European Securities and Markets Authority

Date: 24 January 2020
ESMA70-155-8692

OPINION on position limits on EEX Capesize TC5 Freight contracts

I. Introduction and legal basis

1. On 8 August 2019, the European Securities and Markets Authority (ESMA) received a notification from the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) under Article 57(5) of Directive 2014/65/EU on markets in financial instruments[1] ("MiFID II") regarding the exact position limits BaFin intends to set for Capesize TC5 Freight Futures and Options commodity 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.

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: freight (FRGT)

Commodity sub product: dry (DRYF)

Commodity further sub product: dry bulk carriers (DBCR)

Name of trading venue: EUROPEAN ENERGY EXCHANGE

MIC: XEEE

Venue product codes: CPTM and OCPM

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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 1.12.2016 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 Capesize TC5 Freight contracts are cash settled dry time-charter freight contracts. Their underlying is the price representing the straight average of rates for hiring on a time charter basis for 5 routes per vessel of the capesize class. There is no specification for physical delivery for this commodity derivative contract.

4. The underlying of the futures contract is the price for the hiring of a vessel for a specific period of time for a specific route. In case of the Capesize Time Charter (CPT) the vessel is a dry bulk ship of the Capesize class. Capesize vessels are ships not apt to travel through the Panama and Suez Canal due to their large size. Thus, they need to travel on alternative routes. These vessels have a capacity up to 180,000 dwt (dead weight tons) and the cargos carried are mainly iron ore, coal and grains. CPT contracts of the EEX cover the average price of five routes for one day:

   - C8 (Gibraltar/Hamburg);

   - C9 (Amsterdam-Rotterdam/China-Japan);

   - C10 (China/Japan);

   - C14 (Quingdao/Brazil/China/Japan); and

   - C16 (North China-South Japan/Australia/US West Coast-South Africa-Brazil/UK-Cont-Med).

5. Trading takes place in lots. One lot is one-day hiring of a vessel. Contracts series for Capesize TC5 Freight Futures contracts include months, quarters and calendar years up to a maximum of 84 consecutive months. Tradable maturities for Capesize TC5 Freight Options contracts include up to 36 consecutive months. Options are exercised by booking in the corresponding futures position at the respective exercise price.

6. The prices are based on the prices as published by the Baltic Exchange[4] that provides the Baltic Dry Index which is a composite of all routes and vessel types and prices for the individual routes per vessel type. Panels of independent shipbrokers around the world give their judgement as to the prevailing level of the open market within the parameters of the route they have been asked to assess.

7. The 5TC Index has recently replaced the 4TC Index that comprised only four routes and referred to slightly smaller vessels. The Baltic Exchange does not publish the 4TC Index anymore. As a consequence, EEX does not offer trades in the Capesize 4TC anymore either. However, some market participants still have positions in the Capesize 4TC contract. Some

4 https://www.balticexchange.com

of their positions merely expire whereas others are set off by entering into positions of Capesize TC5 contracts. As a result, the Capesize TC5 contracts gain liquidity rapidly.

8. BaFin is not aware of any restriction on the supply of the underlying. It is estimated that there are currently approximately 520 vessels in active operation. The control of these vessels is highly diversified with different market participants responsible for their operation. Even the largest owners/operators in this segment do not control large shares of total supply. It is not considered possible that supply can be restricted.

9. The supply side of the physical market is comprised of the ship owners and ship operators. The demand side comprises the charterers and cargo owners such as mining companies, grain houses, commodity trading companies and energy companies. Many of the market participants in the physical market are also active in the commodity derivative market. However, there are still many ship owners and demand side players worldwide who are not using freight rate derivatives to hedge their physical exposure to the freight rates. Generally, the market structure is very fluid, i.e. one entity may be at the same time owner, operator and charterer.

10. The physical supply does not fluctuate over the calendar year. The supply is mainly influenced by the construction and delivery of new vessels into the fleet (newbuilding prices in relation to freight rates perspective) and the removal of vessels for scrapping or conversion to other ship types. Floating storage and slow steaming are also factors influencing the supply side.

