MiFID 2: Commodity derivatives - position limits, management and reporting

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Summary

The revised Markets in Financial Instruments Directive (MiFID 2) and the new Markets in Financial Instruments Regulation (MiFIR) were approved by the European Parliament and European Commission in April/May 2014 and published in the Official Journal of the European Union (OJ) in June 2014. MiFID 2 and MiFIR will apply from 3 January 2018. The Level 1 legislation provides further mandates for the Commission to adopt a number of Delegated Acts, and for the European Securities and Markets Authority (ESMA) to develop draft regulatory technical standards (RTS) and implementing technical standards (ITS). Following several rounds of consultation, Level 2 legislation has been (or is in the process of being) adopted by the Commission and is due to be published in the OJ following a period of scrutiny by the European Parliament and Council.

This briefing provides an overview of the principal changes introduced in MiFID 2 and MiFIR in relation to commodity derivatives, emission allowances and derivatives of emission allowances. It is one of two briefings on commodity derivatives under MiFID 2 dealing with (i) scope and (ii) position limits, management and reporting. In addition, we have recently published briefings dealing with (i) market structure, (ii) pre- and post-trade transparency, (iii) transaction reporting and (iv) investor protection.

The texts of MiFID 2 and MiFIR are of EEA relevance and hence will be applicable to non-EU, EEA countries once incorporated into the EEA Agreement. Whether MiFID 2 and MiFIR will continue to apply in the UK after the UK leaves the EU (Brexit), depends upon the future relationship of the UK and the EU. If the UK were to remain a member of the EEA following a Brexit, they would continue to apply; but in other scenarios, the UK would become a third country for the purposes of MiFID 2 and MiFIR, unless special terms were negotiated between the UK and EU.

If the UK becomes a third country for the purposes of MiFID 2 and MiFIR, UK firms are likely to seek to utilise the equivalence recognition provisions, where available. The FCA has confirmed that firms should proceed with the implementation of MiFID 2 and MiFIR, which would enable the UK to demonstrate equivalence if necessary.

Introduction

The introduction of a position limits, reporting and management regime has been one of the most significant and politically sensitive changes to the existing MiFID framework and the Level 2 legislation that deals with commodity derivatives (RTS 20 on scope, RTS 21 on position limits and ITS 4 on position reporting) has been some of the most contentious. Indeed the European Parliament's left leaning political groups only narrowly lost a vote in February 2017 that could have seen a rejection of some of the relevant RTS. On 28 September 2015, ESMA published its "final" drafts of RTS 20 and 21. In April 2016, the European Commission notified ESMA of its intention to endorse the RTS subject to a number of amendments that it considered necessary to meet the objectives of the position limits regime under MiFID 2. On 1 December 2016, the Commission adopted amended RTS. Both RTS await publication in the OJ,

whereas ESMA has recently sent an amended ITS 4 to the European Commission for endorsement.

Key business impacts

- The new position limits regime will impose significant burdens on market participants in terms of managing compliance with such limits.
- Market participants will be subject to the position management controls imposed by the operators of trading venues on which commodity derivatives are traded.
- Investment firms and members of trading venues will have to report their own positions, as well as those of their clients, their clients' clients and so on to the end client.
- Operators of trading venues will need to report positions held on their trading venues to competent authorities (CAs) on a daily and weekly basis.
- Member state CAs will have additional powers to intervene and sanction breaches of position limits on trading venues.

Position limits

One of the objectives of the revision of MiFID was to prevent abusive trading, promote orderly pricing and address systemic risk in commodity markets. To this end, MiFID 2 will require that commodity derivatives traded on regulated markets (RMs), multilateral trading facilities (MTFs) and organised trading facilities (OTFs, and together with RMs and MTFs, "trading venues"), as well as economically equivalent OTC derivatives, be subject to limits on the size of a net position in a commodity derivative which any person can hold at all times. The limits will be set on the basis of all positions held by a person and those held on its behalf, including for a parent undertaking those held by or on behalf of its subsidiaries. The regime will apply to all holders of positions in commodity derivatives irrespective of whether such persons are regulated. However, the limits will not apply to positions held by non-financial entities for commercial hedging purposes, although such positions will still be subject to position reporting requirements – see Position reporting below.

MiFID 2 will require CAs to impose position limits for "spot month contracts" on the one hand, and "other months' contracts" on the other

The position limits regime will apply not only to commodity derivatives with a physical commodity underlying, but to those with no tangible underlying – such as derivatives relating to climatic variables and inflation rates – and to securitised commodity derivatives as well.

Methodology for CAs to set position limits

CAs will be responsible for setting the limits in each member state, following criteria for establishing the limits set out in Level 2 measures.

