European Securities and Markets Authority

Date: 23 October 2017
ESMA70-155-1822

# OPINION on position limits on Copper contracts

## I. Introduction and legal basis

1. On 4 August 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 Copper 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. This notification was supplemented by additional data provided on 6 October 2017.

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: Metals (METL)

Commodity sub product: Non Precious (NPRM)

Commodity further sub product: Copper (COPR)

Name of trading venue(s): THE LONDON METAL EXCHANGE

MIC(s): XLME

Venue product code(s): CA

[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 December 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 London Metal Exchange (LME) has a network of warehouses located across many countries from which the underlying commodity may be sourced. There are 92 approved LME brands of copper.

4. All copper must be of an LME approved brand to be deliverable against LME contracts. LME copper contracts are settled by transfer of a warrant giving ownership of metal located in a warehouse network which includes 600 approved warehouses.

5. The FCA has not identified any restrictions on the transportation of copper from the relevant warehouses that would justify an adjustment to the baseline.

6. The largest consumer of copper is China at around 50% of global demand followed by Europe, the US and Japan. There is no particular seasonality noted in production or consumption of the metal which leads to price fluctuation.

7. The market features a wide range of participants including producers hedging their output, industrial consumers, market intermediaries and longer term investors in commodities such as funds. In addition to the LME, copper is traded on the Commodity Exchange Inc. (COMEX), where the contract is physically settled. The open interest of the COMEX contract is less than 50% of the open interest in the LME contract. Copper is also traded on the Shanghai Futures Exchange (SHFE) for physical settlement. The combined open interest of the two exchanges is equivalent to around two-thirds of LME volume. The global nature of the metals markets and the associated warehousing system means that stocks held outside the LME system can be rapidly introduced to meet delivery obligations.

8. In 2016, copper prices increased by 10% with a gradual decline later in the year due to surplus supply arising from production capacity increases in countries such as Peru. The World Bank expects demand from China to increase in 2017. Supply growth is expected in 2017/2018 although wage negotiations in Chile may have an impact on this.[4]

9. Copper is a metal and non-perishable. The largest deposits are found mainly in Chile (which accounts for a third of global production), US, Indonesia and Peru. Copper is used in a wide range of industries with electrical/electronic manufacturers and construction being the most significant users of the metal. Consumer goods, transport and industrial machinery manufacturers are other industrial consumers of the metal. Copper is also combined with other metals to form alloys such as bronze and is recyclable.[5]

10. Estimated number of market participants / market makers in accordance with Article 19(2) of RTS 21: 808 / 0

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[4] World Bank Commodity Markets Outlook, January 2017

[5] World Bank, Global Economic Prospects Divergences and Risks, June 2016

## IV. Proposed limit and rationale

*Spot month position limit*

11. Deliverable supply amounts to 82,256 lots. A lot is equivalent to 25 tonnes.

12. The contract is settled by transfer of a claim to (or "warrant" over) physical metal. The starting point for calculation of deliverable supply against the LME contract is the published data on stocks of metal held in LME warehouses. The information on LME Official Stocks is available to any person from the LME website[6]. The average of daily levels of LME Official Closing Stock for the calendar year 2016 represented 9,394 lots of the copper contract. This represents the most immediate stock of the commodity which is available for physical delivery.

13. Deliverable supply is represented not only by reported stocks but also a number of other elements which could be used to meet the delivery obligation. These include cancelled LME warrants which may have been taken out of the LME system either to reduce storage charges, in anticipation of movement out of a warehouse, or for other operational reasons. Cancelled warrants may be reinstated on an almost immediate basis by the warehouse-keeper on the instruction of the metal-owner. LME warrants may also be delivered multiple times during the spot month period, because of the LME practice of daily settlement. This further increases the quantity of potential deliverable supply. The re-use of LME warrants to meet delivery obligations is an established characteristic of the LME markets which enables participants to match their requirements for physical metal in specific locations. It also enables the timing of deliveries to take place outside the normal “Third Wednesday” monthly trading cycle which defines the spot month period for the purpose of setting limits.

14. The spot month is defined as the amalgamation of all daily prompts within the 30 days immediately preceding the relevant month’s expiry as this takes into account only trading linked to the relevant expiry month.

15. An additional source of deliverable supply is unwarranted copper that is held by LME warehouse companies in their non-LME licensed warehouses and which can easily be transferred into their LME licensed warehouses and placed on warrant. Often, LME warehouse companies have LME-licensed and non-LME warehouses at the same location. Additional space within LME warehouses allows metal which is not currently within the LME system to be introduced and made eligible for delivery.

16. These additional factors which increase the amount of copper available or potentially available to meet delivery commitments mean that the amount calculated for deliverable supply is significantly greater than the amount recorded as on LME warrant at any point in time.