11. The demand side in case of dry bulk is mainly driven by the world steel production and the transportation need for iron ore and coal, i.e. growth of the world economy. Dry bulk prices are often used as indicators of economic trends.

IV. Proposed limit and rationale

Spot month position limit

12. The Capesize TC5 Freight Futures and Options contracts are freight contracts under Article C(10) of Annex I to Directive 2014/65/EU. According to Position Limit no. 10 of the ESMA Q&As on commodity derivatives, both the spot month and the other months' limits shall be based on the open interest. The spot month period only includes one monthly contract.

<u>Open interest</u>

13. Open interest amounts to 8,900 lots. Open interest value was provided by the exchange. It was calculated as the average size of daily open interest throughout three consecutive months (May, June, July 2019). The open interest of the option contracts has been calculated according to their delta equivalents.

Spot month position limit

14. Spot month limit amounts to 4,005 lots, which represents 45% of open interest.

Spot month position limit rationale

15. The Capesize TC5 Freight Future / Option is an illiquid derivative contract according to Article 15 (1)(a) of Commission Delegated Regulation (EU) 2017/591 as the open interest is below 10 000 lots. Generally, the competent authority (CA) is thus required to set the limit at 2,500 lots.

16. However, as ESMA Q&A Position Limit no. 16 sets out, where commodity derivatives traded on a trading venue have a total combined open interest in spot and other months' contacts between 5,000 and 10,000 lots, CAs may set the limits within the range established by Article 19(2) of Commission Delegated Regulation (EU) 2017/591. The range under Article 19(2) of RTS 21 shall be used where the automatic limit under Article 15(1)(a) would unduly constrain the operation of the market and prevent the contract from supporting the functioning of commercial activities in the underlying.

17. BaFin considers that the Capesize TC5 Freight Future and Option contracts meet the conditions set out in ESMA's Q&A for the spot month limit to be set using the range of 5% to 50% of the reference amount in accordance with Article 19(2) of RTS 21. The total combined open interest in the Capesize TC5 Freight Future and Option contracts is between 5,000 and 10,000 lots and there are no investment firms acting as market makers.

18. Furthermore, the contract is rapidly gaining liquidity, partly due to the shift from the TC4 Index to the TC5 Index. The analysis of position reporting data on the composition and role of market participants, as per Article 20(2)(d) RTS 21 also indicate that most market participants are using the Capesize TC5 Freight contracts to hedge their underlying commercial positions. As there are only a handful of financial counterparties providing liquidity in this contract and acting as counterparties to non-financial counterparties seeking to hedge their position the limit of 2,500 lots under Art. 15 (1) a) would therefore unduly constrain the operation of the market as any further provision of liquidity would result in a breach of the position limit by the liquidity providers. As a consequence, the contract would therefore be prevented from further developing and becoming liquid and hedging activities in the context of Capesize vessels would be restricted.

19. Since the Capesize TC5 Freight Future / Option contracts are not food contracts, their baseline figure for the spot month, which is based on the open interest, was calculated as 25% of open interest, i.e. 25% * 8,900 lots = 2,225 lots. Consistent with the upward flexibility provided under Article 19(2) of RTS 21 and taking into account the composition and role of market participants in the underlying market, BaFin has made an upwards adjustment of 20 percentage points to reflect the factors described in Article 20(2)(d) RTS 21 and ensure that

commercial users have access to an intermediary able to act as a counterparty and respond to their demand for hedging.

20. 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. In considering the volatility in the contract, as required by Article 21 of RTS 21, BaFin notices that there has been some variation in the price of the commodity derivative but BaFin has not found evidence that this is excessive or that lower position limits would reduce volatility.

21. Based on the above, BaFin considers that setting the spot month limit at 45% of open interest, i.e., at 4,005 lots, seems adequate.

