European Securities and Markets Authority

Date: 31 July 2020
ESMA70-155-10340

# OPINION on position limits on EEX Capesize C7 Freight contracts

## I. Introduction and legal basis

1. On 29 May 2020, 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 has set for the EEX Capesize C7 Freight Futures 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: 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 code: C7EM

[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 EEX Capesize C7 Freight Futures contracts are cash settled dry time-charter freight contracts. Their underlying is the price for the hiring of a vessel for a specific period of time for a specific route. In case of the Capesize C7 Time Charter (C7EM) 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 at the C7 route are mainly coal. C7EM contracts of the EEX cover the average price of the following route for one day:

   - C7 (Puerto Bolivar/Rotterdam), mainly coal from South America to Europe.

4. The prices are based on the prices as published by the Baltic Exchange 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.

5. BaFin is not aware of any restriction on the supply of the underlying. It is estimated that there are currently approximately 1600 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.

6. BaFin is not aware of any restrictions on the delivery of the underlying. Also, given that the contract is cash settled there are no specification for physical delivery for this commodity derivative contract.

7. 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, 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.

8. 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.

9. The demand side is mainly driven by the transportation need for coal, i.e. growth of the world economy. Dry bulk prices are often used as indicator of economic trends.

## IV. Proposed limit and rationale

*Spot month position limit*

10. The EEX Capesize C7 Freight Futures contracts are freight contracts under Article C (10) of Annex I to Directive 2014/65/EU. According to Position Limit 10 of the ESMA Q&A on position limits both in the spot month and in the other months should be based on open interest.

Open interest

11. Open interest amounts to 8,640 lots.

12. 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.

13. 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.

Spot month position limit

14. Spot month limit amounts to 4,320 lots, which represents 50% of open interest. The spot month limit applies to the EEX Capesize C7 Freight Futures contracts and includes one monthly contract.

Spot month position limit rationale

15. The EEX Capesize C7 Freight Future 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 EEX Capesize C7 Freight Future 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 EEX Capesize C7 Freight Future 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 migration from NFX. The largest positions are held by only two market participants acting as liquidity providers. As most position holders are new to EEX they are willing to change quickly to SGX or the OTC sphere if liquidity is constrained. The limit of 2,500 lots under Art. 15 (1) (a) of RTS 21 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 could not become liquid and hedging activities in the context of Capesize vessels would be restricted.

19. Since the EEX Capesize C7 Freight Future 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% * 8,640 lots = 2,160 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 25 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. In considering the volatility in the contract, as required by Article 21 of RTS 21, BaFin noted 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 50% of open interest, i.e. 4,320 lots seems adequate.

*Other months' position limit*

Other months' position limit

22. The other months' limit amounts to 4,320 lots, which represents 50% of open interest. The other months' limit applies to the EEX Capesize C7 Freight Futures contracts.

Other months' position limit rationale

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

24. The EEX Capesize C7 Freight Future 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.

25. 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.

26. BaFin considers that the EEX Capesize C7 Freight Future 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 C7 Freight Future and Option contracts is between 5,000 and 10,000 lots and there are no investment firms acting as market makers.

27. Furthermore, the contract is rapidly gaining liquidity, partly due to the migration from NFX. The largest positions are held by only two market participants acting as liquidity providers. As most position holders are new to EEX they are willing to change quickly to SGX or the OTC sphere if liquidity is constrained. The limit of 2,500 lots under Art. 15 (1) (a) of RTS 21 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 could not become liquid and hedging activities in the context of Capesize vessels would be restricted.

28. Since the EEX Capesize C7 Freight Future 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% * 8,640 lots = 2,160 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 25 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.

29. In considering the volatility in the contract, as required by Article 21 of RTS 21, BaFin noted 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.

30. Based on the above, BaFin considers that setting the spot month limit at 50% of open interest, i.e. 4,320 lots seems adequate.

## V. ESMA's Assessment

31. This Opinion concerns positions held in EEX Capesize C7 Freight Futures contracts.

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

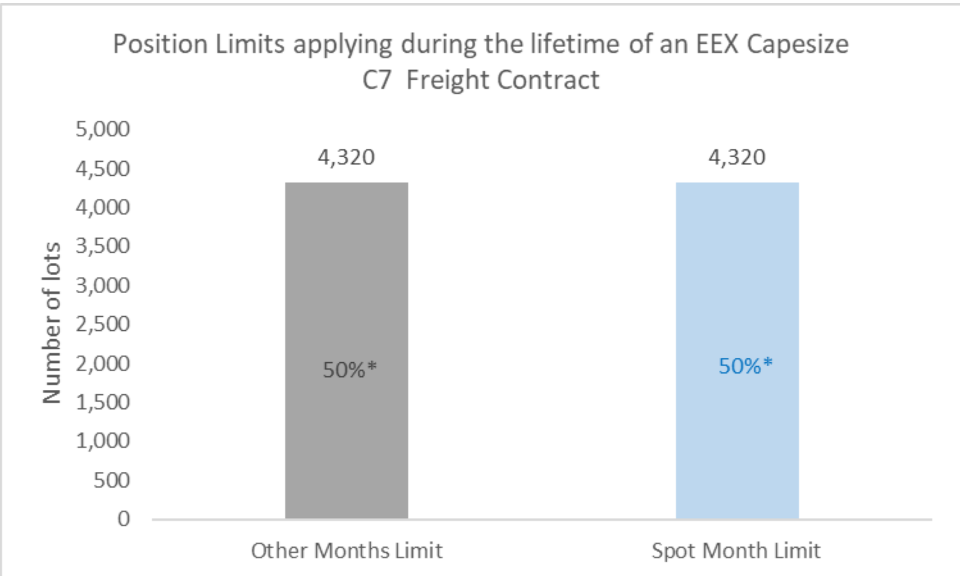
33. Since the contract was traded before on NFX until the end of 2019, when the trading of Dry Bulk Freight was transferred from NFX to EEX, ESMA considers that this is a continuation of trading in the previously existing contract, rather than a new contract. Therefore, it seems appropriate to use the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

34. ESMA notes that when BaFin notified ESMA, the position limits for EEX Capesize C7 Freight Futures contracts had already been set and active.

35. 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*

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




<u>Spot month position limit</u>

37. ESMA agrees that the EEX Capesize C7 Freight Futures 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.

38. 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 three consecutive months (July, August, September 2019). ESMA considers that such an approach is sensible in this case as it allows better taking into account the upward trend in open interest. ESMA also considers this approach to be consistent with Article 12 of RTS 21.

39. As there are no investment firms acting as market makers in accordance with Article 4(1)(7) of MiFID II in the EEX Capsize C7 Freight contracts at the time the position limit was set, and in accordance with its Q&A no. 16 on position limits[4], 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..

40. 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>

41. 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.

*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, ESMA notes that, based on the information provided by the competent authority, that the limit is substantially higher than the open interest in the spot month during the reference period of 1-29 February 2020 and even than the overall open interest during that same period.

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

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

45. 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 C7 Freight futures 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 EEX Capesize C7 Freight futures 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. This 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,

Steven Maijoor

Chair

For the Board of Supervisors