European Securities and Markets Authority

Date: 23 October 2017
ESMA70-155-2270

OPINION on position limits on London Cocoa contracts

I. Introduction and legal basis

1. On 7 August 2017, the European Securities and Markets Authority ("ESMA") received a notification from the Financial Conduct Authority (FCA) under Article 57(5) of Directive 2014/65/EU on markets in financial instruments[1] ("MiFID II") regarding the exact position limits the FCA intends to set for the London Cocoa commodity futures and options contracts in accordance with the methodology for calculation established in Commission Delegated Regulation (EU) 2017/591 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards for the application of position limits in commodity derivatives[2] ("RTS 21") and taking into account the factors referred to in Article 57(3) of MiFID II. This notification was supplemented by additional data provided on 6 October 2017.

2. ESMA's competence to deliver an opinion is based on Article 57(5) of MiFID II. In accordance with Article 44(1) of Regulation (EU) 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority)[3] ("ESMA Regulation"), the Board of Supervisors has adopted this opinion.

II. Contract classification

Commodity base product: agricultural (AGRI)

Commodity sub product: softs (SOFT)

Commodity further sub product: cocoa (CCOA)

Name of trading venue: ICE FUTURES EUROPE – AGRICULTURAL PRODUCTS DIVISION

MIC: IFLX

Venue product code: C

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[1] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (OJ L 173, 12.6.2014, p. 349).
[2] Commission Delegated Regulation (EU) 2017/591 of 1 December 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards for the application of position limits commodity derivatives (OJ L 87, 31.3.2017, p. 479).
[3] Regulation (EU) 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC (OJ L 331, 15. 12.2010, p.84).

III. Market description

3. In 2016, cocoa production was 4,031,000 tonnes according to World Bank data. West Africa is the main producer of cocoa with Cote d'Ivoire the clear leader producing around 1.5 million tonnes in 2016. Ghana is the second largest producer at 820,000 tonnes followed by Indonesia at 320,000 tonnes in 2016. The largest importers of cocoa are the Netherlands, US, Belgium and Malaysia.[4]

4. Cocoa prices were reported to be at a 3.5 year low in 2016 at an average of $2.89 per kilo (compared to $3.14 in 2015) due to production outweighing demand and an increase in health consciousness in countries such as the US and China leading to a reduction of consumption of products such as chocolate.[5]

5. Cocoa is a perishable commodity and will deteriorate if stored for significant periods of time. Cocoa trees begin to yield the pods at peak production levels by their fifth year and continue to be productive for around 10 years. This can result in lags between changes in demand and changes to the deliverable supply of cocoa. The growing season is continuous and ripe pods may be found on the trees all year round, although most production areas have two periods of the year in which production peaks. In most cocoa-growing areas, the main harvest lasts for several months with a second smaller harvest, known as the mid-crop, that lasts for several additional months. Changes in weather can dramatically affect harvest times and cause fluctuations from year to year.[6]

6. Physically settled cocoa futures contracts are traded on ICE Futures U.S., ICE Futures Europe and CME Europe. CME Europe has announced plans to close before the end of 2017, and therefore the small volume of cocoa traded on this venue will not affect the deliverable supply under MIFID II.

7. The underlying commodity of the London Cocoa Future contract qualifies as food intended for human consumption.

8. Trading in the London Cocoa Futures contract takes place in lots. One lot is equivalent to 10 metric tonnes. Delivery months are March, May, July, September and December. Ten delivery months are available for trading. At expiry, the London Cocoa Futures contract is physically settled.

9. The London Cocoa Option expiry months are March, May, July, September, and December, subject to the option expiring before the underlying future. Ten expiry months are available for trading. The exercise of options results in the assignment of future contracts at the exercise price, i.e. at the strike price.

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[4] Source: World Bank Commodity Markets Outlook, January 2017
[5] Source: World Bank Commodity Markets Outlook, January 2017 & World Bank, Pink Sheet, May 2017
[6] Source: World Cocoa Foundation, Cocoa Market Update & CTRM for Agricultural and Soft Commodities

10. The deliverable cocoa growths accepted for delivery in the contract are from a wide range of producing countries including Côte d'Ivoire, Democratic Republic of Congo, Equatorial Guinea, Ghana, Nigeria, Republic of Cameroon, Republic of Sierra Leone, Togo, at contract price. It is possible to deliver cocoa from other origins at set discounted price adjustments.