Other months' position limit

Open interest

22. Open interest amounts to 8,900 lots. Open interest value was provided by the exchange. It was calculated as the average size of daily open interest throughout three consecutive months (May, June, July 2019). The open interest of the option contracts has been calculated according to their delta equivalents.

Other months' position limit

23. Other months' limit amounts to 4,005 lots.

Other months' position limit rationale

24. The rationale for setting the other months' limit replicates the rationale for the spot month limit.

25. The Capesize TC5 Freight Future / Option is an illiquid derivative contract according to Article 15 (1) a) of Commission Delegated Regulation (EU) 2017/591 as the open interest is below 10,000 lots. Generally, the competent authority (CA) is thus required to set the limit at 2,500 lots.

26. However, as ESMA Q&A Position Limit no. 16 sets out, where commodity derivatives traded on a trading venue have a total combined open interest in spot and other months' contracts between 5,000 and 10,000 lots, CAs may set the limits within the range established by Article 19(2) of Commission Delegated Regulation (EU) 2017/591. The range under Article 19(2) of RTS 21 shall be used where the automatic limit under Article 15(1)(a) would unduly constrain the operation of the market and prevent the contract from supporting the functioning of commercial activities in the underlying.

27. BaFin considers that the Capesize TC5 Freight Future and Option contracts meet the conditions set out in ESMA Q&A for the spot month limit to be set using the range of 5% to 50% of the reference amount in accordance with Article 19(2) of RTS 21. The total combined

open interest in the Capesize TC5 Freight Future and Option is between 5,000 and 10,000 lots and there are no investment firms acting as market makers.

28. Furthermore, the contract is rapidly gaining liquidity, partly due to the shift from the TC4 Index to the TC5 Index. The analysis of position reporting data on the composition and role of market participants, as per Article 20(2)(d) RTS 21 also indicate that most market participants are using the Capesize TC5 Freight contracts to hedge their underlying commercial positions. As there are only a handful of financial counterparties providing liquidity in this contract and acting as counterparties to non-financial counterparties seeking to hedge their position the limit of 2,500 lots under Art. 15 (1) a) would therefore unduly constrain the operation of the market as any further provision of liquidity would result in a breach of the position limit by the liquidity providers. As a consequence, the contract would be prevented from further developing and becoming liquid and hedging activities in the context of Capesize vessels would be restricted.

29. Since the Capesize TC5 Freight Future / Option contracts are not food contracts, their baseline figure for the other months' limit was calculated as 25% of open interest, i.e. 25% * 8,900 lots = 2,225 lots. Consistent with the upward flexibility provided under Article 19(2) of RTS 21 and taking into account the composition and role of market participants in the underlying market, BaFin has made an upwards adjustment of 20 percentage points to reflect the factors described in Article 20(2)(d) RTS 21 and ensure that commercial users have access to an intermediary able to act as a counterparty and respond to their demand for hedging.

30. 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. In considering the volatility in the contract, as required by Article 21 of RTS 21, BaFin notices that there has been some variation in the price of the commodity derivative but BaFin has not found evidence that this is excessive or that lower position limits would reduce volatility.

31. Based on the above, BaFin considers that setting the other months' limit at 45% of open interest, i.e., at 4,005 lots, seems adequate.