[6] https://www.lme.com/metals/reports/stocks/

17. In calculating deliverable supply, the FCA has excluded quantities of metal which are committed by commercial entities under long-term arrangements to supply or purchase. These amounts are therefore not available to enter the LME stock system.

18. The calculated amount of total deliverable supply gives a figure for deliverable supply which is consistent with annual refined production of around 23 million tonnes which represents 920,000 lots of LME copper if all production were available[7]. The World Bank figure also does not take into account metal which has been refined and in storage.

19. In summary, the breakdown of the components for calculating deliverable supply using data for the calendar year 2016 are:

| **Deliverable Supply** | **Number (Lots)** | **Notes** |
|---|---|---|
| LME Warehouse Stocks | 9,394 | On-warrant and cancelled warrants |
| Deliverable non-LME Warehouse Stocks | 43,784 | Excluding non-LME branded eligible metal |
| Monthly Production in LME branded metal | 8,375 | Excluding production that would be used for commercial and alternative purposes |
| Re-use of LME Warrants at LME Warehouses | 20,703 | To reflect multiple use of warrants to settle contracts during spot period |
| *Total* | *82,256* | |

*Deliverable non-LME Warehouse Stocks figures from estimates provided by LME*

<u>Spot month position limit rationale</u>

20. The spot month limit is 13,950 lots. This constitutes 17% of the reference amount.

21. The baseline for the spot month limit has been set at 25% of deliverable supply as required by Article 9(1) of RTS 21.

22. Adjustments have been made to the baseline, where necessary, using the rationale for adjustments set out in RTS 21 as follows.

23. Article 17 of RTS 21 requires consideration of whether the commodity is used for other commodity derivative contracts. As the underlying copper may also be delivered against other physically deliverable contracts and those contracts have a material volume of open interest (circa two-thirds of LME open interest), the FCA has made a downwards adjustment of the limit by 3 percentage points. When considering Article 18(1) of RTS 21, a downward adjustment of 1 percentage point has been made due to the large open interest (594,107 lots) in the contract relative to commodity derivative contracts as a whole. The amount of the adjustment was considered against other contracts in the asset class. The estimated very large number

[7] as reported in the World Bank Commodity Markets Outlook, January 2017

of market participants (808) resulted in a further downward adjustment of 4 percentage points in accordance with Article 19(1) of RTS 21.

24. Each of the factors referred to in Article 20 of RTS 21 was also considered but no further adjustment is considered necessary.

*Other months' position limit*

Open interest

25. The open interest amounts to 594,107 lots. A lot is equivalent to 25 Tonnes.

26. The open interest figure has been reported by the trading venue and is calculated as the daily average over a one year period of the number of open futures and delta-adjusted options contracts which have not been closed out or expired. The period used is the calendar year 2016.

Other months' position limit rationale

27. The other months limit amounts to 106,900 of lots. This constitutes 18% of the reference amount.

28. The baseline for the other months has been set at 25% of open interest as required by Article 11 of RTS 21.

29. Adjustments have been made to the baseline, where necessary, using the rationale for adjustments set out in RTS 21 as follows.

30. The FCA has made an upwards adjustment to the baseline of 2 percentage points for the large number of separate expiries (228) of the copper contract when considering Article 16(2) of RTS 21. The large open interest (594,107 lots) in the contract relative to commodity derivative contracts as a whole has been reflected in a downward adjustment of 1 percentage point in accordance with Article 18(1) of RTS 21. The amount of the adjustment was considered against other contracts in the asset class. The FCA also consider the amount of the open interest to be large in relation to deliverable supply (722%), and therefore have made a downwards adjustment of 4 percentage points under Article 18(2) of RTS 21. The FCA made a downwards adjustment of 4 percentage points under Article 19(1) of RTS 21 to reflect the estimated very large number of market participants (808). Following consideration of the relevant factors, no further adjustments were made for the characteristics of the copper market in other months under Article 20 of RTS 21.

Further Comments

31. 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. Although there are no market makers, as defined in RTS 21, in copper according to the data provided by the venue

and this would at first sight suggest that the upper limit boundary to the position limit would be 50% (according to Article 19(2) of RTS 21), as there are many liquidity providers fulfilling an analogous role to market makers such an upward adjustment is not necessary. 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.

32. Adjustments from the initial baseline of 25% have been made as follows to provide the position limit.

33. For the spot month, a total downward adjustment was made of 8 percentage points resulting in an adjusted baseline of 17%. This provides a figure in lots of 13,984 which has been rounded down to a figure of 13,950 lots. This equates to a final limit as a percentage of deliverable supply of 17%.

