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ESMA Reports on Commodity Derivatives Markets

A recent report from ESMA, the European Securities and Markets Authority, highlights the dramatic impact of Brexit on commodity derivatives markets and that a greater number of commodity market participants will potentially have to be authorised (as investment firms) unless the European Commission amends MiFID II at the earliest opportunity.

ESMA's report also provides an insight into the views of ESMA, other authorities and a range of market participants on the impact of MiFID II on commodity derivatives markets. As such it will be of interest to those involved in the trading of commodity derivatives on UK/EU exchanges such as ICE Futures Europe and/or European OTC trading, as well as related regulatory compliance.

The report's focus is the position limits and position management powers which have been in force under MiFID II since January 2018. It follows a call for evidence and consultation process commenced by ESMA in May 2019. Stakeholders that took part included a number of users of commodity derivatives as well as industry associations, market operators and national regulatory and enforcement bodies.

Position limits restrict the maximum size of a position that can be held in a specific derivative contract. The FCA has set position limits on over 350 commodities contracts traded either on ICE Futures Europe or on the LME. Position management is the requirement that operators of trading venues such as ICE Futures Europe and the LME apply controls which enable them to carry out market supervision.

Notable points from the report include the following:

- Brexit has changed the landscape of EU commodity derivative trading. In relation to oil for example, in 2019 the total volume of exchange traded contracts in the UK was in the region of 25 trillion Euros with none in the remaining EU27. Oil, coal and metals are no longer traded on EU venues at all as a result of Brexit, and other asset classes such as emissions allowances are traded only marginally.
- This change in landscape means that the market size calculation (an element of the MiFID II ancillary activity test which exempts commodity derivatives market participants from financial services authorisation) should be reviewed and amended by the European Commission at the earliest opportunity, otherwise greater numbers of market participants are likely to need to be authorised.
- Most stakeholders regard position limits to be of little use in preventing market abuse. ESMA's view however is that position limits are important tools in preventing potential market abuse in the specific form of abuse of a dominant position (i.e. market "squeezes" or "cornering").
- There is no evidence of a shift from exchange-traded to OTC (over the counter) derivatives in order to avoid MiFID II position limits.
- The "C(6) carve out" (which exempts physically settled gas and power contracts on certain trading venues from MiFID II) is not seen to be creating an uneven regulatory playing field between trading venues offering commodity derivative contracts.
- MiFID II should be amended to make clear that position management controls include the power for the operator of a trading venue to require information from market participants about positions they hold not just on a the venue itself but also on other trading venues and in OTC contracts.

The report is provided to the European Commission and is expected to feed into its review of the impact of MiFID II in commodity derivatives markets and related legislative changes.

If you would like further information on MiFID II, market abuse or any other aspect of regulation affecting commodity derivatives trading then please contact David Brown.

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