European Securities and Markets Authority

Date: 3 April 2018
ESMA70-155-4764

OPINION on position limits on UK Feed Wheat contracts

I. Introduction and legal basis

1. On 31 January 2018, 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 UK Feed Wheat Futures and Options commodity contract 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.

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: grain (GRIN)

Commodity further sub product: milling wheat (MWHT)

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

MIC: IFLX

Venue product code: T

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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. ICE Futures Europe is the only venue to trade the UK Feed Wheat contract.

4. Similarly to other agricultural products, wheat harvest is susceptible to weather and climatic variables. Prices are also affected by currency fluctuations. Prices for wheat in the UK typically follow the global supply and demand trend and this has an impact on both UK farmers and UK flour millers.

5. Feed wheat is perishable low grade wheat used in the farming industry primarily as animal feed. All wheat varieties grown in the UK must be on the National List which lists all varieties of the main agricultural species eligible for certification and marketing in the UK.[4]

6. Although the deliverable supply calculation only factors in wheat available in the UK sold for feed wheat purposes to provide a conservative figure, other wheat is available to satisfy delivery under the contract. UK wheat production is seasonal. The contract terms allow for delivery of EU wheat meeting the relevant EU requirements. In 2017/18, the EU is estimated to produce a total of around 151million tonnes of wheat.[5]

7. Trading in the ICE Feed wheat futures contract takes place in lots. One lot is equivalent to one hundred metric tonnes. Delivery months are January, March, May, July and November. Ten delivery months are available for trading. At expiry, the contract is physically settled.

8. Expiry months for the Feed Wheat options expire on the second Thursday of the calendar month immediately preceding the expiry month. The exercise of options results in the assignment of future contracts at the exercise price, i.e. at the strike price.

9. The UK Feed Wheat is physically settled by the delivery of wheat of a suitable grade at a suitable location, in accordance with the contract specification. ICE has around 44 registered grain warehouses in the UK for the receipt, short-term storage and delivery of feed wheat for the purpose of delivery under the contract. These enable market participants to make and take delivery at known points. Deliveries are in units of 100 tonnes, delivered to buyer's lorry in bulk, from a registered store in mainland Great Britain.

10. Deliverable wheat must be in good condition, and meet the technical specifications of the ICE contract. Settlement for Feed Wheat is by delivery from a delivery facility registered with the exchange onto the buyer's lorry. The competent authority is not aware of any structural restrictions on the supply of the underlying product that would justify an adjustment to the limit.

11. The number of market participants is small relative to other commodity derivative markets and to other commodity derivatives in the agricultural asset class. The market is relatively

4 Source: Nabim (National Association of British and Irish Millers).
5 Source: World Bank, commodity Markets Outlook, October 2017.

illiquid with open interest only narrowly above the 10,000 lots threshold set out in Article 15(1)(a) of RTS 21. There is also only one market maker, meaning relatively few market participants providing services that enable the functioning of the underlying commodity market, such as risk management through intermediating or acting as counterparty to commercial hedging transactions in the derivative. There are 42 market participants, predominantly cooperatives, merchants, traders, exporters and processors.

12. Ice Europe is the only venue to trade the UK Feed Wheat contract. The UK Feed Wheat futures contract is relied upon as the European benchmark for the pricing of physical feed wheat.

IV. Proposed limit and rationale

Spot month position limit

Deliverable supply

13. Deliverable supply amounts to 14,542 lots. A lot is equivalent to 100 metric tonnes (MT).

14. Deliverable supply has been calculated based on annual UK wheat production figures obtained from the UK government Department for the Environment, Food and Rural Affairs (DEFRA). As wheat is not generally stored for a significant period of time because it deteriorates, it is regarded as a prudent approach that the amount of wheat in storage has not been considered. Annual production of wheat in the UK in 2016 (which are the latest available figures) was 14,833,000 MT of which 7,271,000 was used for animal feed purposes.[6] The competent authority has taken the conservative approach of not adding wheat in storage to annual production. The FCA has also not included wheat that was sold for human consumption purposes, as although this could be substituted at delivery, it would be at a higher cost for the producer. Given that wheat can however be stored on a short term basis to smooth out production and consumption flows, the FCA considered that the most appropriate approach is to divide total annual production evenly across delivery months notwithstanding the seasonality of UK wheat production.

15. For any wheat futures delivery month, deliverable supply is calculated as annual UK production divided by five to represent the number of delivery months (January, March, May, July, November). Therefore, for each delivery month the supply amount available is 1,454,200 MT thereby providing a figure of wheat available for delivery of 14,542 lots.