MiFID 2 will require CAs to impose position limits for "spot month contracts" on the one hand, and "other months' contracts" on the other. The limits will apply to all persons holding positions in commodity derivatives on EU trading venues (and economically equivalent OTC contracts), irrespective of whether such persons are based in the EU.

Spot month contracts

RTS 21 defines a "spot month contract" as "the commodity derivative contract in relation to a particular underlying commodity whose maturity is the next to expire in accordance with the rules set by the trading venue". The spot month period is specific to each commodity derivative contract and will not correspond necessarily to a month. The position limits for both cash settled and physically settled spot month contracts will be calculated for each commodity derivative contract as a percentage of deliverable supply for that commodity derivative, with deliverable supply being broadly the quantity of the underlying commodity that can be used to fulfil the delivery requirements of that commodity derivative contract. Deliverable supply will include any substitute grades or types of a commodity that can be delivered in settlement of a commodity derivative under the terms of the contract. RTS 21 sets out details on how CAs should determine deliverable supply, although it remains unclear whether CAs will have all the relevant data required to accurately calculate it.

Other months' contracts

For "other months' contracts" – defined in RTS 21 as commodity derivative contracts that are not spot month contracts – the limits will be calculated as a percentage of open interest in the

relevant commodity derivative. Open interest will be calculated by aggregating the number of lots of the relevant commodity derivative that are outstanding on trading venues at a point in time.

The default limit and flexibility for adjustment

> CAs will have discretion to increase the limits up to 35 per cent or decrease down to 5 per cent for each commodity derivative…

RTS 21 sets the default position limit or "baseline figure" at 25 per cent of deliverable supply or open interest as applicable. The limit will be expressed in lots – the unit of trading representing a standardised quantity of the underlying commodity.

However CAs will have discretion to increase the limits up to 35 per cent or decrease down to 5 per cent for each commodity derivative based on an assessment of the potential impact of a number of factors on the integrity of the market for that commodity derivative or its underlying commodity. The factors to be considered include maturity of the commodity derivative contract, deliverable supply, overall open interest (including significant discrepancies between open interest and deliverable supply), number of market participants and characteristics of the underlying commodity markets. In addition, CAs will be required to adjust the limits further where there is excessive volatility in the price of the commodity derivative or the underlying commodity if such adjustment would effectively reduce that volatility.

Exceptions to general methodology

> … but for agricultural commodity derivatives, limits can be reduced to as low as 2.5 per cent

There are a number of exceptions to the standard methodology to take into account certain specificities of types of commodities or financial instruments.

Agricultural commodities: The spot month position limit or "baseline figure" has been set at 20 per cent of deliverable supply for commodity derivatives whose underlying qualifies as food intended for human consumption, where the total combined open interest in spot and other months' contracts exceeds 50,000 lots over a consecutive three month period. In addition, CAs will be able to decrease the position limit for such derivatives to as low as 2.5 per cent (rather than the 5 per cent lower limit set for other derivatives).

C10 commodity derivatives: For certain cash settled contracts for which there is no measurable underlying deliverable supply (for example, derivatives on climatic variables or freight rates), the position limits will be based on open interest for both spot month and other months' contracts.

Securitised commodity derivatives: The definition of commodity derivatives under MiFID 2 and MiFIR includes securitised commodity derivatives. For such derivatives, the concept of spot and other months' does not apply and RTS 21 requires limits to be set by calculating a percentage of the securities in issue and setting out the limit in number of securities. The default position limit will therefore be set at 25 per cent of securities in issue.

Contracts for continuous delivery: Where a commodity derivative contract, relating for example to power or gas, provides that the underlying is delivered constantly over a specified period of time, the same positon limit will apply to related commodity derivatives with the same underlying to the extent their delivery periods overlap. The position limit will be set in units of the underlying.

New and illiquid contracts: In recognition of the fact that a strict range of position limits may not be appropriate for new and illiquid contracts, RTS 21 provides for an alternative regime for such contracts. Rather than apply a limit of a percentage of deliverable supply, open interest or number of securities as the case may be, CAs will be required to set a fixed position limit if liquidity is below certain thresholds and to review the limits upon receiving notification from trading venues that the relevant thresholds have been reached.

Brexit

The impact of Brexit on legislation such as MiFID 2 and MiFIR is yet to be fully understood. In relation to the position limits regime, the methodology for setting position limits has been devised and calibrated on the basis of an EU commodities market that includes the substantial UK market. It remains to be seen whether the regime will need to be recalibrated once the UK leaves the EU and UK trading venues and activity no longer form a part of the EU market.

