

Glossary

Briefing for local groups, January 2012

This glossary accompanies the local groups briefing 'Lobbying MEPs on MiFID'

Aggregate position limits - a limit on the amount of contracts which can be traded by a particular sector of participants (for example financial institutions) in a particular market.

Article - section of European legislation

Commercial end user (or commercial hedger) - a person or company that uses futures markets to manage risk from their commercial activity in buying or selling commodities. This includes farmers, food companies such as Cargill, airlines, hauliers and energy companies.

Commodity derivative - a derivative is a financial contract, the value of which is 'derived' from the price of something else, known as an 'underlying asset'. A commodity derivative therefore has a value based on its underlying commodity - for example, a wheat derivative contract has value because of the value of the wheat.

Directive - in European legislation, a directive is a piece of legislation that needs to be interpreted into national law in each of the EU member states before it takes effect. This can result in it being implemented differently in different member states.

Exchange - a public venue where market participants can buy and sell. In London stocks and shares are traded on the London Stock Exchange; some commodity derivatives are traded on Euronext Liffe exchange. An exchange acts as the intermediary between the buyer and seller of a derivatives contract. So instead of the buyer and seller interacting directly, the clearing exchange becomes the buyer to each seller, and the seller to each buyer, of a contract. The clearing entity makes the payments to each side of the deal, covering the buyer and seller from the risk of the other side defaulting. This in turn provides financial stability by insuring both parties against default. In return for being protected from default, buyers and sellers pay a fee to clearing exchanges. This protects traders from default by the other party and creates a small cost for each trade which takes place. This cost is small for real users of commodity derivatives like farmers. In fact, most farmers choose to use centralised clearing rather than over-the-counter

trading, because their whole reason for using futures contracts in the first place is to protect themselves from risk. However the fee represents a deterrent for financial speculators to buy and sell contracts exclusively as a moneymaking venture.

Hedging - when someone seeks to reduce their risk to price fluctuations. It can be done in many ways. For instance, a farmer can use futures contracts to hedge against large falls in the price of the crop they will sell in the future. They forego the benefit of any price increase, but protect themselves from a fall.

Herding - when traders act following the actions of a larger group rather than acting independently and rationally based on the information available to them.

Liquidity - The number of trading opportunities in a market, which depends on factors such as the number of willing buyers and sellers in a market at any one time. Liquidity is also affected by participants opinions about the market e.g. liquidity is reduced if traders are concerned that opportunities to buy and sell may be reduced in future.

Position - the net value of contracts a trader holds i.e. the number of contracts to buy a particular commodity minus the number of contracts to sell it.

Position limits - a limit on the amount of contracts which can be traded in a particular market. They were created by US regulators in the 1930s to prevent excessive speculation on food commodities, whilst still enabling farmers to use futures contracts to hedge their risk.

Position management - an alternative to position limits which does not involve the setting of strict clear limits on traders' positions but instead gives responsibility to exchanges for ensuring that traders or specific groups of traders don't hold an excessive share of the market. Such a system creates a significant conflict of interest as exchanges have a strong incentive not to intervene in the market as they profit from the trading volume they are responsible for controlling.

Position reporting – traders providing information about their position.

Price discovery - the process of working out how much something is worth – its 'true market value'. According to market theory this is best achieved through a large number of well informed market participants trading in a transparent market (that is where traders have clear information on what is being traded and at what prices) which is highly liquid (where a large amount of trading is taking place).

Rapporteur – the lead MEP for a piece of legislation

Regulated trading venue – this is the term used in MiFID and MiFIR to refer to different categories of trading facilities or exchanges.

Regulation – in European legislation, a regulation is binding and is applied directly to all EU member states without having to be interpreted into national law (as a directive must be).

Acronyms

ESMA - European Securities and Markets Authority, the European financial regulatory institution and supervisory authority

MiFID – Markets in Financial Instruments Directive

MiFIR – Markets in Financial Instruments Regulation

OTC – Over the counter. This refers to trading that is done privately between two financial traders rather than being done publicly (for example, on an exchange) so that the rest of the market can clearly see what is being traded at what price.