ESMA Consultation paper on position limits and position management

A Eurelectric response paper

January 2020

Eurelectric represents the interests of the electricity industry in Europe. Our work covers all major issues affecting our sector. Our members represent the electricity industry in over 30 European countries.

We cover the entire industry from electricity generation and markets to distribution networks and customer issues. We also have affiliates active on several other continents and business associates from a wide variety of sectors with a direct interest in the electricity industry.

We stand for

The vision of the European power sector is to enable and sustain:

- A vibrant competitive European economy, reliably powered by clean, carbon-neutral energy
- A smart, energy efficient and truly sustainable society for all citizens of Europe

We are committed to lead a cost-effective energy transition by:

investing in clean power generation and transition-enabling solutions, to reduce emissions and actively pursue efforts to become carbon-neutral well before mid-century, taking into account different starting points and commercial availability of key transition technologies;

transforming the energy system to make it more responsive, resilient and efficient. This includes increased use of renewable energy, digitalisation, demand side response and reinforcement of grids so they can function as platforms and enablers for customers, cities and communities;

accelerating the energy transition in other economic sectors by offering competitive electricity as a transformation tool for transport, heating and industry;

embedding sustainability in all parts of our value chain and take measures to support the transformation of existing assets towards a zero carbon society;

innovating to discover the cutting-edge business models and develop the breakthrough technologies that are indispensable to allow our industry to lead this transition.

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WG Financial Regulation

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Consultation Paper: https://www.esma.europa.eu/sites/default/files/library/esma70-156-1484_cp_position_limits.pdf

Deadline to provide feedback: 8th January 2020

Preliminary remarks

Eurelectric welcomes ESMA's proposals to improve the current MIFID Position Limit Regime (hereafter "PL Regime"). Commodity derivatives are important instruments for Eurelectric's members to hedge their physical operations/activities. Consequently**, we agree that any PL Regime should restrict hedging needs nor hamper the development of new, illiquid and less liquid contracts.**

The PL Regime has been working reasonably properly for well-developed and liquid contracts. Eurelectric agrees that reducing their scope to a limited set of significant or critical contracts (as proposed by ESMA under section 5.2.2 of the consultation paper) would resolve the headline issues identified by ESMA and market participants. A revised scope would also ensure a level playing field between EU and US market participants as it would align the MIFID's PL Regime better with the approach of the US Commodity Futures Trading Commission (CFTC). Hence, **Eurelectric agrees that this option is the best approach to render the PL regime more fit for purpose.**

As a second best option, Eurelectric would support a more staggered improvement of the PL Regime whilst dealing with the main issues identified in the current consultation paper. Reviewing the overall scope of the PL Regime should only come in a second phase.

Finally, **we believe that the outcome of regulatory review should result in changes which are simple and streamlined compared to the existing regime.** More specifically, digital and IT changes must not render the high expenditure incurred for compliance with the initial regime obsolete nor require inordinate amounts of additional resources.

Part I

Q 1: Which option (Option 1 or Option 2) do you support for dealing with competing contracts? Please explain why. If you support Option 1, do you have any suggestions for amending the definition of "same contract" in Article 5(1) of RTS 21? If you support another alternative, please explain which one and why.

Eurelectric appreciates the attention ESMA is paying to the **possible adverse effects that position limits may have on the development of liquidity on trading venues** facing the competition of other trading venues in the same or similar commodity derivatives contracts. We also recognise the fact that **the definition of "same commodity derivatives" is currently too narrow,** as demonstrated by the inexistence of such derivative contracts today.

Concerning ESMA's proposals, we see both advantages and drawbacks attached to them. On the one hand, Option 1 would provide an updated and clear definition of the "same contract". On the other hand, it includes the risk of capturing under the same limit contracts which do not share precisely the same characteristics.

Therefore, Eurelectric supports Option 2 proposed by ESMA, i.e deletion of the "same contract" procedure. Subsequently, authority should be granted to the National Competent Authorities ("NCAs") to assess whether commodity derivatives traded on their respective trading venues are based on the same underlying and share same characteristics. Under such approach, the limits remain separate and continue to be set by the respective NCAs. This is a simpler alternative to implement and monitor rather than the establishing and monitoring a joint limit by the respective NCAs.