11. ICE Europe has a network of 43 warehouses for storage of bagged and bulk cocoa stock. The warehouses serve a network of eight delivery areas and ports in the EU.

12. Cocoa is typically delivered bagged in individual sacks to make up the nominal net weight of 10 tonnes in a lot. There are three delivery units: Standard (bagged net 10 tonnes), Large (bagged net 100 tonnes), and Bulk (loose net 1,000 tonnes). For bulk delivery, the nominal loose net weight delivered is 1,000 tonnes. The commodity is delivered in an Exchange Nominated Warehouse in a delivery area which is in or sufficiently close to the delivery locations of Amsterdam, Antwerp, Bremen, Hamburg, Le Havre, Liverpool, London and Rotterdam.

13. The main participants in the in the market are commercial consumers and merchants. The contract is also actively traded by institutional and short term investors. There are 142 market participants and one market maker.

IV. Proposed limit and rationale

Spot month position limit

Deliverable supply

14. Deliverable supply amounts to 241,820 lots.

15. The FCA has used the following methodology to calculate deliverable supply.

16. The deliverable supply has been estimated based on annual global production and stock figures. In 2016, cocoa production was 4,031,000 tonnes according to World Bank data. This is generally aligned with the 3 year average figure for production of 4,183,000 metric tonnes (MT) sourced from International Cocoa Organisation data for 2012/2013 – 2014/2015.

17. Cocoa has five delivery months in a year according to the contract terms and is deliverable from any origin. Therefore the production figure for 2016 is divided by the number of delivery months i.e. 4,031,000 / 5 to give 806,200 MT per expiry or 80,620 lots (10 MT per lot).

18. For any individual delivery month for cocoa, it is possible to deliver the cocoa which is currently in storage and to transport and prepare for delivery fresh production from origin countries. Therefore, the deliverable supply for that delivery period is annual global production divided by five for the number of cocoa delivery months in a year, plus the amount of available stocks, given that those stocks are available for delivery at that moment in time.

19. Global stock, obtained from the International Cocoa Organisation warehouse data forecasts for 2016/2017 (1,612,000 MT), is then added to the deliverable supply from the 2016 World Bank data production figure of 806,200 MT providing a total of 2,418,200 MT or 241,820 lots.

Spot month position limit

20. The spot month limit is 48,350 lots, i.e. 20% of deliverable supply. The spot month is the period until the expiry of the next contract to expire. It does not necessarily include a set number of days. The spot month limit applies to ICE London Cocoa futures and option contracts.

Spot month position limit rationale

21. The baseline for the spot month has been set at 20% as required by Article 9(4) of RTS 21 as this is a contract for food intended for human consumption with an open interest of more than 50,000 lots.

22. Although a commodity derivative for cocoa can also be traded on ICE Futures US, the FCA considers that there is a large amount of deliverable supply of cocoa relative to other agricultural contracts so no adjustment is needed under Article 17 of RTS 21. Less than 3% of the ICE Europe contract's deliverable supply is needed for orderly settlement to satisfy all physical demand from expired contracts, with a similar figure expected for the ICE US and CME Cocoa contracts. Therefore, the FCA considers that the physical settling of ICE US and CME contract is extremely unlikely to disrupt physical settlement of the ICE contract.

23. Although cocoa is perishable, no adjustment has been made under Article 20(2)(a) of RTS 21, as cocoa can be stored for many years without deterioration if stored correctly.

24. All other factors have been considered and are not regarded by the FCA as material or relevant to require additional adjustments, either up or down, from the baseline. In considering the volatility in the contract, as required by Article 21 of RTS21, there has been some variation in the price of the commodity derivative but the FCA has not found evidence that this is excessive or that lower position limits would reduce volatility.

25. As no adjustment was made to the baseline of 20%, this provides a figure in lots of 48,364 which has been rounded down to a figure of 48,350 lots. This equates to a final limit as a percentage of deliverable supply of 20.0%.

