Policy briefing

MiFID2: set to fail on food speculation

Why the review of the Markets in Financial Instruments Directive will not fulfil its mandate

April 2013

Civil society organisations have campaigned for more than a year to curb food speculation through the review of the Markets in Financial Instruments Directive (MiFID2). The campaign has helped to improve the original text but it still contains significant loopholes. If the current text is adopted by the Council of Economic and Finance Affairs ministers (ECOFIN) and upheld in the following trialogues between the European institutions (the Commission, the Council and the Parliament), food speculation will be little affected and will continue to distort global commodity prices at the expense of citizens around the world, contributing to hunger and poverty.

One of the original objectives of MiFID2 with regards to commodities was to "reduce excessive volatility", as agreed by the G20 in 2009. In 2011, the G20 made explicit that to achieve that goal, "market regulators should have formal position management powers, including the power to set ex ante position limits as appropriate". Although the term 'speculation' is not used in the MiFID texts, the purpose of position limits is to reduce the size and detrimental impact of financial speculation on essential commodities.

The obvious way to reduce the impact of speculation on a market or to preserve part of it for specific users is to set market-wide limits on categories of participants. In many cities, a defined proportion of housing capacity is preserved for social housing. Other examples include securing part of the electricity or water market for households. The aim behind such measures is always the same: to ring-fence legitimate end-users of a market in order to protect them from the detrimental effects of speculation. Commodity derivative markets allow for easy implementation of that principle (unlike capital markets), since a clear distinction can then be made between speculators and legitimate users. Therefore a maximum proportion of speculation can be set, for example at 30%.

Position limits can also be applied by setting a limit on the number of contracts an individual trader can hold for speculative purposes. Such position limits were used on commodity markets in the US for most of the twentieth century and are currently used on exchanges in Australia, Hong Kong, Japan, South Africa and Singapore. A briefing published in 2012 by Friends of the Earth Europe, Oxfam, WEED and World Development Movement explains in more detail why position limits are necessary and why self-regulatory position management systems used without limits are inadequate. This briefing can be accessed at http://tinyurl.com/cnhfzz8.

Unfortunately, **market-wide position limits** have not been mentioned by international regulatory bodies in their recommendations to the G20, reflecting the industry view that any sort of limit (let alone market-wide) is unacceptable. To date, EU decision-makers have only debated **position limits on individual traders**, as a percentage of the market. For instance a 2.5% limit does help to prevent market abuse (the larger the position, the larger the influence on prices) but does little to curb speculation: it would still be possible to have 40 banks holding 100% of the market, affecting prices.

Yet if the limits are defined strictly, they could be a very useful first step in managing speculative behaviour – which is why the financial industry is fighting hard against the proposals. **Currently there are a number of significant loopholes in the text** (requiring around ten amendments to close) **that would prevent the new MiFID rules from effectively reducing speculation on essential commodities.**

These loopholes lead to problems in the following four main areas:

- Position limits would be **set at national (rather than European) level** – pitting member states against each other in a 'race to the bottom' to set the most generous limits and so win business for their national markets.
- Many **exemptions to the position limit** have been introduced: limits would not apply to certain types of trading (such as over-the-counter or OTC trading) or actors (the limit would only apply to individual traders and therefore fails to recognise the cumulative impact of many individual traders who group together to influence the market). Nor would limits apply to 'treasury financing activities' which include investment banks trading for their own profit and could account for significant amounts of speculation.
- **Further exemptions:** limits do not apply to all types of contract (depending on settlement modalities) at all times – allowing speculators to adapt their practices and the design of contracts to avoid the limits.
- **Transparency/reporting requirements** on positions (a prerequisite for the implementation of limits) are incomplete and irregular, which makes the implementation and monitoring of position limits ineffective.

In addition, decision makers should be aware that there is a risk that measures to tackle food speculation agreed in MiFID2 could be ruled illegal under free trade agreements such as the one being negotiated between the EU and US as they focus on measures for financial stability rather than curbing commodity price speculation and volatility.

