

OPINION on position limits for ZINC 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 instruments¹ (“MiFID II”) regarding the exact position limits the FCA intends to set for the Zinc 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 derivatives² (“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: Metals (METL)

Commodity sub product: Non Precious (NPRM)

Commodity further sub product: Zinc (ZINC)

Name of trading venue(s): THE LONDON METAL EXCHANGE

MIC(s): XLME

Venue product code(s): ZS

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. The London Metal Exchange (LME) has a network of 600 warehouses located across many countries from which the underlying commodity may be delivered.
4. All zinc must be of an LME approved brand to be deliverable against LME contracts and must be special high-grade zinc of 99.995% purity (minimum). The contract is delivered by transfer of ownership of an electronic warrant. In recent years, zinc mines in Australia and Ireland closed, two mines in Canada closed in 2012 and a mine closed in Australia in 2015 in addition to slowing production in Peru which created upward pressure on the physical zinc price. This situation has recently reversed and mines in the US, India and Peru are due to double output in 2017. Global production of refined zinc was around 14 million tonnes in 2015.^{4 5 6} 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.
5. No restrictions on the transportation of zinc from the relevant warehouses that would justify an adjustment to the baseline have been identified.
6. The highest consumers of zinc are China, US and Japan. China, Australia, Canada and Peru are the main mining sources of zinc. China accounts for around 40% of global output and is due to boost capacity by 244,000 tonnes in 2017.⁷ There is no particular seasonality noted in production or consumption of the metal which leads to price fluctuation.
7. 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. Because of its role as an industrial metal, major industrial producers and consumers are the main participants in the market. Market participants may also trade physically settled zinc contracts on the Shanghai Futures Exchange (SHFE). The SHFE has an open interest of approximately 125,000 equivalent lots, or approximately 25% the size of the LME market.
8. Reuters reported on 11 April 2017 that an expected shortage of zinc may not materialise due to an increase in mining output as a result of recent price increases. Demand growth for 2017 is expected to be lower than 2016 at around 1.5% compared with 3.5% partly due to slower construction development in China.^{8 9}

⁴ World Bank, Global Economic Prospects Divergences and Risks, June 2016

⁵ Commodity Markets Outlook, January 2017

⁶ Reuters, December 2016 <http://www.reuters.com/article/us-glencore-zinc-ahome-column-idUSKBN13R1PO>

⁷ Reuters, Market nervous on zinc bull story as shortages fail to emerge, 11 April 2017: <http://uk.reuters.com/article/us-metals-zinc-bulls-idUSKBN17E03G>

⁸ Reuters, Market nervous on zinc bull story as shortages fail to emerge, 11 April 2017, <http://uk.reuters.com/article/us-metals-zinc-bulls-idUSKBN17E03G>

⁹ MetalMiner: "Zinc: Does the Predicted Deficit Mean Higher Prices in 2017?", 17 May 2017, <https://agmetminer.com/2017/05/17/zinc-does-deficit-mean-higher-prices-in-2017/>

9. Zinc is a metal and non-perishable. 70% of zinc originates from mines with the remaining 30% from recycling secondary zinc.
10. Estimated number of market participants / market makers in accordance with Article 19(2) of RTS 21: 663 / 0.

IV. Proposed limit and rationale

Spot month position limit

Deliverable supply / Open interest

11. Deliverable supply amounts to 36,799 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 the 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 website¹⁰. The average of daily levels of LME Official Closing Stock for the calendar year 2016 was 17,557 lots of the zinc contract. This represents the most immediate stock of the commodity which is available for physical delivery.
13. Deliverable supply is represented not only by reported stocks but also a number of other elements which could be used to meet the delivery obligation. These include cancelled warrants which cover metal that 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. However, the FCA has not adjusted upwards the deliverable supply estimate to take into account the re-use of zinc warrants because the number of zinc 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 zinc that is held by LME warehouse companies in their non-LME licensed warehouses and which can easily be transferred

¹⁰ <https://www.lme.com/metals/reports/stocks/>

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.

