MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

Via Electronic Mail

22 April 2016

Steven Maijoor
Chair, ESMA
103, rue de Grenelle
F-75007, Paris

PROPOSED AMENDMENTS TO MiFID II RTS 2 AND 21

Dear Chair Maijoor,

Managed Funds Association ("**MFA**")[1] is writing to you in connection with the comments and amendments requested by the European Commission ("**Commission**") in its letters to ESMA of 14 March 2016 relating to the MiFID II Regulatory Technical Standards ("**RTS**") published by ESMA on 28 September 2015[2]. We include in this letter certain proposals as to how we consider the Commission's requested amendments could most effectively be incorporated into the RTS, with the aim of seeking a pragmatic outcome that adheres to the spirit of proposals made both by the Commission and by the European Parliament.

MFA would like to thank ESMA for its open and collaborative approach to drafting the MiFID II RTS, which we have commented on throughout the drafting process, and we hope that the suggestions set out in this letter will prove constructive.

(A) Commodity derivative position limits

Please see below a discussion of the Commission's major proposals relating to commodity derivative position limits. We have included certain drafting suggestions for the revision of RTS 21 in an Annex to this letter.

Baseline for non-spot month limits

The Commission has proposed that the position limits framework should provide for an adjustment in non-spot month limits where there is a significant discrepancy between open interest

[1] Managed Funds Association represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organisation established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organisations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, the Americas, Australia and many other regions where MFA members are market participants.

[2] See ESMA Regulatory technical and implementing standards – Annex I, available at https://www.esma.europa.eu/policy-rules/mifid-ii-and-mifir

and deliverable supply. Specifically, the Commission notes that, when open interest is significantly higher than deliverable supply, position limits should be set lower.

As explained in detail in our response to ESMA's consultation paper on MiFID II/MiFIR dated 19 December 2014[3], we support an open interest baseline for non-spot month limits. Thus, we consider that the current drafting in RTS 21, which incorporates an open interest baseline, should be retained, since it will help to avoid unnecessarily constraining risk management activity. Nevertheless, to the extent that ESMA does go forward with incorporating the Commission's proposal into RTS 21, we would urge that the interpretation of what constitutes a "significant discrepancy" between open interest and deliverable supply is left to national competent authorities ("**NCAs**"). This would be far preferable to attempting to set the required ratio through the RTS methodology framework itself, for the reasons set out below.

1. Scope of EU position limits framework

The scope of the EU position limits framework, as set by Article 57 of MiFID II[4], is unprecedented, given that it applies across such a broad range of commodity derivative contracts. As such, the methodology set by ESMA under RTS 21 will need to be sufficiently flexible to adapt to a wide range of different contracts and market conditions. The best way of ensuring that the relationship between open interest and deliverable supply is set appropriately for each type of contract is to allow for it to be set on a case-by-case basis by NCAs, with ESMA taking steps to ensure harmonisation as appropriate. We note in this respect the conclusion of a study on commodity price volatility, prepared ahead of the G20 Paris meeting in 2011, that different commodities respond to "their own unique supply and demand dynamics".[5] Attempting to set one ratio across a range of different contracts would ignore these diverse features, and could potentially lead to significant market disruption.

2. Ability of ESMA to harmonise the regime over time

It will be open to ESMA to monitor the implementation of the position limits regime, and to ensure that NCAs take a similar approach to setting the permitted ratio between deliverable supply and open interest[6]. In that sense, allowing NCAs to consider and apply such a ratio on a case-by-case basis should not have a negative impact on harmonisation in the longer term.

3. Danger of constraining risk management activity

If ESMA were to set a ratio between open interest and deliverable supply in the draft RTS that was too low to accommodate the sizable hedging activity currently taking place in cash-settled contracts, the result could be extremely damaging to market liquidity. This would

[3] Our response can be found at: https://www.managedfunds.org/wp-content/uploads/2015/03/ESMA_CP1.pdf

[4] Directive 2014/65/EU.