There are currently two versions of the MiFID2 text. One was approved by the European Parliament in plenary on 26 October 2012; the second is a working draft from the Council working group which continues to convene ahead of the ECOFIN general approach, expected in May 2013.

Both versions contain loopholes, some of which appear in both documents. The table on the three following pages summarizes the key points in the current texts (MiFID2 articles 59 and 60) that should be amended in order for the Directive to have an impact on food speculation.

Necessary measures to tackle excessive speculation	Conditions required to achieve objectives	Status	What is in the Council/Parliament text	Why is it necessary to go (much) further
EU-wide limits	**1.** Position limits must be established and applied at EU level	✖	Every member state (MS) would establish and apply position limits in a commodity derivative on the various actors in the national market. This means that a particular MS (e.g. the UK) could set limits at a level that did not effectively restrict trading. It would also meant that there would be no aggregated limit at the EU level, meaning a bank active in many MS could hold an very large position at EU level (comprising the maximum amount allowed by each MS) while still remaining within national position limits. Most financial institutions with a large presence in commodity trading are indeed active via branches or subsidiaries in many MS.	Positions limits that are established and applied with national discretion will lead to weak and inconsistent limits, and therefore continue to allow dangerous distortions within the hedging function and the quality of price formation mechanisms in these markets within the EU. The lack of effective position limits at EU level will make MiFID2 totally ineffective when trading activities are performed on more than one exchange. The reality is that trading activities are mostly performed cross-border, within the EU and outside the EU.
No exemption on type of trading, contract or actor	**2.** Position limits must apply to over-the-counter (OTC) transactions (those contracts made bilaterally rather than traded transparently on an exchange)	✖	Position limits would only apply to transactions executed on an exchange: OTC transactions would be exempted from the rule.	Currently, many commodity derivatives contracts are traded on exchanges because they are standardized, and can therefore be traded in large volumes by many different players. However, if limits only apply to these contracts, it would be easy to add a few 'fake' features to them so that they become 'non-standard' and can therefore be traded outside an exchange and labelled OTC. It is therefore important that position limits apply to all types of contracts, including OTC. By contrast, the current Commission proposal for a Financial Transaction Tax will apply to all transactions, whether carried out on an exchange or OTC.
	3. Position limits must apply to any activity that is not directly protecting a trader from adverse price fluctuations for a physical commodity that they are trading	✖	Exemptions from position limits would apply to positions that can be proved to cover the risk of real commercial activity (for example, a soy bean producer enters a future contract to sell their produce at a certain price at a future date in order to secure their future income), and to 'treasury financing activities' of any company, including financial institutions.	The exemption for 'treasury financing activities' is not acceptable because it would allow speculators to access these markets without trading in the actual physical commodity. Treasury financing activities could cover all types of trading by a corporation or a bank, including pure proprietary speculation. The mention of treasury financing activities simply needs to be removed from the text. Only positions related to exposure to the physical market should be exempted upon demonstration of such exposure.

