European Securities and Markets Authority

Date: 7 December 2017
ESMA70-155-1535

OPINION on position limits on ICE Brent Crude contracts

I. Introduction and legal basis

1. On 20 October 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 instruments[1] ("MiFID II") regarding the exact position limits the FCA intends to set for the ICE Brent Crude 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 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: NRGY_energy

Commodity sub product: OILP_oil

Commodity further sub product: BRNT_brent

Name of trading venue(s): INTERCONTINENTAL EXCHANGE - ICE FUTURES EUROPE

MIC(s): IFEU

Venue product code(s): B

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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, p84).

III.Market description

3. Crude oil is a non-perishable commodity. There are numerous grades depending upon its chemical composition. The type of oil and its level of sulphur determines its use and the types of market participants involved in that market.

4. Brent blend is a light crude oil (LCO), though not as light as West Texas Intermediate (WTI). It contains approximately 0.37% of sulphur, classifying it as sweet crude, yet not as sweet as WTI. Brent is suitable for production of petrol and middle distillates. It is typically refined in Northwest Europe.

5. Brent is one of the largest offshore UK oilfields. Brent is extracted from the North Sea and forms part of the basket of oil that makes up the benchmark along with Forties, Oseberg and Ekofisk. As of January 2018, the Troll oil field will be included in Platts' price assessment of the Brent basket.

6. The Brent crude oil market represents the primary benchmark for crude oil globally. It has become the most important price discovery and hedging mechanism that directly prices around 2/3rds of the world's crude oil supply. Factors such as Brent's accessibility and reach as a seaborne crude, production, adaptation to changing global economics in the oil market, stability and geographic location have consolidated Brent's global benchmark position and contributed to physical participants, such as international airlines and oil producers in Asia, adopting Brent as a primary hedging tool. Price and supply can be affected by industry and geopolitical issues such as OPEC decisions concerning supply to the global market, legislative provisions and political unrest.

7. The contract is available for trading for up to 96 consecutive months. Trading shall cease at the end of the designated settlement period on the last business day of the second month preceding the relevant contract month (e.g. the March contract month will expire on the last business day of January).

8. Under the ICE Brent Crude contract, alternative grades of oil are acceptable for delivery as long as its price is expressed in relation to Brent, at a premium or discount. This broadens the range of market participants who wish to trade in ICE Brent making this market one of the largest and most commonly used by a range of industries for hedging purposes.

9. The contract is based on exchange for physical (EFP) delivery with an option to cash settle against the ICE Brent Index price for the last trading day of the futures contract. The Exchange shall publish a cash settlement price (the ICE Brent Index price) on the next trading day following the last trading day for the contract month.

10. The Brent Index is the cash settlement price for the contract based on the ICE Futures Brent index at expiry of the front month ICE Brent futures contract. Currently, the index represents the average price of trading in the 25-day Brent Blend, Forties, Oseberg, Ekofisk (BFOE) market in the relevant delivery month as reported and confirmed by the industry me-

dia. Only published cargo size (600,000 barrels or 95,000 m^3) trades and assessments are taken into consideration.

11. The index is calculated as an average of the following elements:

a. A weighted average of first month cargo trades in the 25-day BFOE market.

b. A weighted average of second month cargo trades in the 25-day BFOE market plus or minus a straight average of the spread trades between the first and second months.

c. A straight average of designated assessments published in media reports.

IV. Proposed limit and rationale

Spot month position limit

Deliverable supply

12. Deliverable supply amounts to 555,827 lots. A lot is equivalent to 1,000 barrels (bbl).

13. The ICE Brent futures is deliverable in physical form with an option to cash settle. The physical settlement is by Exchange for Physical (EFP) method, which may take place in a variety of grades of crude oil.

14. The major elements of deliverable supply for Brent include the North Sea fields for the Cash and Dated markets, major Russian/FSU fields which also feed supplies via pipeline into Europe and other near-Eastern grades (such as Azeri, CPC and any west-bound Siberian crude oil) which are priced in relation to Brent. Significant flows include North African/Mediterranean grades and African (mainly West African, such as Angolan and Nigerian) light sweet grades, which also flow directly into the European Brent waterborne delivery system, and which use the Brent benchmark pricing.

15. Deliverable supply for Brent Crude Oil and other substitute grades has been calculated by adding production data from countries whose oil quality is similar to that of Brent and that is priced on the basis of Brent. These oils may be used to deliver against the Brent contract, with an appropriate price adjustment, if necessary. Therefore the production data from a range of sources for the UK, Norway, Russia, Libya, Algeria, Angola, Nigeria and the rest of Europe over the period of 2016 inclusive has been aggregated to determine the deliverable supply value.

16. The deliverable supply figure has been calculated by dividing an annual 2016 production figure of 6,669,923,130 barrels of deliverable grades by 12 to get a monthly production figure of 555,826,928 barrels, which has been divided by 1,000 to convert barrels into lots, resulting in a deliverable supply of 555,827 lots.