[5] *Commodity Price Volatility*, Devlin, Woods and Coates, Economic Roundup Issue 1, 2011, available at: www.treasury.gov.au/PublicationsAndMedia/Publications/2011/Economic-Roundup-Issue-1/Report/Commodity-price-volatility.

[6] We note in this respect that ESMA has a mandate to monitor national implementation under Article 57(7) of MiFID II.

have a knock-on impact on the ability of end users effectively to hedge their commercial exposures. In addition, constraining the liquidity provided by trading in cash-settled contracts could reduce price transparency/discovery over time. At present, end users of commodities are able to use the information embedded in commodity derivatives prices to make better resource allocation decisions, but if the ratio contemplated by the Commission forms a constraint on liquidity, the quality of this information will decrease over time.

It is also important to bear in mind that position limits are only one tool available to EU regulators to attempt to manage volatility on the commodity markets, and that rather than being seen as a solution they should be seen as one of a combination of policy responses. Regulators should work towards the goal of promoting a well-functioning, liquid commodity derivatives market, which could (in the view of the IMF and others) "play a significant role in reducing or smoothing price fluctuations".[7]

Definition of "economically equivalent" commodity derivative contracts

In general, MFA is in favour of the definition of an "economically equivalent" OTC derivative contract that currently appears in draft RTS 21, given that in our view the reference to "identical" contractual specifications, terms and conditions to those of the exchange-traded commodity derivatives provides market certainty. However, we note that the Commission has requested that the definition be amended so that contracts which yield a "similar economic exposure for position holders" to exchange-traded contracts, but which do not necessarily have identical in contractual terms, are categorised as economically equivalent.

Whilst we support the Commission's efforts to limit circumvention of the position limits regime, we urge ESMA to ensure that as much certainty as possible is provided in relation to the scope of the regime. Otherwise, market participants will be subject to uncertainty and increased compliance costs in analysing which of their contracts may be caught by the scope of the regime. We therefore propose that ESMA should revise the wording of the draft RTS to refer to OTC commodity derivatives resulting in the "same economic exposure" (rather than referring to identical contractual specifications etc.) as exchange-traded contracts. In order to address concerns surrounding circumvention, ESMA could however consider the potential inclusion of wording prohibiting the deliberate evasion of the position limits regime[8]. If possible, MFA would prefer to see ESMA include listed examples of OTC derivative transactions which could be classed as "economically equivalent" on its online database, to avoid market uncertainty in the application of the position limits regime.

Volatility

The Commission has requested that the position limits methodology take greater account of the features of underlying commodities, and that certain agricultural commodities should in particular attract lower limits because of their high volatility. MFA acknowledges in this respect that "the volatility of the relevant markets" is a feature that the position limits

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[7] *See* OECD Policy Report on "Price Volatility in Food and Agricultural Markets", including contributions by the FAO, IFAD, IMF,OECD, UNCTAD, WFP, the World Bank, the WTO, IFPRI and the UN HLTF, available at: https://www.oecd.org/tad/agricultural-trade/48152638.pdf

[8] We note that a similar approach has been taken in relation to the MiFID II derivatives trading obligation (pursuant to draft RTS 5) and the EMIR clearing obligation (pursuant to Commission Delegated Regulation (EU) No 285/2014), both of which incorporate anti-evasion provisions.

methodology is required to take into account under the terms of Article 57 of MiFID II. The European Parliament has also confirmed that the volatility of the relevant markets should be taken into account in setting limits[9]. Notably, however, neither the Level 1 text of MiFID II nor the European Parliament referred to a need for *lower* limits to be set as a result of volatility in the markets.

Thus, whilst we acknowledge that the Level 1 text introduces a need for NCAs to take volatility into account in setting position limits, MFA does not consider that the RTS should mandate that greater volatility must necessarily result in lower position limits[10]. Indeed, imposing a lower limit on an already volatile market could result in existing market participants "racing" to close out positions, further exacerbating volatility.

