



EUROPEAN COMMISSION

Directorate-General for Financial Stability, Financial Services and Capital Markets Union

Director General

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Mr Steven Maijoor
Chairman
European Securities and Markets
Authority - ESMA
103, rue de Grenelle
F-75345 Paris

Dear Mr Maijoor,

On 28 September 2015, ESMA submitted to the European Commission (Commission) the draft regulatory technical standard (draft RTS 21) on the application of position limits to commodity derivatives pursuant to Article 57(3) and (12) of Directive 2014/65/EU (MIFID II).

ESMA draft RTS provides the methodology for the calculation of position limits with the aim of establishing a harmonised position limit regime for derivatives traded on trading venues and their economically equivalent OTC (EEOTC) contracts.

The draft RTS lays down how competent authorities should apply the seven factors of Article 57(3) when establishing the spot month position limit and the other months' position limit for physically and cash settled contracts. The draft RTS also specifies how aggregation of positions within a group should be calculated, and what positions may qualify as reducing risk or when a firm may use a hedging exemption. Finally the draft RTS further specifies what constitutes an EEOTC contract for the purposes of applying position limits.

ESMA draft RTS proposes a methodology whereby spot month limits can vary between 5% and 35% of the deliverable supply underpinning the commodity derivative. The other months' limits are to be set between 5% and 35% of the open interest in that commodity derivative. Furthermore, ESMA's draft RTS defines EEOTC as needing to have contractual specifications that are identical to the contract traded on a venue.

With this letter I would like to inform ESMA that the Commission intends to endorse the ESMA standard on position limits only in case certain amendments are made.

These amendments also take into account concerns raised by the European Parliament in this area.

Overall, the Commission is supportive of the general approach that ESMA has taken to this standard. However, the Commission considers that changes are necessary to meet the objective of the position limit regime as set out in Article 57(1) and recitals (125) and (127).

Notably, the approach, as proposed by ESMA, may not be sufficiently nuanced to allow for an effective system of position limits that would be justified for certain types of very liquid or illiquid commodity derivatives. In addition, the dependence exclusively on the open interest for other months' limits could in certain cases produce an inconsistent limit regime and could lead to limits not justified for certain contracts. Finally, ESMA proposals on EEOTC contracts would allow easy circumvention and compromise the effectiveness of the position limit regime.

Such an approach is consistent with some of the concerns raised by the European Parliament ECON Committee regarding this standard.

In particular, the Commission is of the view that the methodology currently proposed in the draft RTS needs to take greater account of the specificities of each type of underlying commodity. Such differentiation is necessary to take into account the distinction between different commodity derivatives where some commodity derivatives have very few participants and are illiquid, whilst others are, in contrast, very liquid. It is, therefore, justified to reflect the specific characteristics of these commodity derivatives when determining position limits, so that the proposed rules meet the objectives of preventing market abuse, supporting orderly pricing and settlement conditions and promoting the integrity of the market.

As such, it is necessary to set lower limits for contracts which attract high levels of liquidity and which may directly affect consumers in terms of food prices. Conversely, the limit regime needs to provide for higher limits in cases where commodity markets work on the basis of very few market participants, with market-maker models that can be subject to very high peaks of demand and supply due to production and transportation models.

In addition, the choice of the open interest as a parameter to calculate the other months' position limits may in certain cases be inconsistent with the aim of establishing a harmonised position limit regime. In particular, linking other months' limits to the open interest would yield in certain cases considerably higher limits, notably when trading in the commodity derivative, and hence the open interest, increases. In order to correct this problem, it is necessary to check the relationship of the open interest and deliverable supply for each contract. Where the open interest is considerably higher than the deliverable supply, the limits should be adjusted downwards, which is consistent with the objective to achieve orderly pricing and settlements and to reduce risks to market integrity.

Finally, the narrow definition of EEOTC proposed could allow for easy circumvention of the regime using OTC contracts, which would have similar economic exposures, by simply changing a minor parameter of the exchange traded contract. This result hinders the objective pursued by the position limits' mechanism devised in Article 57 with respect to commodity derivatives.

The Commission considers that, in order for the draft RTS submitted by ESMA to take full account of the objective of, and the mandate contained in, Article 57 of Directive 2014/65/EU, the following amendments are required:

- *Sensitivity to different types of underlying commodities:* Very liquid and highly traded agricultural commodities should attract lower limits for both the spot and other months' limits because of their high volatility and their impact on the real economy. ESMA should, if appropriate, lower the baseline for these contracts or adjust the minimal limit range, taking into account the specific characteristics of those underlying commodities. In parallel, ESMA should provide contracts with few market participants, with low levels of liquidity or subject to sudden peaks in supply and

demand due to structural production and delivery factors, with higher maximum limit ranges.

Other month limits: The RTS should be adjusted so that other month's limits are not skewed by the choice of the open interest as a parameter for setting the limits. The RTS should adjust the other months' limits where there is a large discrepancy between the open interest and deliverable supply. A large discrepancy would occur when the open interest is significantly higher than the deliverable supply; in such cases, the limits should be set lower. Conversely when the open interest is significantly smaller than the deliverable supply, a higher limit should apply.

The degree of adjustment of the position limit should reflect the size of the discrepancy, considering the cumulative impact of other factors that may be relevant to setting the final limit.

- Economically Equivalent OTC (EEOTC) Contracts: The definition of EEOTC contracts should be altered so that contracts which yield similar economic exposure for position holders whilst not necessarily identical in contractual terms are considered in scope of the limit regime. In particular, ESMA should consider whether variations in lot sizes, delivery dates, locations or any remaining terms change the economic exposure of the position.
- Applicability of the methodology: The resulting methodology should provide, as appropriate, competent authorities with a sufficient degree of certainty with respect to the application of the relevant factors in order to ensure uniform limits regime across the Union based on objective criteria.

I therefore inform you that the Commission, acting in accordance with the procedure set out in the fifth and sixth subparagraphs of Article 10(1) of Regulation (EU) No 1095/2010, intends to endorse the draft regulatory technical standard submitted by ESMA for the application of position limits to commodity derivatives pursuant to Article 57(3) and (12) of Directive 2014/65/EU (MiFID II) once the above mentioned concerns are adequately taken into account and the necessary modifications are made.

I am very grateful for the work that has been undertaken by ESMA and its members to deliver the MiFID II level II package of measures. This is a substantial package that has been delivered professionally and to a high standard. The standards that have been submitted, if endorsed by the co-legislators, will contribute to better functioning markets in the EU with a high level of investor protection.

Yours sincerely,



Olivier Guersent