Spot month position limit

17. The spot month limit is set at 75,000 lots, which represents 13.5% of deliverable supply. The spot month limit applies to ICE Brent Futures and Options contracts.

18. In addition to the spot month limit set by the FCA, ICE has expiry limits that apply in the period immediately prior to the expiry of the contract. The limit set by the FCA applies for the entire spot month and is therefore higher than the trading venue limit. It is set at a level to support orderly pricing, and enable price discovery, as well as ensure a smooth transition of positions from the other months period to the spot month period.

Spot month position limit rationale

19. Given the multiple sources of oil that can be used to meet delivery obligations against the Brent contract, the FCA does not consider that there are restrictions on supply that affect orderly settlement.

20. As the daily average open interest in 2016 is above 20,000 lots, the ICE Brent oil contract is classified as a 'liquid' contract with a baseline limit of 25% and a standard range of the limit between 5% and 35%, according to Article 18 of RTS 21.

21. The FCA has made a downward adjustment of 7.5 percentage points under Article 18(1) of RTS 21 due to the exceptionally large open interest in the contract (2,808,216 lots). Another downward adjustment of 4 percentage points was made given the market structure and the large number of market participants (834) under Article 19 of RTS 21.

22. Although it is possible for certain grades of oil which are deliverable against the Brent contract to also be delivered against other contracts, no downward adjustment was made based on Article 17 of RTS 21 because of the large amount of deliverable supply available.

23. As there are also many methods of delivery, the FCA does not think that there are delivery capacity constraints that would justify an amendment to the position limit under Article 20(2)(b) of RTS 21.

24. No other adjustments have been judged as necessary to be made in the spot month. 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, 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.

25. Given the characteristics of this contract and its global relevance and status, the FCA has decided to set a total downward adjustment of 11.5 percentage points resulting in an adjusted baseline of 13.5% of deliverable supply. This provides a figure in lots of 75,037, which has been rounded down to 75,000 lots. This equates to a final limit as a percentage of deliverable supply of 13.5%.

Other months' position limit

Open interest

26. The open interest amounts to 2,808,216 lots based on figures reported by the trading venue considering the daily average for 2016 of the number of open contracts that have not been closed out or expired, including the open interest of options on a delta adjusted basis. There are no "same" or EEOTC contracts identified by the trading venue and therefore only the on venue open interest is taken into consideration.

Other months' position limit

27. The other months' limit is set at 294,850 lots, which represents 10.5% of open interest. The other months limit applies to ICE Brent Futures and Options contracts.

Other months' position limit rationale

28. The baseline for the other months limit has been set at 25% as required by Article 9(1) of RTS 21.

29. The FCA has decided to adjust the limit downwards from the baseline due to various reasons based on Articles 18 and 19 of RTS 21.

30. The overall open interest (Article 18 of RTS 21): The FCA noted that open interest is 5 times the deliverable supply for this particular contract. The FCA therefore decided to make a downward adjustment of 3 percentage points according to Article 18(1). Another downward adjustment of 7.5 percentage points was made due to the large open interest under Article 18(2).

31. The number of market participants and market makers (Article 19(1) of RTS 21): The trading venue has identified 834 market participants holding open interest over a year, and therefore the FCA has made a further downward adjustment of 4 percentage points under Article 19(1) due to the very large number of market participants.

32. All the other potential adjustment factors set out in RTS 21 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, 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.

33. A total downward adjustment of 14.5 percentage points was made to the baseline, providing a figure of 294,850 lots. This equates to a final limit as a percentage of open interest of 10.5%.

V. ESMA’s Assessment

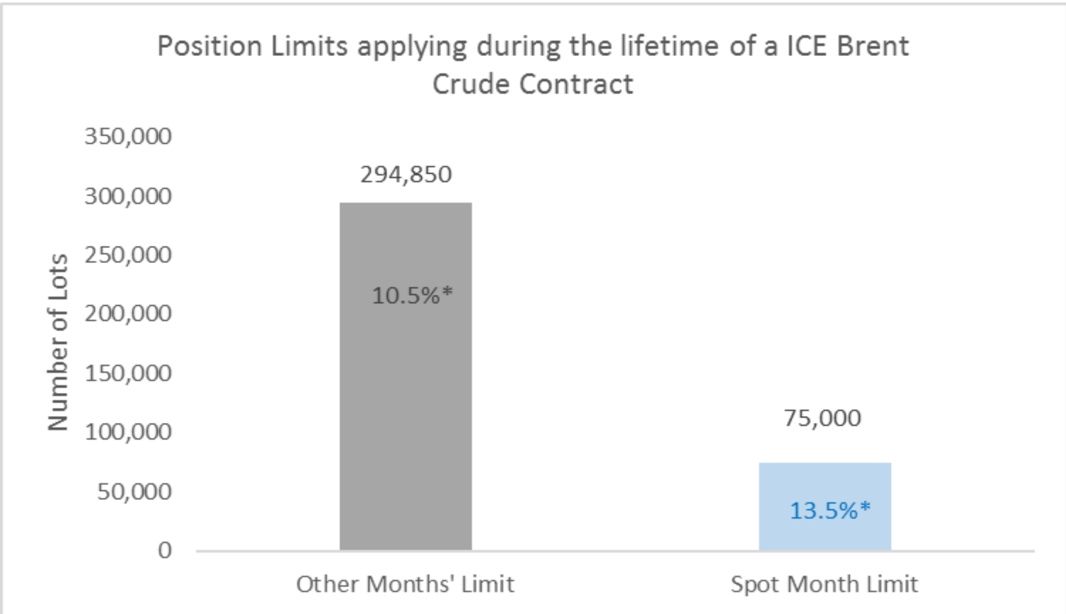
34. This Opinion concerns positions held in the ICE Brent Crude contracts.

