The addition of a new Article 52 par15(a) and new Recital 32(a) would require ESMA to assess whether a minimum holding period for options, futures, swaps, forwards and other derivatives contracts would effectively limit volatility in energy, agricultural and emission allowances markets, without negatively impacting the functioning of these markets. The amendment's initial justification suggests a differentiation between long-term "legitimate" speculation for hedging of energy consumers and short-term "illegitimate" speculation for the benefit of high-frequency traders. We generally think that this attempted differentiation indicates misunderstanding about the reasons derivatives users participate in markets.

- **Hedging**: Market participants would be prevented from adjusting their positions in volatile markets. In times of market stress, market participants need to adjust positions more frequently. Similarly, market participants would be prevented from unwinding positions in the event of unforeseen circumstances. Further, market participants could also be forced into having to take unplanned delivery under their hedges, for example when hedging cargos purchased under an LNG Annual deliver plan on the 31st March and then selling the May cargo on an FOB basis, the hedges placed on the Ice Futures TTF Front month contract need to be unwound but a minimum holding period means one could be forced to take the contract to delivery. A minimum holding period would consequently reduce the effectiveness of these markets for traders, with negative implications for liquidity as market participants would be reluctant to open positions. Market participants would also be prevented from entering into new hedges while having to hold onto old positions as doing so may exceed position limits or fall short of a holding period.
- **Reduction of the product scope on exchanges, mandatory roll-over?** Exchanges offer commodity derivatives with different maturities, including several products with maturities of less than the initially suggested period of 30 days. Would exchanges be expected to remove all products with shorter maturities than the suggested holding period?

- **Hedge adjustments due to unplanned outages:** The Commodities markets deal with physical assets which have real-world issues, which include unplanned outages and force majeures. Traders must be able to always adjust their hedging to take into account these physical problems. Failure to be able adjust hedging positions can leave physical market participants with non-offsetting positions and exposed to market movements until such time that the holding period ends. This could lead to considerable losses for the hedging participants.
- **Hedging Swaps or Balance of the Month products:** Some products such as Swaps or Balance of the Month products, price rateably throughout a monthly period. In this case, traders must rateably adjust their hedges daily to match their related exposures. The application of a minimum hold period would mean that these products could only be entered into or hedged, at a time greater than the holding period and the pricing period combined. This could mean that market participants would potentially have to trade at least 2 months before final pricing. This will severely constrain liquidity in those markets and the corresponding liquidity and supply they help risk manage.
- **Adjusting hedge closer to settlement:** Different commodity venues have differing prompt date structure unique to the underlying asserts and their delivery times. Traders may initially select a prompt date that has most liquidity (for example 3 months from the date of the trade) and then as the settlement date comes closer, they will change the date to suit their actual needs. For example, market users may hold a contract initially for 30 days (or longer) but in order to ensure they have as close a hedge as possible, they will then roll the date using shorter term prompts. Such short-term contract may violate a holding period and therefore could mean any firms subject to this obligation would be unable to access the liquidity on the venue and would be prejudiced against other firms who were able to hedge more effectively.

Recommendation 4: The Associations do not see the benefits of ESMA producing a report on this matter and recommend deleting Art. 52 par. 15a and recital 32a, proposed by the EP.

5. Circuit Breakers – amended Art. 48 par. 12 of MiFID

In Art. 48 par. 12 of MiFID II, the European Parliament proposes to include a mandate for ESMA to determine the principles for establishing the main technical parameters regulated markets shall consider taking into account the liquidity of different asset classes and sub-classes, the nature of the market model and the types of users when establishing their mechanisms to halt trading in accordance with paragraph 5 of this Article.

Our members support transparency around circuit breakers. However, we believe exchanges need to be provided with sufficient flexibility to ensure that the parameters for halting or constraining trading are appropriately calibrated to account for different markets, exchange structures and products, allowing them to take into account the liquidity and volatility profiles of different asset classes and sub-asset classes, the nature of the market model and types of users. Consequently, we see no added value in a mandate for ESMA to define the principles for establishing the main technical parameters regulated markets shall consider when establishing their mechanisms.

Recommendation 5: The Associations recommend the deletion of Art. 48 par 12 (ga), as proposed by the EP.

6. Own account dealing exemption - amended Art. 2 (1) (d)(ii)

We support to re-instate the original exemption of Art. 2 (1)(d)(ii). Non-financial firms should be able to reduce the risk of their commercial activities or treasury financing activities with financial instruments (other than commodity derivatives) traded on a regulated market or an MTF without becoming subject to an authorisation requirement.

Recommendation 6: The Associations support the changes to Art. 2 (1)(d)(ii), as proposed by the EP.

The co-signatories

CMCE

Commodity Markets Council Europe (CMCE) is the only association in Europe representing the range of commodity market participants - agriculture, energy, metals and other commodity market participants, benchmark providers, price reporting agencies, and trading venues operating in the EU, EEA, Switzerland and neighbouring countries. The majority of CMCE members use commodity derivative markets to hedge the risks related to their physical activities and assets. CMCE's key purpose is to engage with policymakers and regulators to promote liquid and well-functioning commodity derivative markets in Europe. For more information: www.commoditymkts.org.

EFET

The European Federation of Energy Traders (EFET) promotes and facilitates European energy trading in open, transparent and liquid wholesale markets, unhindered by national borders or other undue obstacles. We build trust in power and gas markets across Europe, so that they underpin a sustainable and secure energy supply and enable the transition to a carbon neutral economy. EFET currently represents more than 130 energy trading companies, active in over 27 European countries. For more information: www.efet.org.

Europex

Europex, the Association of European Energy Exchanges, is a not-for-profit association of European energy exchanges with 32 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. For more information: www.europex.org.

FESE

The Federation of European Securities Exchanges (FESE) represents 35 exchanges in equities, bonds, derivatives and commodities through 16 Full Members and 1 Affiliate Member across 30 countries.

At the end of February 2023, FESE members had 8827 companies listed on their markets, of which 17% are foreign companies contributing towards European integration and providing broad and liquid access to Europe's capital markets. Many of our members also organise specialised markets that allow small and medium-sized companies across Europe to access capital markets; 1676 companies were listed in these specialised markets/segments in equity, increasing choice for investors and issuers. Through their RM and MTF operations, FESE members are keen to support the European Commission's objective of creating a Capital Markets Union. FESE is registered in the European Union Transparency Register: 71488206456-23. For more information: www.fese.eu.

FIA

FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C. FIA's membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from about 50 countries as well as technology vendors, law firms and other professional service providers. FIA's mission is to support open, transparent and competitive markets, protect and enhance the integrity of the financial system, and promote high standards of professional conduct. As the principal members of derivatives clearinghouses worldwide, FIA's clearing firm members play a critical role in the reduction of systemic risk in global financial markets. Information about FIA and its activities is available on www.fia.org.

ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 79 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on www.isda.org.