EURONEXT

MEMO

MiFID Refit – Euronext Position on Commodity markets

MiFID II Objectives

The overall objective of MiFID II / MiFIR, based on the 2009 G20 Pittsburgh Summit recommendations, was to '*improve the functioning and transparency of financial and commodity markets and address excessive commodity price volatility*.' In Europe, this objective has been implemented via two separate provisions: the **position limits regime** to improve '*the functioning and transparency*' of commodity markets and **appropriate position monitoring and market oversight practices** for trading venues to '*address excessive commodity price volatility*'.

Euronext welcomes the Commission's review of the MiFID II / MiFIR framework and proposals to amend the existing position limits and position management regimes. We share the Commission's assessment that the rules on pre-trade transparency and position limits should be recalibrated, with a view to fostering more trading of commodity derivatives denominated in euros, the emergence of new nascent commodity contracts and a shift of over the counter (OTC) trading to "on-venue" electronic trading.

We believe that **the current MiFID II framework has so far been successful** in improving the functioning and transparency of commodity markets and addressing excessive commodity price volatility. The position limit framework and pre-trade transparency regime has provided added value to commodities markets, in particular **with respect to our benchmark contracts** (i.e. Milling Wheat, Rapeseed and Corn). It has also facilitated a shift of transactions on trading venues from OTC markets.

Although the new regime brought benefits to existing commodity contracts, when it comes to the development of new products and the further growth of existing illiquid commodity derivative markets, we believe there would be merit in amending the current position limit regime to facilitate the **emergence of nascent commodity contracts.**

Included below is a summary of the Euronext position on the commodity markets section of the Commission's MiFID II/MiFIR consultation, focusing on pre-trade transparency, position limit recalibration and critical contracts.

Pre-trade transparency regime

In our view, the pre-trade transparency regime for commodity markets has demonstrated value by requiring OTC reporting. More generally, the formalisation of pre-negotiated transactions on a trading venue with clearing mitigates counterparty risk and helps promote and foster EU commodity markets. However, we believe the regime could be better tailored to commodity derivatives, thereby allowing for greater levels of trading on lit exchanges and central clearing. Therefore, we welcome ESMA's parallel review of the current design of the pre-trade transparency regime to commodity derivatives contracts at both Level 1 and Level 2.

Recalibrating the position limits regime for new nascent and illiquid contracts

The MiFID II position limits regime functions well for our benchmark contracts (i.e. Milling Wheat, Rapeseed and Corn). These contracts are characterised by a large number of different types of active trading firms and an overall substantial amount of open interest. However, Euronext believes there would be merit in amending the current position limit regime to facilitate the **emergence of nascent commodity**

contracts. Given that the market considers an 'illiquid' open interest contract as composed of at least 25,000 lots on average, we believe the limit under the available derogation from applying the regime - 2,500 lots - should be raised to 300,000 lots across all sectors.

It is important that the position limits regime, whilst improving transparency, should not adversely act as a barrier to the functioning of the financial and commodity markets. Nascent commodity contracts should be able to develop in all sectors, with a regime that incentivises the creation and proper functioning of new contracts. Not only would this meet participants' demand for adequate pricing risk coverage across the sector's value-chain, but recalibrating the regime would also allow for the creation of euro-denominated futures contracts, which could then mature into global benchmarks contracts in the future.

This has certainly been the case for the agricultural sector. For example, in under 22 years since its creation, the Euronext Milling Wheat contract has become a global proxy for the global wheat futures market. With the addition of Rapeseed and Corn contracts, Euronext euro-denominated benchmarks futures contracts are now used extensively as price discovery and risk management tools by agricultural producers, exporters, trader-houses, refiners, wholesalers and manufacturers, enabling support to the real economy.

If the position limits regime were to be adjusted to better cater to the emergence of new nascent agricultural commodities contracts, European agricultural stakeholders would not only benefit from a higher level of price discovery and transparency of the relevant markets, but the EU would also gain a bigger share in futures trading in that sector internationally, in line with its Capital Markets Union and Banking Union objectives. New futures contracts would inevitably be developed to become euro-denominated benchmark contracts in fast growing markets for the benefit of the EU agricultural trading sector. The development of a euro-denominated agricultural futures market goes hand-in-hand with a strong role of the euro in international trade.

Noting that these issues do not arise in respect of highly liquid benchmark contracts, Euronext would recommend **limiting the scope of the position limit regime** to such contracts only. As opposed to nascent contracts, these types of contracts are characterised by high levels of open interest and normally do not require more urgent updates to their classification or position limits.

Creation of critical contracts

In our view, the focus of the position limit regime should be on ensuring **effective price formation process in the underlying commodities market**. This is important to prevent any excessive speculation which may negatively impact global retail prices. As such, the regime should focus on those contracts that are relevant in this context, specifically mature products which serve as a benchmark for their respective markets. This would focus the position limit mechanism on delivering the core policy objective and would replicate the model set by other jurisdictions, notably the US.

A possible approach to defining critical contracts could include:

- Identifying contracts which are benchmarks for the underlying products' markets, rather than determining the categorisation solely on measuring their liquidity or volatility;

- Agreeing on underlying commodity markets that are considered as important and strategic for the EU internal market. The EU 'critical' contracts should be similar to the 'core referenced futures contracts' that are identified in the US regime; and,

- Establishing that contracts should have at least 300,000 lots of open interest on average over a year to qualify as 'critical'.

Other considerations

In addition to changes to the 2,500 lots limit on new and illiquid contracts and creation of commodity 'critical contracts', Euronext supports the Commission's consideration of a **position limit exemption for a financial counterparty under mandatory liquidity provision for nascent and illiquid commodity contracts**. This exemption is needed to incentivise trading in contracts by financial or non-financial entities.

In addition, we believe that **securitised derivative**s should be excluded from the scope of the position limit and position reporting regime to ensure a more consistent approach of instruments sharing similar characteristics under MiFID II. As opposed to commodity derivative contracts, securitised derivatives based on commodities are transferable securities where the amount of open interest, and thereby the size of a position, is potentially unlimited. Moreover, the notion of spot month and other months is not applicable to securitised derivatives. The concept of open interest is also not well suited to those instruments.

Last but not least, Euronext strongly recommends excluding **cash-settled derivatives** on broad-based indices composed of commodities related items from the regime. These products have been wrongly captured by the position limits regime. With the policy objective to avoid market abuse and ensure orderly pricing and settlement in the commodities derivatives market, cash-settled derivatives should be under trading venues' appropriate position monitoring and market oversight practices.

While the position limits regime includes **exemptions for market participants pursuing hedging activity**, the MiFID II definition of hedging as set out in RTS 20 is clear that only non-financial entities can engage in such activity. It is therefore not applicable to investment banks nor commodity trading houses which play, nonetheless, a vital role in providing smaller commercial players with access to commodity derivatives markets. Therefore, we support the Commission's proposal to change the hedging exemption definition to include "*financial counterparties belonging to a predominantly commercial group that hedges positions held by a non-financial entity belonging to the same group*".

We believe a compliance system, inclusive of financial counterparties, could be operated by financial regulators across the EU, all the more given the amount of information they receive about the activities of such entities. Based on our experience with operating an internal position management system based on hedging exemptions, hedging intentions can be adequately documented and demonstrated. This ensures that genuine hedging activity is not restricted and allows commodity market participants to manage their risks efficiently.