Spot month position limit

16. The spot month limit is 3,600 lots, i.e. 24,8% of deliverable supply. The spot month is the period until the expiry of the next contract. It does not necessarily include a set number of

[6] Source: Defra, Agriculture in the United Kingdom 2016

days. The spot month position limit applies to the ICE Feed Wheat Futures and Options contracts.

Spot month limit rationale

17. The baseline for the spot month limit has been set at 25% of deliverable supply as required by Article 9(1) of RTS 21. UK Feed Wheat is not an underlying that qualifies as food intended for human consumption, so Article 9(4) of RTS 21 is not applicable.

18. No adjustments were considered necessary by the competent authority. Although this is a perishable commodity, no adjustment was made under Article 20(2)(d) of RTS 21 on the characteristics of the commodity as quantities of stocks have not been included in the deliverable supply and therefore do not need to be adjusted.

19. As no adjustments were made to the baseline of 25%, this provides a figure in lots of 3,636 which has been rounded down to a figure of 3,600 lots. This equates to a final limit as a percentage of deliverable supply of 24.8%.

Other months' position limit

Open interest

20. The open interest amounts to 10,177 lots. The open interest figure has been reported by the trading venue and is calculated as the daily average over a one year calendar period of 2017 of the number of open futures and delta-adjusted options contracts that have not been closed out or expired.

Other months' limit

21. The other months limit amounts to 3,750 lots, i.e. to 36.8% of open interest.

Other months' limit rationale

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

23. An upwards adjustment of 2.0 percentage points has been made to the baseline as the open interest is significantly lower than the deliverable supply (70%), when considering Article 18(3) of RTS 21.

24. The contract can have a position limit set between 5%-50% as set out in Article 19(2)(b) of RTS 21 as the number of investment firms acting as a market maker in accordance with Article 4(1)(7) of Directive 2014/65/EU in the commodity derivative at the time the position limit is set or reviewed is lower than three. Consistent with the upward flexibility provided under Article 19(2)(d) and the single market maker for the contract, and given that the analysis of market data on the composition and role of market participants (as per Article

20(2)(d) of RTS 21) also indicated commercial positions in excess of the 25% baseline, the FCA has made an additional upward adjustment of 10.0 percentage points to reflect those factors and help ensure that commercial users have access to an intermediary able to act as a counterparty to their commercial hedging transactions.

25. All other factors have been considered and are not regarded as material or relevant to require additional adjustments, either up or down, from the baseline. Although there is seasonality in UK Feed wheat production, the ability to store in the short term between one harvest and the next does not justify an adjustment under Article 20(2)(c) of RTS 21. 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 competent authority has not found evidence that this is excessive or that lower position limits would reduce volatility.

26. A total upward adjustment was made of 12.0 percentage points resulting in an adjusted baseline of 37%. This provides a figure in lots of 3,765 which has been rounded down to a figure of 3,750 lots. This equates to a final limit as a percentage of open interest of 36.8%.

V. ESMA's Assessment

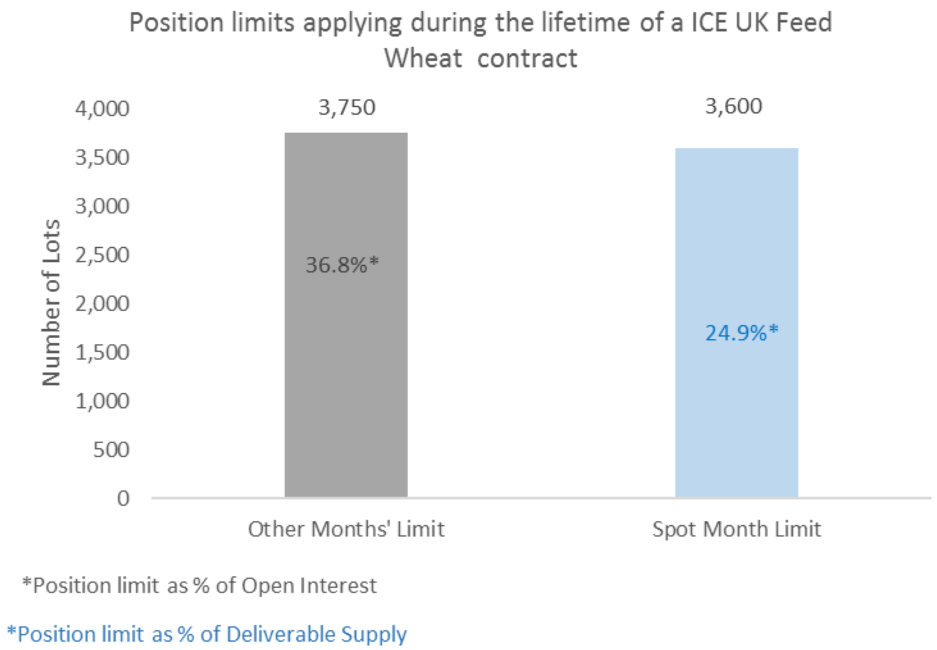
27. This Opinion concerns positions held in UK Feed Wheat Futures and Options contracts.