Necessary measures to tackle excessive speculation	Conditions required to achieve objectives	Status	What is in the Council/Parliament text	Why is it necessary to go (much) further
No exemption on type of trading, contract or actor (continued)	**4.** Position limits must apply to all types of contracts at all times	✖	The current text would allow for: a) different position limits for contracts that are: • cash settled, where the commodity is never physically transferred to the buyer but cash is exchanged at expiry to cover the cost of the physical commodity; and • physically settled, where the commodity is physically delivered to the buyer at the expiry date in accordance with the contract; Proposing weaker or no limits for cash settled contracts would encourage speculators to use cash settled contracts to increase the amount of speculation they can undertake. b) no limits to apply to contracts until they are close to their expiry date.	a) Giving an advantage to cash-settled contracts will lead to more speculative volume in cash-settled markets, where trades are more likely to have a betting intention than to cover real economic risks. Indeed, one way to ensure that derivatives in commodities are used mainly to hedge economic risk is to favour physical delivery – the delivery of tons of soy beans may deter speculators who are, by definition, unable to handle such deliveries. b) Limits applied only to the end of the contract allow high levels of speculation via contracts that are not close to their expiry date. This can still have an impact on the underlying market. Contracts can include automatic renewal near its expiry date (known as a roll-over clause), or any other structuring features, thus allowing speculators to avoid the limits.
	5. Position limits must apply to the entire position taken by a trader, independently of their trading strategy	✖	The current text would apply position limits only to the 'net' position held by a trader, not to their aggregate open positions. If a trader bought a large number of contracts in a specific commodity but also sold the same amount of contracts in the same commodity, their net position for the purpose of applying the limit would be zero because the buy and sell positions cancel out, even though they would have an impact on the underlying market (especially on markets where the reporting requirement of positions limits was not in real time, e.g. end of day reporting).	A trader could have a large position to buy a particular commodity, and another to sell it under slightly different terms (the type of commodity to be delivered, the settlement terms, etc.) and these would be 'netted' off against each other, potentially giving a zero net exposure for position limit purposes. For example, one contract might be to sell in 3 months while the other might be to buy the same commodity in one year. These positions might be considered able to be netted because they are in the same underlying commodity but the contracts are different and can impact prices. In addition, in markets where the reporting requirements for position limits are not in real time, such as where only end-of-day reporting applies, traders could build up and sell down large intra-day positions.

Necessary measures to tackle excessive speculation	Conditions required to achieve objectives	Status	What is in the Council/Parliament text	Why is it necessary to go (much) further
Appropriate criteria for use of limits	**6.** Ensure limits can be used for the purpose of preventing excessive speculation	✖	Limits could be used to “support liquidity” when in fact their purpose should be to reduce excessive levels of speculative trading (i.e. “positions which do not objectively reduce risks directly related to commercial activities […] and are not necessary to facilitate positions which do”). This is not mentioned in the current text.	The consequences of excessive speculation can be disastrous for end-users involved in the trade and for consumers, particularly those on low incomes, who have to bear price swings that do not relate to costs of production but to bets on rumours of price moves or unrelated factors such as changes in other financial markets. This happened in July 2010, when wheat prices increased 60% following news of drought and wildfires in Russia. Despite the fact that there was a record global harvest, speculation contributed to a price spike that distorted prices away from levels dictated by supply and demand.
Ability to prevent a group of speculators distorting prices	**7.** Group position limits	✖	If there is not a market limit (limit on the total amount of speculation allowed in the market), as a minimum, there must be limits on the positions of groups of traders (defined as “holding similar exposures that could influence the market“) because of the cumulative size of the aggregated position they hold together. Position limits will be ineffective if only applied to individual traders.	A group trader position is the cumulative position of all the traders in the group. If all the traders take the same position within the permitted limit (e.g. they all buy individually the maximum permitted amount of soy bean contracts), the aggregated position could become very significant and can influence the market, whilst remaining within the legal limit from the perspective of an individual trader. Without group position limits, there would be a risk that banks could accumulate a multiple of the position limits in the same country through subsidiaries, circumventing the position limit.
Full transparency	**8.** Transparency (reporting) on positions must be complete and automatic	✖	Reporting (and hence the ability to check limits are not being breached) would not be imposed for traders below a certain threshold and only upon request from regulators.	If a threshold applied, speculators could multiply small positions in as many markets as possible. The reporting of all activities should be systematic and regular. A report of the positions held in real time (i.e. instantaneously at any time during the day) is possible in EU commodity markets, and therefore should be mandatory. At a minimum, daily reporting would allow regulators to identify potential problems or abusive behaviour in time to prevent it from materialising.

For more information, please visit **www.makefinancework.org**
or contact Anne van Schaik **anne.vanschaik@foeeurope.org +32 (0)2 893 1020**