(B) Non-equities transparency

In general, MFA strongly supports the application of proportionate and effective transparency requirements in the non-equities markets, particularly in relation to derivatives. In this regard, we agree with the amendments to RTS 2 proposed by the Commission. The Commission's proposal to require annual assessments of liquidity levels in all classes of bonds will in particular help to ensure that transparency has been set at the correct level and is not negatively affecting liquidity.

However, in light of the more cautious approach to bond transparency suggested by the Commission, MFA wishes to caution ESMA from applying the same standard in relation to the bond and derivatives markets. We consider in particular that the maximum post-trade transparency deferral period set by RTS 2 should not be set at the same level across both types of instrument; in particular, whilst a two day deferral period applying to illiquid or large in scale bond transactions may be appropriate for bonds, our members do not consider that the same deferral period (which may in some cases be extended as long as four weeks) is necessary in the case of cleared derivatives in particular. Indeed, deferring the publication of transparency data for cleared derivative transactions longer than necessary could be detrimental to CCP risk management and undermine the ability of market participants to accurately value their cleared portfolios and accurately calculate and/or validate initial and variation margin amounts.

We note that under the U.S. CFTC reporting regime,[11] the time delay for block trades involving a dealer is capped at 15 minutes immediately after execution (other than off-facility trades which are not subject to mandatory clearing, and which will be capped at 30 minutes after execution). In our view, such a significant disparity in the treatment of post-trade transparency for cleared derivatives runs counter to the G20 aim of promoting transparency in the derivatives markets on a cross-border basis. We therefore encourage ESMA to consider

[9] *See*:
https://europe.fia.org/sites/default/files/content_attachments/D51226_Hill_Regulatory%20technical%20standards%20under%20MiFID%20II_MiFIR%20-%20CL.PDF.

[10] *See*, for example, the IMF Working Paper "Peaks, Spikes, and Barrels: Modeling Sharp Movements in Oil Prices", which concludes that there is no clear link between "speculative" trading in commodity derivatives and volatility in oil prices.

[11] *See* CFTC's final rulemaking on "Real-Time Public Reporting of Swap Transaction Data", 77 Fed. Reg. 1182 (January 9, 2012), section 43.5(d) at 1248.

amending RTS 2 such that the maximum permitted post-trade transparency delay for cleared derivatives is 15 minutes, in line with the CFTC regime.

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MFA would be pleased to discuss the issues addressed in this letter with you. Please do not hesitate to contact Jennifer Han (JHan@managedfunds.org), Laura Harper Powell (LHarperPowell@managedfunds.org) or Stuart J. Kaswell (SKaswell@managedfunds.org), in relation to the issues raised in this letter.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell
Executive Vice President, Managing Director &
General Counsel

ANNEX

Suggested Amendments to RTS 21

Article 6

(Article 57(1) of Directive 2014/65/EU)

OTC contracts economically equivalent to commodity derivatives traded on trading venues

An OTC derivative shall be considered economically equivalent to a commodity derivative traded on a trading venue where it has the same economic outcome as ~~has identical contractual specifications, terms and conditions, excluding post trade risk management arrangements, to those of~~ that of a commodity derivative traded on a trading venue.

Article 17

(Article 57(3)(b) of Directive 2014/65/EU)

Deliverable supply in the underlying commodity

1. Where the deliverable supply in the underlying commodity can be restricted or controlled or if the level of deliverable supply is low relative to the amount required for orderly settlement competent authorities shall set the position limit at a level lower than the baseline figure. Competent authorities shall assess the extent to which this deliverable supply is used also as the deliverable supply for other commodity derivatives.

2. Competent authorities should determine whether there is a significant discrepancy in deliverable supply and open interest in each commodity derivative market, and consider whether the discrepancy is such that the baseline figure for other months position limits requires adjustment.

Article 20a

(Article 57(3)(d) of Directive 2014/65/EU)

The volatility of the relevant markets

Competent authorities shall assess whether the volatility of the relevant markets in the commodity derivative is such that the baseline figure for the position limit requires adjustment.