

## OPINION on position limits on ALUMINIUM contracts

### I. Introduction and legal basis

1. On 4 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<sup>1</sup> (“MiFID II”) regarding the exact position limits the FCA intends to set for the Aluminium 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<sup>2</sup> (“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)<sup>3</sup> (“ESMA Regulation”), the Board of Supervisors has adopted this opinion.

### II. Contract classification

Commodity base product: metals (METL)

Commodity sub product: non-precious (NPRM)

Commodity further sub product: aluminium (ALUM)

Name of trading venue: THE LONDON METAL EXCHANGE

MIC: XLME

Venue product code: AH

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<sup>1</sup> 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).

<sup>2</sup> 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).

<sup>3</sup> 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. Aluminium is a metal and is non-perishable. It is extracted from bauxite found mainly in China, the US and Russia. In addition, aluminium is recyclable which also has an effect by increasing supply of the refined metal.
4. The largest consumer of aluminium is China, followed by Europe, the US and Japan. In 2016, estimated overall production was around 58 million tonnes with China as the largest producer at over 31 million tonnes. There is no particular seasonality noted in production or consumption of the metal which leads to price fluctuation.<sup>4</sup>
5. China's production exceeded consumption in 2016 which maintained the 2015 low prices. In November 2016, aluminium on the London Metal Exchange (LME) reached a 6.5 year low price of \$1,432.50 per tonne recovering to \$1,907 on 11 April 2017. The World Bank forecasts aluminium prices to rise on a continual upward trend.<sup>5</sup>
6. The market features a wide range of participants including producers hedging their output, industrial consumers, market intermediaries and longer term investors in commodities, such as funds. In addition to the LME, aluminium is traded on SHFE (Shanghai Futures Exchange) and the Commodity Exchange Inc. (COMEX). Both contracts are also physically settled, with negligible volume on COMEX and under 10% of the LME volume on SHFE. The global nature of the metals markets and the associated warehousing system means that stocks held outside the LME system can be rapidly introduced to meet delivery obligations.
7. The LME has a network of 600 approved warehouses located across many countries from which the underlying commodity may be delivered. There are 120 LME approved brands of primary aluminium which may be delivered against the contract.
8. All aluminium must be of an LME approved brand to be deliverable against LME contracts. LME aluminium contracts are settled by transfer of a warrant giving ownership of metal located in the warehouse network. There have been well-publicised problems at two of the warehouses affecting the physical delivery of the underlying metal from these warehouses but not the ability to settle the derivative contract.
9. There have previously been queue-related restrictions on the physical transportation of aluminium from two LME warehouses. Rule changes by the LME are reducing these queues, which affect the withdrawal of metal from the LME system by end-users. A large position holder can cancel a quantity of LME warrants which may create a queue to remove aluminium from a warehouse, which could influence the price of the LME contract.

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<sup>4</sup> Sources: World Aluminium & Aluminium Leader

<sup>5</sup> World Bank Commodities Market Outlook April 2017



10. Number of market participants / market makers in accordance with Article 19(2) of RTS 21: 778 / 0.

#### **IV. Proposed limit and rationale**

##### *Spot month position limit*

11. Deliverable supply amounts to 327,537 lots. A lot is equivalent to 25 tonnes.
12. The contract is settled by transfer of a claim to (or "warrant" over) physical metal. The starting point for calculation of deliverable supply against the LME contract is the published data on stocks of metal held in LME warehouses. The information on LME Official Stocks is available to any person from the LME website<sup>6</sup>. The average of daily levels of LME Official Closing Stock for the calendar year 2016 was 97,583 lots of the aluminium contract. This represents the most immediate stock of the commodity which is available for physical delivery.
13. Deliverable supply is, however, represented not only by reported LME stocks but also by a number of other elements which could be used to meet the delivery obligation. These include cancelled LME warrants which may have been taken out of the LME system either to reduce storage charges, in anticipation of movement out of a warehouse, or for other operational reasons. Cancelled warrants may be reinstated on an almost immediate basis by the warehouse-keeper on the instruction of the metal-owner. LME warrants may also be delivered multiple times during the spot month period, because of the LME practice of daily settlement. This further increases the quantity of potential deliverable supply. However, the FCA has not adjusted upwards the deliverable supply estimate to take into account the re-use of aluminium warrants because the number of aluminium warrants delivered in an average month is below the average level of LME stocks held. The re-use of LME warrants to meet delivery obligations is an established characteristic of the LME markets which enables participants to match their requirements for physical metal in specific locations. It also enables the timing of deliveries to take place outside the normal "Third Wednesday" monthly trading cycle which defines the spot month period for the purpose of setting limits.
14. The spot month is defined as the amalgamation of all daily prompts within the 30 days immediately preceding the relevant month's expiry as this takes into account only trading linked to the relevant expiry month.
15. An additional source of deliverable supply is unwarranted aluminium that is held by LME warehouse companies in their non-LME licensed warehouses and which can easily be transferred into their LME licensed warehouses and placed on warrant. Often, LME warehouse companies have LME-licensed and non-LME warehouses at the same location. Additional space within LME warehouses allows metal which is not currently within the LME system to be introduced and made eligible for delivery.