Requiring from the NCA in charge of the less liquid trading venue(s) to set the other months' limit at 25% of the open interest based on the most liquid market will be an effective mechanism. Indeed, it could promote a level playing field between trading venues, enhance the development of the less liquid trading venue whilst still allowing the NCA to adjust the limit based on the characteristics and other relevant factors for its market. It will also provide adequate choice of trading venues for market participants.

Q 2: Do you agree that the C(6) carve-out creates an unlevel playing field across trading venues and should be reconsidered? If not, please explain why.

Open, robust, liquid, competitive and transparent energy markets are key to ensure a secure, sustainable and competitive energy supply to the real economy and end-consumers. Eurelectric strongly disagrees with both ESMA's findings and the conclusion stating that the so-called C(6) carve-out creates an unlevel playing field across trading venues and has led to a shift of trading volumes towards OTFs. Such conclusion not only ignores the fundamental and structural differences between financial markets and physical energy markets, but is also not supported by data-driven evidence. To the contrary, publicly available data demonstrate the opposite. **Therefore, Eurelectric strongly opposes a reconsideration of the C(6) carve-out.**

Firstly, there are substantial structural differences between the Energy Sector and the Financial Sector which are not considered by ESMA. Whereas in the financial sector systemic risk (as manifested in the financial crisis) is present, the energy sector poses no systemic risk to the financial market. Wholesale energy trading happens between trading professionals and aims at managing physical supply and demand between professional counterparties which are inherently different from retails investors in the traditional financial sector for whom investor protection is needed. In that vein, the transparency requirements differ significantly between the two industries, e.g the energy sector is already exposed to specific sector regulation such as REMIT. Moreover, the differences between the financial sector and the energy sector materialise even more, when it comes to the overall trading approach and objective.

Secondly, the C(6) carve-out has been a well-considered exemption by EU stakeholders and sufficient safeguards are built to only capture physically-delivered wholesale energy transactions (gas and power only). The removal of the C(6) carve-out would render the REMIT regulation almost redundant. Pursuant to REMIT, the C(6) carve-out contracts are supervised under a tailored regime through a specialised authority, which ensures the well-functioning of the gas and power energy markets. Moreover, there is no substantiated evidence that physical gas and power contracts pose a threat to the well-functioning of the financial market. The deletion of the REMIT carve-out would jeopardises the political aim of the Third Energy Package and the attained successes of the internal European energy market to the detriment of energy consumers and the real economy. It will lead not only to a significant increase in costs for market participants, but also to a loss of competitiveness of EU energy markets and severe impacts on wholesale energy market functioning and market participation.

Thirdly, MiFID II did not cause liquidity to move away from regulated markets. Contrary to ESMA's analysis (page 23 – recital 88), the data, which is publicly available1, indicates that since the implementation of MiFID II, the market share of exchange executed transactions in gas and power has increased. By introducing OTFs, MiFID II just provided formalisation of the previously (MIFID I) non-MTF broker platforms. The physical gas and power products have been out of scope of

[1] https://www.trayport.com/category/market-dynamics-report/

financial regulation since MiFID I, because they were traded on non-MiFID I regulated broker platforms (so-called non-MTF brokers). It is therefore, factually wrong to state that trading in physically settled wholesale energy contracts shifted from MiFID regulated platforms to OTFs.

Finally, ESMA's conclusions are based on an ill stated conception of the objectives of MiFID II. At page 23 of the consultation paper, ESMA states in Recital 91: "ESMA first notes that the creation of the OTF category aimed at making the EU financial markets more transparent and efficient and at levelling the playing field between various venues offering multilateral trading services (8)." The footnote (8) refers to Recital (8) of MiFID II, which says: "It is appropriate to include in the list of financial instruments commodity derivatives and others which are constituted and traded in such a manner as to give rise to regulatory issues comparable to traditional financial instruments." We cannot derive from the text any responsibility for ESMA to impose the same regulatory burden to all trading venues. "Regulatory issues" do certainly not include influencing the competition among trading venues by extending financial market regulation to physical commodity markets. The introduction of OTFs adequately addressed regulatory arbitrage[2]. Regulated markets have advantages over bilateral physical markets (e.g. credit risk mitigation, anonymous trading) which can justify higher transaction costs (fees, margins, regulatory obligations) compared to bilateral trading. It is not ESMA's role to shift the trading volumes to the market segments it understands best or which are under its supervision thereby introducing unjustified regulatory burden on the real economy.