16. 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.
17. These additional factors mean the amount of metal calculated to be in the deliverable supply against the LME contract is greater than the amount recorded as on LME warrant at any point in time. LME estimates annual global production of zinc at 13.1 million tonnes, or equivalent to 524,000 lots of the LME contract.¹¹ This is broadly in line with World Bank figures.
18. In summary, the breakdown of the components for calculating deliverable supply using data for the calendar year 2016 are:

Deliverable Supply	Number (Lots)	Notes
LME Warehouse Stocks	17,557	On-warrant and cancelled warrants
Deliverable non-LME Warehouse Stocks	14,578	Excluding non LME-branded eligible metal
Monthly Production of LME branded metal	4,664	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
<i>Total</i>	<i>36,799</i>	

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

Spot month position limit rationale

19. The spot month limit is 7,000 lots. This constitutes 19% of the reference amount.
20. The baseline for the spot month limit has been set at 25% of deliverable supply as required by Article 9(1) of RTS 21.
21. Article 17 of RTS 21 requires consideration of whether the commodity is used for other commodity derivative contracts. As the underlying zinc may also be delivered against another physically deliverable contract, (despite that contract having a relatively small volume of open interest of 124,702 equivalent lots), the FCA has made a downwards adjustment of the limit by 2 percentage points. The FCA has made a downward adjustment of 1 percentage point

¹¹ <https://www.lme.com/metals/non-ferrous/zinc/production-and-consumption>



under Article 18(1) of RTS 21 as there is a large amount of open interest (543,548 lots). The estimated large number of market participants (663) resulted in a downward adjustment of 3 percentage points being made in accordance with Article 19(1) of RTS 21.

22. Other characteristics of the contract were considered and no further adjustments were considered necessary.

Other months' position limit

Open interest

23. The open interest amounts to 543,548 lots. A lot is equivalent to 25 tonnes.
24. 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.
25. 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

26. The other months limit amounts to 78,800 of lots. This constitutes 14.5% of the reference amount.
27. The baseline for the other months has been set at 25% of open interest as required by Article 11 of RTS 21.
28. Adjustments have been made to the baseline, where necessary, using the rationale for adjustments set out in RTS 21 as follows.
29. The FCA has made an upwards adjustment to the baseline of 1 percentage point for the large number of separate expiries (158) of the zinc contract when considering Article 16(2) of RTS 21. The FCA has made a downward adjustment of 1 percentage point under Article 18(1) as there is a large amount of open interest (543,548 lots). The FCA also considers the amount of the open interest to be exceptionally large in relation to deliverable supply (1477%), and therefore have made a downwards adjustment of 7.5 percentage points under Article 18(2) of RTS 21. The FCA made a downwards adjustment of 3 percentage points under Article 19(1) of RTS 21 to reflect the estimated large number of market participants (663).
30. Other characteristics of the contract were considered and no further adjustments were considered necessary.



Further Comments

31. 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. There are no market makers (as defined in RTS 21) in zinc according to the data provided by the venue, it would suggest that the upper limit boundary to the position limit would be 50% (according to Article 19(2) of RTS 21). However, as there are many liquidity providers fulfilling an analogous role to market makers such an upward adjustment is not necessary. 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.
32. For the spot month, a total downward adjustment has been made of 6 percentage points resulting in an adjusted baseline of 19%. This provides a figure in lots of 6,992 which has been rounded up to a figure of 7,000 lots. This equates to a final limit as a percentage of deliverable supply of 19%.
33. For the other months, a total downward adjustment has been made of 10.5 percentage points resulting in an adjusted baseline of 14.5%. This provides a figure in lots of 78,814 which has been rounded down to 78,800 lots. This equates to a final limit as a percentage of open interest of 14.5%.