V. ESMA's Assessment

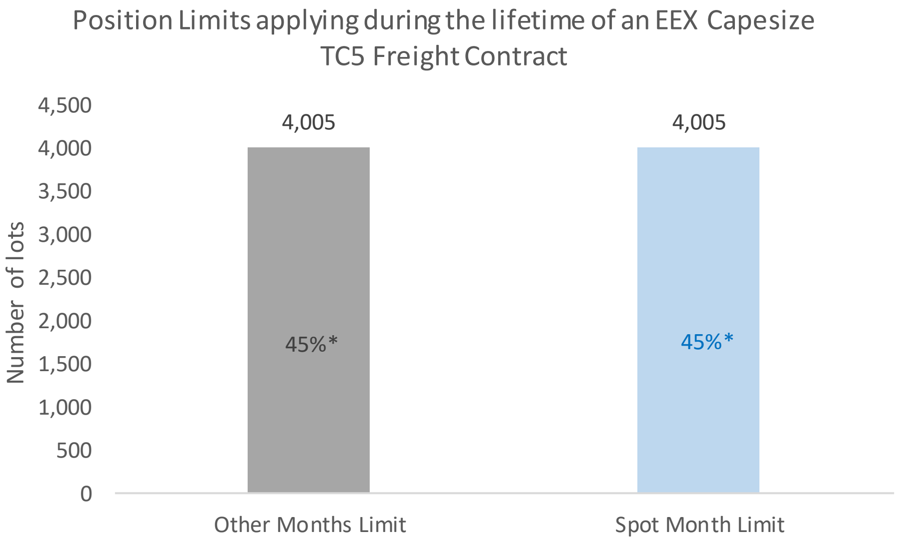
32. This Opinion concerns positions held in Capesize TC5 Freight Futures and Options contracts.

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

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. BaFin has set the same position limit for the spot month and for the other months.



*Position limit as % of Open Interest

<u>Spot month position limit</u>

36. ESMA agrees that the Capesize TC5 Freight Futures and Options contracts are freight contracts under Article C(10) of Annex I of MiFID II and that, accordingly, the spot month limit is to be set as a percentage of the open interest in those contracts.

37. The open interest was calculated as the average size of daily open interest throughout the three consecutive months (May, June, July 2019) immediately prior to setting the position limits. ESMA considers that such an approach is sensible in this case as it allows better taking into account the upward trend in open interest in this contract. ESMA also considers this approach to be consistent with Article 12 of RTS 21.

38. As there are no investment firms acting as market makers in accordance with Article 4(1)(7) of MiFID II in the Capsize TC5 Freight contracts at the time the position limit was set, and in accordance with its Q&A no. 16 on position limits[5], ESMA agrees that the spot month limit for this less liquid contract can be set within the range established by Article 19(2) of RTS 21 when the default limit would unduly constrain the operation of the market. Based on

[5] https://www.esma.europa.eu/sites/default/files/library/esma70-872942901-36_qas_commodity_derivatives.pdf

the information provided by the competent authority, ESMA notes that the Capsize TC5 Freight contract is replacing the Capsize TC4 Freight contract and that growth in the Capsize TC4 Freight contract has been hampered by the default limit set out under Article 15(a) of RTS 21 as liquidity providers were not able to respond to hedging transactions demand.

39. The spot month limit has been adjusted upwards considering the significant proportion of positions held by commercial market participants and to help ensuring that commercial users can find an intermediary able to act as a counterparty to their commercial hedging transactions. This upward adjustment appears consistent with Article 20(2)(d) of RTS 21.

<u>Other months' position limit</u>

40. The other months' limit has been set by the competent authority based on the same data and rationale as for the spot month limit. ESMA considers this a reasonable approach as the arguments underpinning the upward adjustment of the spot month limit in accordance with Articles 19(2) and 20(2)(d) of RTS 21 appear to be also well-grounded for setting a bespoke other months' limit and adjusting the baseline upwards.

41. 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

42. 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.

43. With respect to the spot month limit and based on the information provided by the competent authority, ESMA notes that the limit is substantially higher than the open interest in the spot month throughout the reference period considered. There is a risk that the objectives set out in Article 57(1) of MiFID II may not be achieved where the limit set for the spot month is well above the positions held by market participants.

44. ESMA understands the need to avoid the risk of unduly constraining trading in this commodity derivative market where market participants in the underlying market 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 limit set for the spot month is well above the positions held by market participants in the spot month.

45. In light of the assessment above, ESMA considers that the position limit set for the spot month and the other months, 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 commodity market and the liquidity of the Capesize TC5 Freight contracts are not hampered.

46. 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 Capesize TC5 Freight contracts 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

47. 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 also comply with the methodology established in RTS 21 and is consistent with the objectives of Article 57 of MiFID II.

Done at Paris,

Steven Maijoor

Chair

For the Board of Supervisors