Calculation of net position

For each commodity derivative, a person's net position which is required to be compliant with the relevant position limit will be the sum of its positions in all contracts considered to be "the same commodity derivative" on trading venues and its positions in "economically equivalent

OTC contracts", minus – for non-financial entities – positions held for commercial hedging purposes. Net positions will need to be determined separately for spot month contracts and other months' contracts. RTS 21 sets out detail on a number of concepts required to calculate net positions.

Aggregating positions within a group

Position limits will apply "on the basis of all positions held by a person and those held on its behalf at an aggregate group level". Under RTS 21, a person's net position should be aggregated with those of its subsidiary undertakings but not with those of fellow subsidiaries of a mutual parent. This means that it may be possible to have positions calculated at the level of a parent undertaking that are larger or (due to netting of long and short positions) lower than those calculated at the level of subsidiary undertakings.

A parent undertaking of a collective investment undertaking or management company will not need to aggregate its positions with those of any collective investment undertaking whose investment decisions to open, hold or close positions it does not influence.

Economically equivalent OTC derivatives

To avoid circumvention of the regime by entering into commodity derivatives outside trading venues, position limits will also apply to "economically equivalent OTC contracts". Under RTS 21, an OTC commodity derivative will be within scope of the position limit regime if it has identical contractual specifications, terms and conditions to a commodity derivative contract traded on a trading venue (regardless of differences in post-trade risk management arrangements and lot size specifications and divergence in delivery dates by less than a calendar day). ESMA has deliberately narrowed the scope of the concept of "economically equivalent" to prevent persons from being able to net down their positions over a wider number and range of contracts. There has been a question as to whether this interpretation of economically equivalent is consistent with the text of MiFID 2 as, arguably, OTC derivative contracts will essentially need to be legally identical to be considered economically equivalent. The implication of this interpretation is that a large proportion of OTC commodity derivatives will be outside the position limits regime. Firms will be concerned that the limits will apply to positions that do not reflect the economic reality of their overall positions because of the inability to net off on-venue positions against economically-related OTC transactions.

It will not be possible to include positions held on non-EU trading venues in the aggregation and netting for the purposes of the EU position limits regime

Aggregating and netting OTC and on-venue commodity derivatives

In order to calculate a single net position held by a person, commodity derivatives traded on trading venues and their economically equivalent OTC contracts would need to be aggregated and netted. It appears that it will not be possible to include positions held on non-EU trading venues in the aggregation and netting for this purpose. For example, persons will not be able to rely on transactions entered into on non-EU trading venues for hedging positions held in the EU to reduce the size of their net position. In addition, ESMA has stated that it will not be possible to net against instruments which are outside the scope of MiFID 2 or against physical holdings.

"Same commodity derivatives"

The calculation of a person's net position in a commodity derivative is required to take into account derivatives considered the "same commodity derivatives" traded on other trading venues. Under RTS 21, a commodity derivative traded on one venue is the same as a commodity derivative traded on another venue if both derivatives have identical contractual specifications, terms and conditions (excluding post-trade risk management arrangements) and form a single fungible pool of open interest (or in the case of securitised commodity derivatives, securities in issue).

Where the same commodity derivative is traded in significant volumes on trading venues in more than one jurisdiction, the CA of the venue with the largest volume (the central CA) will, in consultation with the other CAs, set a limit on that commodity derivative to be applied across all venues. RTS 21 sets out criteria for determining the meaning of "significant volume" for these purposes. The CAs of the venues where the same commodity derivative is traded and the CAs of position holders in that commodity derivative shall put in place cooperation arrangements including exchange of relevant data, to enable monitoring and enforcement of the single position limit.

Positions held for hedging purposes

Under MiFID 2, position limits will not apply to positions held by or on behalf of non-financial entities which are objectively measurable as reducing risks directly relating to commercial activity. RTS 21 defines a "non-financial entity" as an entity which is not authorised under MiFID 2 or other EU financial services legislation or a third-country entity which would meet this definition if it were based in the EU and subject to EU law.

Under RTS 21, positions will qualify as reducing risk for the purposes of this exemption if: (i) they reduce the risk arising from the potential change in the value of assets, services, inputs, products, commodities or liabilities that the non-financial entity or its group owns, produces, uses or sells in the normal course of its business; or (ii) they qualify as hedging contracts pursuant to the International Financial Reporting Standards.

RTS 21 sets out specific requirements for positions which are part of a portfolio to qualify for the exemption, requiring in particular that firms are able to describe in their internal policies the link between the portfolio and the risks being mitigated, separately identify contracts within the portfolio that are entered into other than for hedging and provide a sufficiently disaggregated view of the portfolio.