28. ESMA has performed the assessment based on the information provided by the competent authority.

29. 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

30. The FCA has set two position limits: one for the entire spot month, and one for the other months.



Spot month limit

31. The calculation of the deliverable supply is based on UK feed wheat production data for 2016 as provided by the UK government department for the environment, food and rural affairs. Although UK wheat for human consumption could potentially be delivered as a substitute, the FCA did not include UK wheat production for human consumption in the calculation of deliverable supply as such option appears unlikely due to the higher cost for the producer. ESMA considers this approach as reasonable.

32. 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, which 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”.

33. Compared to the baseline figure of 25% of deliverable supply applicable to derivative contracts where the underlying does not qualify as food intended for human consumption, the position limit has not been adjusted.

34. In particular, the spot month limit has not been adjusted downwards to take into account the perishability of feed wheat as foreseen in Article 20(2)(a) of RTS 21 as perishability would most likely had affected UK feed wheat stocks, which are not included in the calculation of deliverable supply. In these circumstances, ESMA considers that it is as a reasonable approach not to have adjusted the spot month limit downwards under this provision of RTS 21.

35. ESMA highlights that, in addition to the spot month limit set by the competent authority, ICE has delivery limits that apply in the period immediately prior to the expiry of the contract. Currently, the ICE delivery limit for the ICE Feed Wheat contracts (in aggregate) is set at 2,000 lots and applies at the close of business on the expiry day of the first notice day.

36. This limit of 2,000 lots will be part of the position management powers of the trading venue. ESMA notes that the ICE delivery limit is lower than the spot month position limit of 3,600 lots set by the competent authority.

37. As it results from the information provided by the competent authority, the reason for this discrepancy 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.

38. It was considered unnecessary 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.

Other months' limit

39. The open interest was calculated as the daily average over a one-year period of the number of open contracts that have not been closed out or expired. The period used is the calendar year 2017. 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.

40. The other months' limit has been adjusted upwards to take into consideration the fact that the amount of open interest is slightly lower than deliverable supply. This is consistent with Article 18(3) of RTS 21.

41. The other month's limit has also been adjusted upwards to cater for the significant positions held by underlying market participants in the relatively low liquidity UK Feed Wheat contract and help ensure that commercial users do have an intermediary able to act as a counterparty to their commercial hedging transactions. This upward adjustment appears consistent with Article 19(2) of RTS 21 as the number of market makers is lower than three and with Article 20(2)(d) of RTS 21.

42. As the result of the upward adjustments made to the baseline, the other months' limit is set at 37.6% of open interest, which is consistent with the range set out in Article 192)(b) of RTS 21 for contracts with less than three market makers.

43. Overall, these position limits have been set following the methodology established by RTS 21.

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

44. Under Article 57(1) of MiFID II, the objectives of the position limits are to prevent market abuse and support orderly pricing and settlement conditions including preventing market distorting positions.

45. The significant difference between deliverable supply and a lower amount of open interest has been adequately taken into account to increase the other months' limit from the baseline as this imbalance reflects the rather low level of liquidity of the UK Feed Wheat contract. The upward adjustment of the other months' limit will also contribute to orderly pricing by allowing market participants to provide liquidity and act as counterparties to commercial users seeking to hedge their substantial positions in the underlying market.

46. With respect to the spot month limit, ESMA notes, based on the information provided by the competent authority, that the limit is higher than open interest in the spot month throughout 2017.

47. ESMA understands the need to avoid the risk of unduly constraining trading in this relatively less liquid commodity derivative market where underlying market participants have a key presence. However, there is a risk that the objectives set out in Article 57(1) of MiFID II may not be achieved where the spot month limit set for the spot month is well above the positions held by market participants

48. In light of the assessment above, ESMA considers that the position limit set for the spot month and the other months, in conjunction with the position management powers of the trading venue, overall appear to achieve a reasonable balance between the need to prevent market abuse and to ensure an orderly market and orderly settlement while ensuring that the development of commercial activities in the underlying feed wheat market and the liquidity of the ICE Feed Wheat futures and options contracts are not hampered

49. However, to help ensure that the risk of not achieving the objectives set out in Article 57(1) of MiFID II does not materialise, ESMA considers that trading patterns in the UK feed wheat should be carefully monitored by the competent authority in particular during the spot month, and that the spot month limit should be reviewed on a timely basis.

VI. Conclusion

50. Based on all the considerations and analysis presented above, it is ESMA's opinion that this 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, 3 April 2018

Steven Maijoor

Chair

For the Board of Supervisors