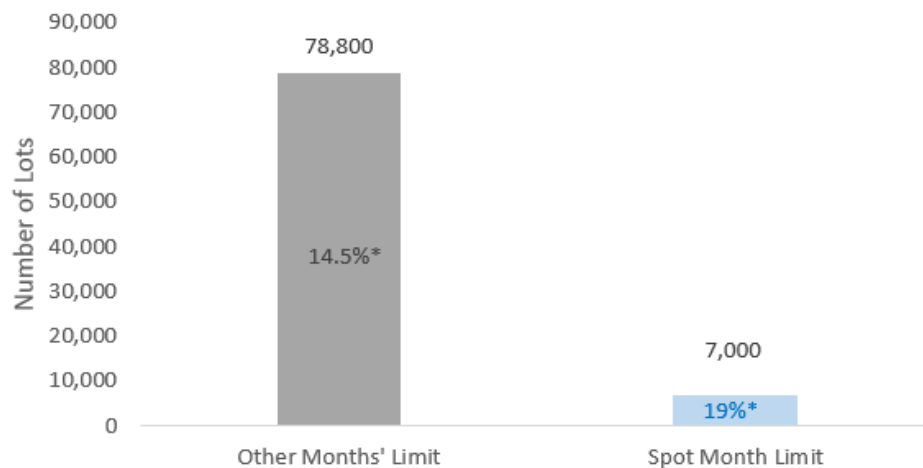
V. ESMA's Assessment

34. This Opinion concerns positions held in Zinc contracts.
35. ESMA has performed the assessment based on the information provided by the FCA.
36. 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

37. The FCA has set two position limits. One for the entire spot month (30 days), and one for the other months.

Position Limits applying during the lifetime of a LME Zinc Contract



*Position limit as % of Open Interest

*Position limit as % of Deliverable Supply

Spot Month Limit

38. Deliverable supply calculations assess a combination of factors that contribute 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.
39. ESMA recognizes that the 're-use of warrants' market practice is particular to individual contracts and not ubiquitous across all LME contracts. The existence of the activity is dictated by the prevailing market nature and conditions, and as such will not be included in all deliverable supply calculations.
40. EMSA considers this approach 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".
41. While the metal supply within 'non-LME warehouses' is not immediately available for delivery, ESMA accepts that it can be easily transferred into licensed warehouses, and accordingly their stock can be added to the deliverable supply.
42. ESMA considers the adjustments made under Article 17 of RTS 21 for the use of deliverable supply being required to fulfil other metal contracts as appropriate.
43. 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. This approach seems prudent given the lack of guidance regarding the quantification of 'high'.

44. ESMA considers the adjustments made under Article 18 of RTS 21 as appropriate given their application is in accordance to a proportional methodology following cross-class analysis of all LME metal contracts.

Other Months' Limit

45. Open interest calculations took the average daily open interest volume over 2016 of contracts that have not expired or been closed out, including options on a delta adjusted basis.
46. ESMA considers such an approach sensible in this case, as an average over a time period gives a more stable measure of open interest, and considers such approach consistent with Article 12 of RTS 21.
47. The adjustments made under Article 16 of RTS 21 have been applied due to the existence of daily contracts in the spot month 158 expiries (for contracts that trade 63 months forward) is not the largest number offered at the LME. However, ESMA agrees that the adjustments made here are aligned with a cross asset class methodology and are subsequently appropriate.
48. ESMA considers the adjustments made under Article 18 of RTS 21 as appropriate given their application is in accordance to a proportional methodology following cross-class analysis of all LME metal contracts.
49. 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

50. 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.
51. ESMA considers these position limits to have been set in accordance with the above mentioned objectives and fully take into account the liquidity profiles of the contracts. Zinc has a long term structure (63 months) which acts to dampen the effects of the larger other months limit. Accounting for this, and the market profile, ESMA considers these limits suitable for the market conditions within which they will be active.
52. 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 bal-



ance 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 zinc market and the liquidity of the LME Zinc futures and options are not hampered.

VI. Conclusion

53. 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 Maijor

Chair

For the Board of Supervisors