The exemption for hedging transactions will not apply automatically. Non-financial entities will need to apply to the CA which sets the position limit for each relevant commodity derivative

The exemption for hedging transactions will not apply automatically. Non-financial entities will need to apply to the CA which sets the position limit for the relevant commodity derivative, demonstrating how the position reduces risks relating to the non-financial entity's commercial activity. CAs will have 21 calendar days within which to approve or reject an application for an exemption. In the UK, the FCA has stated that a firm will only need to apply for an exemption where it thinks its trading activity might otherwise lead to the firm exceeding a position limit.

A non-financial entity will be expected to assess its activities periodically to ensure that the continued application of the exemption is justified, and notify the CA if there is a significant change to the nature or value of its commercial or trading activities on the basis of which an exemption has been granted. Where there has been such a change, the non-financial entity will need to submit a new application for the exemption if it intends to continue to use it.

Limits apply "at all times"

Position limits will apply "at all times", meaning firms will need to have systems in place to calculate and monitor net positions not just at the end of the day but constantly throughout the day. This is likely to be a significant operational challenge, particularly taking into account the need to aggregate at group level.

Position management

Operators of trading venues on which commodity derivatives are traded will have to apply position management controls. These will include the monitoring of open positions, information access (including obtaining information about the underlying owners of positions and assets or liabilities in the underlying market) and the ability to require persons to terminate or reduce their positions or to provide liquidity back into the market to mitigate a large or dominant position.

Position limits and position management controls should be transparent and non-discriminatory, specifying the persons to whom they apply and taking into account the nature and composition of market participants and the use they make of the relevant contracts.

CAs will be required to communicate the details of any position limits and position management controls established in their member states to ESMA, which will publish summaries of this information on its website.

Position reporting

Operators of trading venues on which commodity derivatives and emission allowances or derivatives in them[1] are traded will be required to publish weekly reports on the aggregate

[1] Although the obligation dealing with position limits appears only to apply to commodity derivatives, position reporting obligations are extended to trading venues on which emission allowances and derivatives in them are traded, and investment firms which trade in them.

positions held by different categories of position holders and to communicate such reports to CAs and ESMA. In addition, operators will be required to provide more detailed reports to their CAs on a daily basis, setting out a complete breakdown of all position holders, including trading venue members, participants and their clients.

Members or participants in such trading venues will have to provide information to the operator on their own positions held through contracts traded on that trading venue and the positions of their clients, their clients' clients (and so on until the end client is reached) on a daily basis to enable the operator to monitor compliance with the position limits.

The requirement to report positions "at least on a daily basis" is likely to prove challenging for firms

Investment firms trading outside a trading venue will need to provide the relevant CA with a complete breakdown of their positions in each on-venue commodity derivative and economically equivalent OTC derivative, as well as those of their clients, their clients' clients (and so on until the end client is reached) on a daily basis. Reports to CAs will need to differentiate between positions entered into for commercial hedging purposes and other positions.

The requirement to report positions "at least on a daily basis" is likely to prove challenging for firms, especially in light of the need to collate and reconcile details of positions and possibly across different time zones.

Another challenge for firms will be whether they can report positions on behalf of "clients and the clients of those clients until the end client" without breaching confidentiality requirements. The meaning of "end client" is not specified in MiFID 2 and may be subject to further guidance from ESMA or CAs.

Firms will need to ensure that they have agreements in place to require clients to obtain and provide information to enable them to comply with their position reporting obligations.

Powers of authorities

In addition to the general sanctions available under MiFID 2, CAs will have power to intervene on an *ad hoc* basis in respect of the position limits regime, including by requiring information regarding the size and purpose of a position or exposure entered into through a commodity derivative, requesting any person to reduce the size of a position or exposure or limiting the ability of any person to enter into a commodity derivative.

CAs will be able to apply their sanctioning powers under MiFID 2 to: (i) persons situated or operating in their territory or abroad for breaches of position limits on trading venues within their territory; or (ii) persons situated or operating in their territory for breaches of limits set by CAs in other member states.

Under MiFIR, ESMA will play a role coordinating the exercise by member state CAs of their powers. If certain specific conditions are met, ESMA will itself be able to exercise "position management powers" to request information from any person regarding their position in relation to a derivative contract, request that a position be reduced or (as a last resort) limit the ability of a person to enter into commodity derivatives.

For more information please contact:

James Smethurst
Partner, UK
T +44 20 7832 7478
E james.smethurst@freshfields.com

Mukumbi Litana
Senior Associate, UK
T +44 20 7716 4294
E mukumbi.litana@freshfields.com

freshfields.com

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