European Securities and Markets Authority

Date: 31 July 2020
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OPINION on position limits on EEX Capesize TC5 Freight contracts

I. Introduction and legal basis

1. On 13 May 2020, the European Securities and Markets Authority (ESMA) received a new 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 has 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.

3. On 24 January 2020, ESMA issued a first Opinion regarding the exact position limits BaFin intended to set for the Capesize TC5 Fright Futures and Options commodity contracts. The position limits considered by BaFin was 4,005 lots for the spot month limit and 4,005 lots for the other months' limit. In this opinion, ESMA concluded that the position limits considered by BaFin complied with the methodology established in RTS 21 and were consistent with the objectives of Article 57 of MiFID II.

4. According to Article 57(4) of MiFID II, a competent authority shall review position limits where there is a significant change on the market, based on its determination of deliverable supply and open interest and reset the position limit. In the course of 2019, BaFin considered that there had been a significant increase in the open interest in 2019 to the extent that the position limit had to be reset for both the spot month limit and the other months' limit. ESMA understands that the new position limits apply since 12 December 2019 and are replacing the previous position limits as determined by BaFin. In the opinion herewith, ESMA is assessing whether the new position limits BaFin has set for the Panamax TC Freight futures and options

[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).

commodity contracts comply with the methodology established in RTS 21 and are consistent with the objectives of Article 57 of MiFID II.

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

III.Market description

5. The EEX 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.

6. 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).

7. Trading takes place in lots. One lot is one-day hiring of a vessel. Contracts series for EEX Capesize TC5 Freight Futures contracts include months, quarters and calendar years up to a maximum of 84 consecutive months. Tradable maturities for EEX 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.

8. 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.

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

10. 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.

11. 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.

12. 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.

13. 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.

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4 https://www.balticexchange.com

IV. Proposed limit and rationale

Spot month position limit

14. The EEX 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.

Open interest

15. Open interest amounts to 54,365 lots.

16. EEX has acquired Nasdaq Futures Inc.' (NFX) set of dry freight contracts with effect from 12 December 2019. At this date all trading at NFX ceased and continued at EEX. During the preceding weeks most trading members had therefore migrated their positions to EEX. Furthermore, trading members were required to announce the number of positions they were to migrate to EEX until 21 November 2020.

17. Open interest value was provided by the exchange. It was calculated as the sum of the migrated positions as announced by former NFX's trading members as of 21 November 2019 and the average size of daily open interest throughout three consecutive months (July, August, September 2019) at EXX. The open interest of the option contracts has been calculated according to their delta equivalents.

Spot month position limit

18. Spot month limit amounts to 13,591 lots, which represents 25% of open interest.

Spot month position limit rationale

19. Since the EEX 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% * 54,365 lots = 13,591 lots. There is no market maker active. Thus, the limit is to be set within a range of 5% - 50%. Spot month is the next calendar month which is available to trade. The spot month period only includes one monthly contract.

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 25% of open interest, i.e., at 13,591 lots, seems adequate.

Other months' position limit

Open interest

22. Open interest amounts to 54,365 lots.

23. EEX has acquired Nasdaq Futures Inc.' (NFX) set of dry freight contracts with effect from 12 December 2019. At this date all trading at NFX ceased and continued at EEX. During the preceding weeks most trading members had therefore migrated their positions to EEX. Furthermore, trading members were required to announce the number of positions they were to migrate to EEX until 21 November 2020.

24. Open interest value was provided by the exchange. It was calculated as the sum of the migrated positions as announced by former NFX's trading members as of 21 November 2019 and the average size of daily open interest throughout three consecutive months (July, August, September 2019) at EXX. The open interest of the option contracts has been calculated according to their delta equivalents.

Other months' position limit

25. Other months' limit amounts to 13,591 lots, which represents 25% of open interest.

Other months' position limit rationale

26. Since the EEX 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% * 54,365 lots = 13,591 lots. There is no market maker active. Thus, the limit is to be set within a range of 5% - 50%. Spot month is the next calendar month which is available to trade. The spot month period only includes one monthly contract.

27. 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.

28. Based on the above, BaFin considers that setting the spot month limit at 25% of open interest, i.e., at 13,591 lots, seems adequate.

V. ESMA's Assessment

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

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

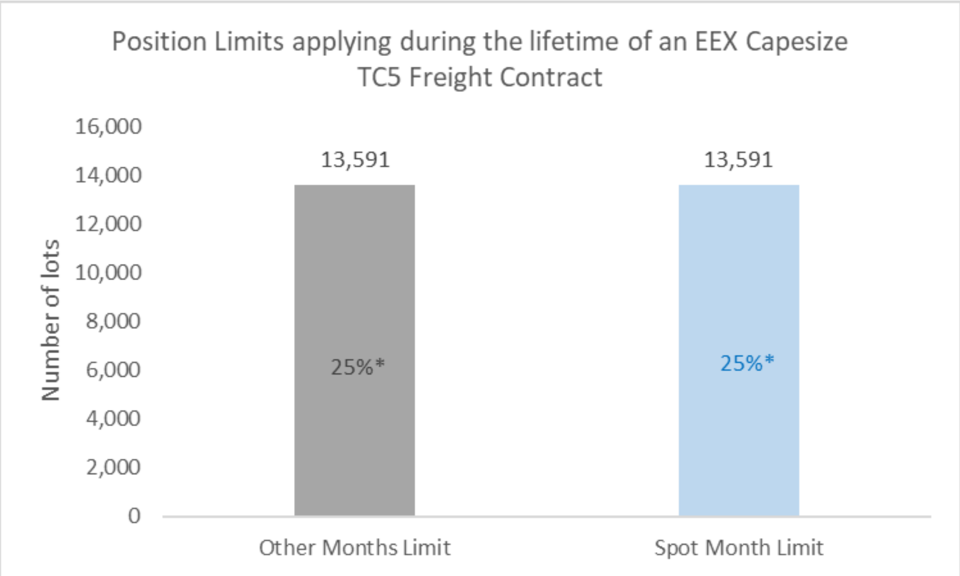
31. Since the contract was traded before on NFX until the end of 2019, when the trading of Dry Bulk Freight was transferred from NFX to EEX, ESMA considers that this is a continuation of trading in the previously existing contract, rather than a new contract. Therefore, it seems appropriate to use the previously observed OI level on NFX, for the purpose of setting the relevant position limits.

32. ESMA notes that when BaFin notified ESMA, the position limits for EEX Capesize TC5 Freight Futures and Options contracts had already been set and active.

33. 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

34. 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>

35. ESMA agrees that the EEX 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.

36. The open interest was calculated as the sum of the migrated positions as announced by former NFX's trading members as of 21 November 2019 and the average size of daily open

interest throughout the three consecutive months (July, August, September 2019). The open interest of the option contracts has been calculated according to their delta equivalents. ESMA also considers this approach to be consistent with Article 12 of RTS 21.

37. ESMA considers in particular as a reasonable approach not to have adjusted the spot month limit downwards based on the characteristics of the contract.

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

38. ESMA considers in particular as a reasonable approach not to have adjusted the spot month limit downwards based on the characteristics of the contract.

39. 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

40. 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.

41. In light of the assessment above, ESMA considers that the position limits set for the spot month and for the other months 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 power market and the liquidity of the EEX Capesize TC5 Freight contracts futures and options contracts are not hampered

VI. Conclusion

42. 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. This 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