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<sup>6</sup> <https://www.lme.com/metals/reports/stocks/>

16. These additional factors which increase the amount of aluminium available to meet delivery commitments mean that the amount calculated for deliverable supply is significantly greater than the amount of aluminium recorded as on LME warrant at any point in time.
17. The calculated amount of total deliverable supply gives a figure for deliverable supply which is significantly lower than the amount of global monthly production. Monthly refined production is estimated at around 4.8 million tonnes or 193,333 lots of LME aluminium. As aluminium does not degrade in storage, the metal from many years' production which is held in storage may also be used in the deliverable supply.<sup>7</sup>
18. In calculating deliverable supply, the FCA has excluded quantities of metal which are committed by commercial entities under long-term arrangements to supply or purchase. These amounts are therefore not available to enter the LME stock system.
19. In summary, the breakdown of the components for calculating deliverable supply using data for the calendar year 2016 are:

<b>Deliverable Supply</b>	<b>Number (Lots)</b>	<b>Notes</b>
LME Warehouse Stocks	97,583	On-warrant and cancelled warrants
Deliverable non-LME Warehouse Stocks	212,664	Excluding non LME-branded eligible metal
Monthly Production of LME branded metal	17,290	Excluding production that would be used for commercial and alternative purposes
Re-use of LME Warrants at LME Warehouses	0	To reflect multiple use of warrants to settle contracts during spot period
<b>Total</b>	<b>327,537</b>	

*Deliverable non-LME Warehouse Stocks figures from estimates provided by LME*

#### Spot month position limit rationale

20. The spot month limit is 47,450 lots and represents 14.5% of the deliverable supply.
21. The baseline for the spot month limit has been set at 25% of deliverable supply as required by Article 9(1) of RTS 21.
22. When applying Article 18(1) of RTS 21, a downward adjustment of 5 percentage points was made in response to the very large volume of open interest (1,229,999 lots) in the contract relative to commodity derivative contracts as a whole. The amount of the adjustment was considered against other contracts in the asset class.
23. The large number of market participants (778) resulted in a downward adjustment of 3.5 percentage points in accordance with Article 19(1) of RTS 21. Each of the factors referred to

<sup>7</sup> World Bank Commodity Markets Outlook, January 2017

in Article 20 of RTS 21 was considered and a further 2 percentage point downwards adjustment was made to reflect issues with delivery capacity given the warehousing situation described below.

24. There have been significant waiting times at specific LME warehouses which have affected delivery of the metal from warehouse. Queues have recently reduced but are not entirely eliminated. There is still the potential that queues could be used to try to influence LME's aluminium price as the length of queues can be one factor in determining the LME price. This justifies a small (2 percentage point) downwards adjustment in the spot month position limit. However, the queues have been reducing and the current length is not enough to justify a larger adjustment.
25. While a supply of metal is also needed to settle other trading venues' contracts, trading volumes at these other trading venues is small (circa 10%) compared with LME trading. The FCA has not therefore made a downward adjustment under Article 17 of RTS 21 to the limit to reflect trading at other venues.
26. No other adjustments were considered necessary to the spot month limit for the other factors referred to in Article 20 of RTS 21.

#### *Other months' position limit*

#### Open interest

27. The open interest amounts to 1,229,999 lots. A lot is equivalent to 25 tonnes.
28. The open interest figure has been reported by the trading venue and is calculated as 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 period used is the calendar year 2016.
29. This is not a "same" commodity derivative contract so there is no requirement to aggregate the open interest on multiple trading venues.

#### Other months' position limit rationale

30. The other months limit amounts to 202,950 of lots and represents 16.5% of the open interest.
31. The baseline for the other months has been set at 25% of open interest as required by Article 11 of RTS 21.
32. Adjustments have been made to the baseline, where necessary, using the rationale for adjustments set out in RTS 21 as follows.

33. The FCA has made an upwards adjustment to the baseline of 2 percentage points for the large number of separate expiries (228) of the aluminium contract when considering Article 16(1) of RTS 21.
34. The FCA has made a downward adjustment of 5 percentage points on account of the very large open interest (1,229,999 lots) in accordance with Article 18(1) of RTS 21 relative to commodity derivative contracts as a whole. The amount of the adjustment was considered against other contracts in the asset class. The FCA also has considered the amount of the open interest to be large in relation to deliverable supply (376%), and therefore has made a downwards adjustment of 2 percentage points under Article 18(2) of RTS 21. The FCA has made a downwards adjustment of 3.5 percentage points under Article 19(1) of RTS 21 to reflect the large number of market participants (778).
35. No other adjustments were considered necessary to the other months limit in respect of the factors referred to in Article 20 of RTS 21.
36. For the spot month, a total downward adjustment was made of 10.5 percentage points resulting in an adjusted baseline of 14.5%. This provides a figure in lots of 47,493 which has been rounded up to a figure of 47,450 lots.
37. For the other months, a total downward adjustment was made of 8.5 percentage points, resulting in an adjusted baseline of 16.5%. This provides a figure in lots of 202.950.