Other months' position limit

Open interest

26. The open interest amounts to 410,352 lots. The open interest figure has been reported by the trading venue based on publicly available data and is the daily average over a one

year period of the number of open futures and delta-adjusted options contracts which have not been closed out or expired. The reference period is 2016.

Other months limit

27. The other months' limit amounts to 102,550 of lots, i.e. 25% of open interest.

Other months limit rationale

28. The baseline for the other months has been set at 25% of open interest as required by Article 11 of RTS 21.

29. Although cocoa is perishable, no adjustment has been made under Article 20(2)(a) of RTS 21, as cocoa can be stored for many years without deterioration if stored correctly.

30. All other potential factors have been considered and are not regarded by the FCA as material or relevant to require additional adjustments, either up or down, from the baseline. In considering the volatility in the contract, as required by Article 21 of RTS 21, there has been some variation in the price of the commodity derivative but the FCA has not found evidence that this is excessive or that lower position limits would reduce volatility.

31. As no adjustments were made to the baseline of 25%, this provides a figure in lots of 102,588, which has been rounded down to a figure of 102,550 lots. This equates to a final limit as a percentage of deliverable supply of 25%.

V. ESMA's Assessment

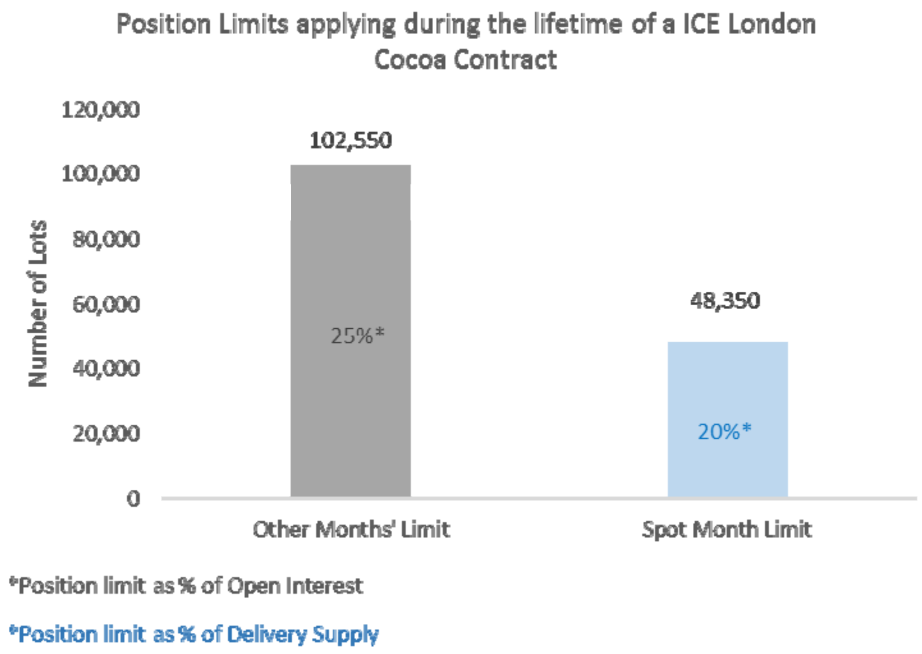
32. This Opinion concerns positions held in London Cocoa futures and options contracts.

33. ESMA has performed the assessment based on the information provided by the FCA.

34. For the purposes of this Opinion, ESMA has assessed the compatibility of the intended position limits with the objectives of Article 57(1) of MiFID II and with the methodology for calculation of position limits established in RTS 21, in accordance with Article 57(3) of MiFID II.

Compatibility with the methodology for calculation of position limits established in RTS 21 in accordance with Article 57(3) of MiFID II

35. The FCA has set a single position limit for both the whole spot month and for other months.



Spot month limit

36. The calculation of the deliverable supply is based on total production of cocoa in 2016 and on cocoa stock data for 2016/2017. ESMA notes that cocoa is a perishable commodity if not properly stored and no information is provided on the quality and characteristics of stored cocoa, nor on the average length of storage. Therefore, by including all cocoa stock data, deliverable supply is likely to be overestimated. However, ESMA also notes that there is no publicly available information that would allow assessing the correction factor to be potentially applied. Consequently, ESMA considers total production of cacao in 2019 and cocoa stock data for 2016/2017 is not an unreasonable proxy for the estimate of deliverable supply.

