European Securities and Markets Authority

Date: 18 January 2019
ESMA70-155-5284

OPINION on position limits on Panamax TC Freight contracts

I. Introduction and legal basis

1. On 5 July 2018, 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 Panamax TC Freight Futures and Options 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 codes: PTCM, OPTM

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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 Panamax TC Freight Futures and Options 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 four routes per vessel of the Panamax class. They do not include any specifications for physical delivery for this commodity derivative contract.

4. The underlying is the price for the hiring of a vessel for a specific period of time for a specific route. In case of the Panamax Time Charter (PTC), the vessel is a dry bulk ship of the Panamax class. Panamax are terms for the size limits for ships travelling through the Panama Canal. These vessels have a capacity between 60 000 and 100 000 dwt (dead weight tons) and the cargos carried are mainly iron ore, coal and grains. PTC contracts of the EEX cover the average price of four routes for one day:

    a. P1A (Transatlantic Route)

    b. P2A (Taiwan/Japan to Eastern Americas)

    c. P3A (Japan to Australia)

    d. P4A (Taiwan/Japan to Western Americas)

5. Trading takes place in lots. One lot is 1,000 metric tonnes (MT). Contracts series include months, quarters and calendar years out to a maximum of 72 months.

6. The prices are based on the prices as published by the Baltic Exchange[4] that also 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. BaFin is not aware of any restriction on the supply of the underlying. It is estimated that there were approximately 2 500 vessels in active operation in 2017. The control of these vessels is highly diversified with hundreds of different market participants responsible for their operation. Further, it is estimated that even the largest owners/operators in this segment control at a maximum less than 5% of total supply. It is not considered possible that supply can be restricted.

8. The supply side of the physical market is the ship owners and ship operators. The demand is 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

[4] The prices for the respective routes are published by the Baltic Exchange (https://www.balticexchange.com).

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.

9. 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.

10. 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 indicator of economic trends.

IV. Proposed limit and rationale

Spot month position limit

11. The Panamax TC Freight Futures and Options 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

12. Open interest amounts to 16,194 lots. Open interest value was provided by the exchange. It was calculated as the average size of daily open interest throughout three consecutive months (January, February, March 2018). The open interest of the options has been calculated according to their delta equivalents.

Spot month position limit

13. Spot month limit amounts to 4,049 lots, which represents 25% of open interest. The spot month limit applies to the Panamax TC Freight Futures and Options contracts.

Spot month position limit rationale

14. As the underlying of the Panamax TC Freight Futures/Options contract does not qualify as food intended for human consumption, the baseline figure for the spot month is set at 25% of the reference amount, i.e. open interest, in accordance with Article 9 of RTS 21 (25% * 16 194 lots = 4 049 lots). The Panamax TC Freight Futures/Options contract is a "less liquid" derivative contract according to Article 15 (1) (b) of RTS 21 as the open interest is below 20,000 lots over a consecutive three-month period.

15. After considering all the characteristics of the contract, BaFin has decided not to make any adjustments under any of the Articles of RTS 21. No factors that would justify an adjustment from the baseline, either up or down, have been identified.

16. Although another commodity derivative at Nasdaq Commodities is based on the same underlying, a downward adjustment has not been applied under Article 17 of RTS 21 because the spot month limit is not based on deliverable supply. The level of deliverable supply thus does not impact on the settlement of the contract.

17. 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.

18. As no adjustment was made to the baseline, this results in a spot month limit of 4,049 lots, which equates to 25% of open interest.

Other months' position limit

Other months' position limit

19. The other months' limit amounts to 4,049 lots, which represents 25% of open interest. The other months' limit applies to the Panamax TC Freight Futures and Options contracts.

Other months' position limit rationale

20. As the underlying of the Panamax TC Freight Futures/Options contract does not qualify as food intended for human consumption, the baseline figure for the spot month is set at 25% of the reference amount, i.e. open interest, in accordance with Article 9 of RTS 21 (25% * 16 194 lots = 4 049 lots). The Panamax TC Freight Futures/Options contract is a "less liquid" derivative contract according to Article 15 (1) (b) of RTS 21 as the open interest is below 20,000 lots over a consecutive three-month period.

21. All potential adjustment factors have been considered by BaFin and, based on the characteristics of the contract, are not regarded as material or relevant to require additional adjustments, either up or down, from the baseline.

22. 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 BaFin has not found evidence that this is excessive or that lower position limits would reduce volatility.

23. As no adjustment were made to the baseline, this results in a spot month limit of 4,049 lots, which equates to 25% of open interest.

V. ESMA's Assessment

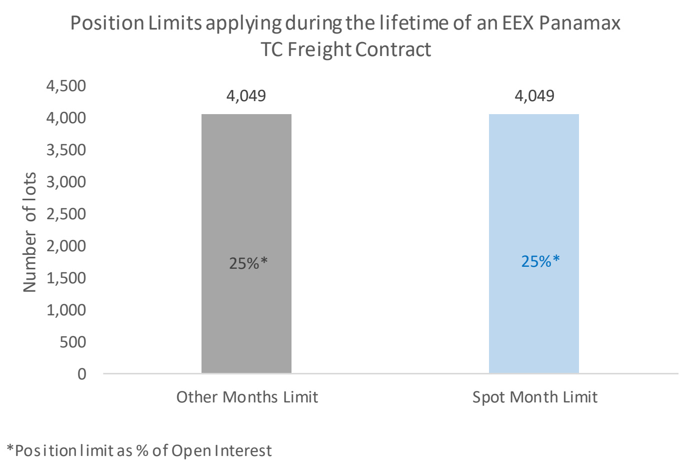
24. This Opinion concerns positions held in Panamax TC Freight Futures/Options contracts.

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

26. 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

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



<u>Spot month position limit</u>

28. ESMA agrees that the Panamax TC 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.

29. The open interest was calculated as the average size of daily open interest throughout the three first calendar months in 2018. 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.

30. ESMA considers in particular as a reasonable approach not to have adjusted the spot month limit downwards based on Article 17 of RTS 21 to take into account the Nasdaq Commodity contracts with the same freight underlying as the EEX and the Nasdaq contracts are cash settled. There is therefore no risk to orderly settlement arising from low or insufficient deliverable supply, which Article 17 of RTS 21 aims at addressing.

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

29. ESMA agrees that most of the potential adjustment factors in RTS 21 are not relevant for cash settled contracts where open interest serves as a baseline both for the spot month and for the other months'.

31. 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

32. 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.

33. Based on the information provided by the competent authority, ESMA notes that the spot month limit for the Panamax TC Freight contracts exceeds the highest open interest in the spot month during 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.

34. 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 Panamax TC Freight contracts futures and options contracts are not hampered

35. 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 Panamax TC Freight contracts should be carefully monitored by the competent authority, in particular during the spot month, and that the limit should be reviewed on a timely basis.

VI. Conclusion

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

Done at Paris, 18 January 2019

Steven Maijoor

Chair

For the Board of Supervisors