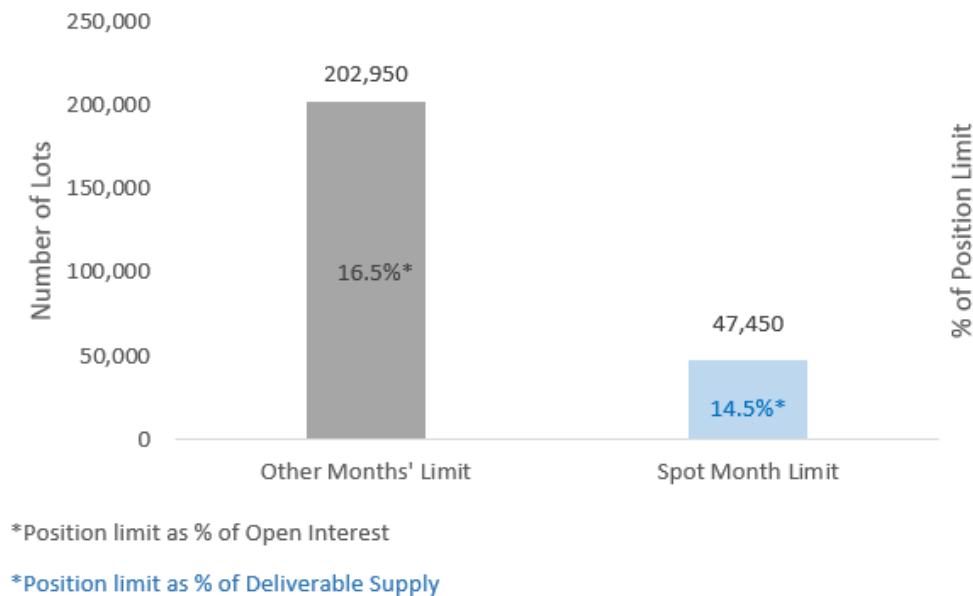
## **V. ESMA's Assessment**

38. This Opinion concerns positions held in Aluminium contracts.
39. ESMA has performed the assessment based on the information provided by the FCA.
40. 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*

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

Position limits applying during the lifetime of the LME Aluminium contract



### Spot month position limit

42. Deliverable supply has been calculated by assessing a combination of factors that all contributed to the average monthly amount of the underlying commodity for delivery. In this case (1) average daily LME warehouse stocks, (2) deliverable non-LME warehouse stocks, and (3) monthly production in LME branded metal.
43. ESMA considers that 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”.
44. While the deliverable non-LME warehouses are not immediately available for delivery, they can be transferred into licensed warehouse and accordingly their stock can be added to the deliverable supply. The level of adjustments was considered with reference to other metal contracts, and seems appropriate.
45. The large open interest and number of market participants indicate high activity in trading in aluminum contract, thus lower spot month limit should not cause an impairment to trading in this commodity, while limiting the possibility of single participant to have large impact on prices.
46. ESMA notes that LME metals contracts are 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. As such, ESMA considers the adjustments



made under Article 19 of RTS 21 as appropriate given their application is in accordance to a proportional methodology following cross-class analysis of all LME metal contracts.

47. The constraints with delivery of aluminum due to issues with certain warehouses also justify a lower limit, which will facilitate settlement of the contract.

#### Other months position limit

48. The open interest was calculated as the average daily value of open interest over 2016 of contracts that have not expired or been closed out.

49. 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.

50. The adjustments made with reference to large open interest and number of market participants can be explained by large volume of trading, which indicate that stricter limits should not impair the trading while improving market integrity. The upward adjustment due to large number of separate expiries is made to account for numerous expiries allowing market participants to close their positions more frequently.

51. 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*

52. 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) MiFID II.

53. ESMA considers these position limits to have been set in accordance with the above mentioned objectives and fully take into account that the liquidity profile of the aluminium contract is one of the most liquid on LME. Aluminium has the longest term structure available at LME, which acts to dampen the effects of the larger other months limit, whilst queuing at the warehouses was of particular concern when considering the spot month limit. Accounting for this, and the market profile, ESMA considers these limits suitable for the market conditions within which they will be active.

54. Overall, the position limit 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 an orderly market and orderly settlement, while ensuring that the development of commercial activities in the underlying aluminium market and the liquidity of the LME Aluminium futures and options are not hampered.





## **VI. Conclusion**

55. 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. In addition, the other months' position limit complies 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