Please note that Eurelectric co-signed the JEAG Joint Paper on ESMA Consultation Paper on position limits and position management published on 19/12/2019 and accessible via the following link:

https://cdn.eurelectric.org/media/4142/jeag_response_mifid_ii_cp_remit_191220219_final_clean-2019-030-0761-01-e-h-3B13975A.pdf

The position on the REMIT Carve-Out is detailed in this Joint paper.

Q 3: Do you agree that the position limit framework should not apply to securitised derivatives? If not, please explain why.

<NA>

Q 4: Which option do you support to address the negative impact of position limits on new and illiquid commodity derivatives: Option 1 or Option 2? Please explain why. If you support another alternative, please explain which one and why.

As per our introductory remarks, Eurelectric supports Option 1, e.g. to reduce the scope of the PL Regime to a more limited set of significant or critical contracts where PL would provide most benefits. This will reduce uncertainty and the complexity currently occurring in commodify derivatives markets.

As regards Option 2, an increase of limits on illiquid contracts to 50% of the reference amount would represent a slight improvement of the current situation but by no means a guarantee that the difficulties with new and illiquid will be overcome.

Q 5: If you support Option 1 and would suggest different or additional criteria to determine whether a contract qualifies as a critical contract, please explain which ones.

We agree with the criteria listed by ESMA to determine whether a contract would qualify as "critical." A combination of quantitative (e.g. open interest) and qualitative (e.g. type of market

[2] Recital (10) of MiFID II

participants) criteria is the preferable approach. We would expect ESMA to determine such criteria and/or contracts following a dedicated consultation with trading venues and market participants.

Q 6: Which open interest and participant threshold would you suggest for qualifying a commodity derivative as a critical one?

<NA>

Q 7: Would you support a position limit exemption for financial counterparties under mandatory liquidity provision obligations? If not, please explain why.

Yes, we would support a position limit exemption for financial counterparties under mandatory liquidity provision obligations. For consistency reasons, the exemption should mirror the liquidity provision exemption as stipulated under the "privileged transactions" for the Ancillary Activity Exemption.

Additionally, it is important to emphasise that also non-financial counterparties could also be subject to mandatory liquidity obligations. Therefore, **Eurelectric supports a PL exemption for the mandatory liquidity provision obligation for both financial and non-financial counterparties as there is no legitimate reason to limit the scope of such exemption to financial counterparties only.**

Q 8: Would you support introducing a hedging exemption for financial counterparties along the lines described above? If not, please explain why.

Yes, Eurelectric fully supports the introduction of a hedging exemption in the circumstances mentioned by ESMA in respect of financial counterparties belonging to a predominantly commercial group. These investment firms do act as a market facing entity for their industrial group and hence intragroup hedges should not count against that investment firms own position limits even in dealing in own account.

In respect of the hedging exemption, we urge ESMA to also promote greater harmonization in the implementation of, and application for the PL hedging exemption across the EU. Some NRAs impose quantitative limits to the hedging exemption, causing unnecessary administrative burden, as a new application should be filed if firms face a larger hedging need due to increased power production. Therefore, we believe that firms should be granted a hedging exemption without the imposition of a quantitative limit to this exemption and that such approach should be harmonised amongst NRAs. Quantitative limits create unnecessary administrative burden. The robustness of the regime and the supervisory capabilities of NCAs would be unaffected as NCAs can monitor the use of the exemption on the basis of the daily position reports.

Q 9: Do you agree with ESMA's proposals to amend Article 57(8)(b) of MiFID II and to introduce Level 2 measures on position management controls? If not, please explain why.

Trading venues already have functioning position management controls in place and Eurelectric believes that the task of determining how to implement and initiate tailor-made position management controls is appropriately placed at the trading venues. **Hence, Eurelectric does not see a need for requiring Level 1 changes.**

Part II

Q 10: Do you agree with the revised proposed minimum threshold level for the open interest criterion for the publication of weekly position reports? If not, please state your preferred alternative for the definition of this threshold and explain why.

<NA>

Q 11: Do you have any comment on the current number of position holders required for the publication of weekly position reports?

Eurelectric suggests to assess how burdensome the change in the minimum threshold will be on the industry.

Eurelectric pursues in all its activities the application of the following sustainable development values:

Economic Development

- Growth, added-value, efficiency

Environmental Leadership

- Commitment, innovation, pro-activeness

Social Responsibility

- Transparency, ethics, accountability

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