37. As there are five delivery months per year, the annual available deliverable supply has been divided by five. This approach is consistent with Article 10(2) of RTS 21 that sets out that “Competent authorities shall determine the deliverable supply […] by reference to the average monthly amount of the underlying commodity available for delivery over the one year period immediately preceding the determination.”

38. Compared to the baseline figure of 20% of deliverable supply for derivative contracts with an underlying that qualifies as food intended for human consumption with a total interest in spot and other months’ contract exceeding 50,000 lots, the spot position limit has not been adjusted.

39. ESMA notes that the ICE London Cocoa contract is traded on a global basis and agree that the position limits should be set alongside comparable UK global contracts, taking into

account the market characteristics of those contracts. In particular, ESMA agrees that compared to other globally traded UK commodity derivative contracts, the number of market participants (142) does not appear high and consequently does require no downward adjustment under Article 19(1) of RTS 21.

40. ESMA also highlights that, in addition to the spot month limit set by the FCA, ICE has delivery limits that apply in the period immediately prior to the expiry of the contract. Currently, ICE delivery limit for the ICE London Cocoa and Euro Cocoa contracts (in aggregate) is set at 7,500 lots and applies at the close of business on the expiry day of the delivery month. This limit of 7,500 lots will be part of the position management powers of the trading venue. ESMA notes that the ICE delivery limit is significantly lower than the spot month position limit of 48,350 lots set by the FCA for the London Cocoa contracts only. The reason for this is that the spot month limit applies to the whole of the spot month while the trading venue expiry limit applies only to the period immediately prior to the expiry of the contract. The two limits are complementary and will work together without duplication to ensure orderly trading and settlement. The FCA has decided not to duplicate the existing venue delivery limit controls where these are believed to be established and effective as the objective of the delivery limit of the trading venue is only to manage the physical delivery process and to ensure that market participants meet their delivery commitments. The spot month limit is set by the FCA at a level to support orderly pricing, and enable price discovery, as well as ensure a smooth transition of positions from the other months period to the spot month period.

Other months' limit

41. The open interest was calculated as the daily average over a one-year period of the number of open contracts which have not been closed out or expired. The period used is the calendar year 2016. ESMA considers such an approach sensible in this case as an average for a period of time gives a more stable measure of open interest and considers such approach consistent with Article 12 of RTS 21.

42. Compared to the baseline figure of 25%, the position limit has not been adjusted. as none of the adjustment factors listed in RTS 21 were regarded as relevant or material by the FCA. As for the spot month limit, ESMA notes at the ICE Cocoa contract is traded on a global basis and agree that the position limit should be set alongside comparable UK global contracts, taking into account the market characteristics of those contracts.

43. In particular, ESMA is of the view that it is reasonable not to consider that the open interest is of a large amount and not to adjust the baseline downwards based on Article 18(1) of RTS 21. Likewise, compared to other globally traded UK contracts, the amount of open interest does not appear significantly higher than deliverable supply and it appears justified not to have adjusted the other months 'position limit downward under Article 18(2) of RTS 21.

44. Consequently, these position limits have been set following the methodology established by RTS 21.

Compatibility with the objectives of Article 57(1) of MiFID II

45. ESMA has found no evidence indicating that the proposed position limits are not consistent with the objectives of preventing market abuse and supporting orderly pricing and settlement conditions established in Article 57(1) of MiFID II.

46. Overall, the position limits set for the spot month and the other months, in conjunction with the position management powers of the trading venue, appear to achieve a reasonable balance between the need to prevent market abuse and to ensure orderly pricing and orderly settlement, while also ensuring that the development of commercial activities in the underlying cocoa market and the liquidity of the ICE London Cocoa futures and options contracts are not hampered.

VI. Conclusion

47. Based on all the considerations and analysis presented above, it is ESMA's opinion that the spot month position limit does comply with the methodology established in RTS 21 and is consistent with the objectives of Article 57 of MiFID II. The other months' position limit does comply with the methodology established in RTS 21 and is consistent with the objectives of Article 57 of MiFID II.

Done at Paris, 23 October 2017

Steven Maijoor

Chair

For the Board of Supervisors