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 a position limit for the whole spot month and another position limit for other months.



*Position limit as % of Open Interest

*Position limit as % of Deliverable Supply

<u>Spot month position limit</u>

38. While the Brent contract originated based on oil produced in BFOE fields, it is now what is commonly referred to as a benchmark contract that serves as a hedging and pricing tool for a large part of the world’s oil market. ESMA considers that (as many different types of oil can be used to settle against the Brent contract as long as their price is adjusted based on Brent) using the production figures of all those oils for the calculation of deliverable supply appears

compatible with Article 10(1) of RTS 21. ESMA notes that the deliverable supply calculation made by the FCA is relatively conservative as it excludes potential oil supplies that are not directly priced off Brent.

39. ESMA considers that the deliverable supply calculation's methodology is consistent with Article 10(2) of RTS 21 that 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".

40. ESMA considers that a significant downward adjustment to the baseline under Article 18(1) of RTS 21 seems appropriate given the large open interest and the status of Brent as a global benchmark contract used for hedging for a large number of market participants across the world. ESMA also agrees with the adjustment made under Article 18(2) of RTS 21 given the large difference between deliverable supply and open interest.

41. ESMA agrees that compared to other globally traded UK commodity derivative contracts, the number of market participants on this contract appears high and consequently it does require a downward adjustment under Article 19(1) of RTS 21.

42. ESMA also highlights that the trading venue currently applies a spot month expiry limit of 6,000 lots to the Brent contract. This limit of 6,000 lots will be part of the position management powers of the trading venue. ESMA notes that this limit is significantly lower than the spot month position limit of 75,000 lots.

43. The reason provided for this discrepancy is that the spot limit applies to the whole of the spot month while the trading venue expiry limit refers only to the last 5 days prior to expiration. ESMA agrees that the two limits are complementary and will work together without duplication to ensure orderly trading and settlement.

44. ESMA therefore agreed that it is not considered necessary to duplicate the existing venue expiry limit controls where these are believed to be established and effective as the objective of the expiry limit of the trading venue is only to manage the physical delivery process and to ensure that market participants meet their delivery commitments.

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

45. The open interest was calculated as the daily average for 2016 of the number of open contracts that have not been closed out or expired. ESMA considers such an approach sensible in this case as an average for a period of time gives a more stable measure of open interest and considers such approach consistent with Article 12 of RTS 21.

46. ESMA agrees that in accordance with Article 18(1) the large volume of open interest justifies the downward adjustment of the other months limit.

47. As open interest is significantly higher than deliverable supply due to the very liquid nature of the Brent contract, ESMA also considers a significant downward adjustment under Article 18(2) appropriate.

48. Likewise, the large number of market participants necessitate the downwards adjustment for the other months limit, under Article 19(1).

49. ESMA notes that an upward adjustment factor could be considered given the large number of separate expiries (96) according to Article 16(2). The FCA has noted the relatively large number of separate expiries. However, because of the other factors pointing to a downward adjustment from the baseline, it decided not to make an upward adjustment in this case.

50. ESMA agrees with the FCA that the downward adjustment factors weigh higher than the large number of separate expiries given the characteristics and the global nature of the contract, in itself and compared to other global contracts, and therefore agrees with the downward adjustment from the baseline set by the FCA.

51. 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

52. 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) of MiFID II.

53. The limits set take into account the contract's status as the primary benchmark for crude oil globally. In addition, the other months limit balances the long term structure of this contract, with maturities reaching 96 months, with the fact that open interest in this contract is exceptionally large and much larger than deliverable supply. ESMA is of the view that, taking into consideration the specifics of the underlying market, these limits are suitable for the conditions under which they will be active.

54. Overall, the position limit set for the spot month and the other months 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 market and the liquidity of the ICE Brent contract are not hampered.

VI. Conclusion

55. 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, 7 December 2017

Steven Maijoor

Chair

For the Board of Supervisors