34. For the other months, a total downward adjustment was made of 7 percentage points resulting in an adjusted baseline of 18%. This provides a figure in lots of 106,939 which has been rounded down to 106,900. This equates to a final limit as a percentage of open interest of 18%.

## V. ESMA's Assessment

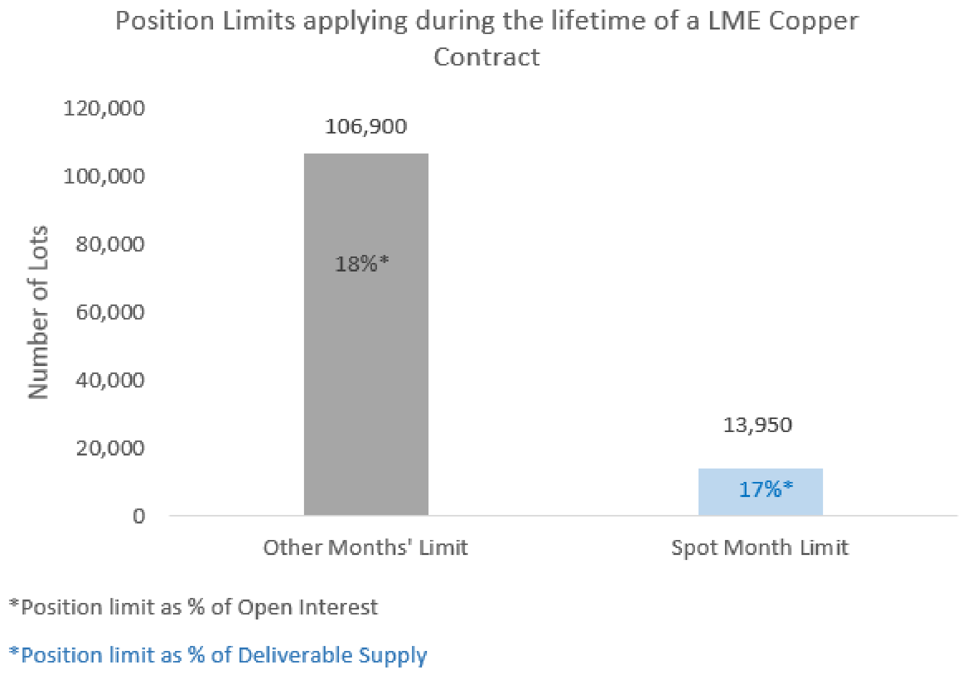
35. This Opinion concerns positions held in Copper contracts.

36. ESMA has performed the assessment based on the information provided by the FCA.

37. 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*

38. The FCA has set two position limits. One for the entire spot month (30 days), and one for the other months.




Spot Month Limit

39. Deliverable supply calculations assess a combination of factors that contribute to the average monthly amount of the underlying commodity for delivery. In this case (1) average daily LME warehouse stocks, (2) deliverable non-LME warehouse stocks, (3) monthly production in LME branded metal, and (4) re-use of LME warrants at LME warehouses.

40. ESMA recognizes that the 're-use of warrants' market practice is particular to individual contracts and not ubiquitous across all LME contracts. The existence of the activity is dictated by the prevailing market nature and conditions, and as such will not be included in all deliverable supply calculations.

41. ESMA considers this approach consistent with Article 10(2) of RTS 21, which 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".

42. While the metal supply within 'non-LME warehouses' is not immediately available for delivery, ESMA accepts that it can be easily transferred into licensed warehouses, and accordingly their stock can be added to the deliverable supply.

43. ESMA considers the adjustments made under Article 17 of RTS 21 for the use of deliverable supply being required to fulfil other metal contracts as appropriate.

44. The open interest and overall number of market participants indicates robust copper trading activity, thus a stricter spot month limit should not cause an impairment to trading, whilst limiting the possibility of a single participant having a large impact on prices.

45. ESMA considers the adjustments made under Article 18 of RTS 21 as appropriate given their application is in accordance to a proportional methodology following cross-class analysis of all LME metal contracts.

46. ESMA notes that LME metals contracts are traded on a global basis and agree that the position limits should be set alongside comparable UK global contracts, taking into account the market characteristics of those contracts. As such, ESMA considers the adjustments made under Article 19 of RTS 21 as appropriate given their application is in accordance to a proportional methodology following cross-class analysis of all LME metal contracts.

<u>Other Months' Limit</u>

47. Open interest calculations took the average daily open interest volume over 2016 of contracts that have not expired or been closed out, including options on a delta adjusted basis.

48. ESMA considers such an approach sensible in this case, as an average over a time period gives a more stable measure of open interest, and considers such approach consistent with Article 12 of RTS 21.

49. The adjustments made under Article 16 of RTS 21 have been applied due to the existence of daily contracts in the spot month 228 expiries is the largest number offered at the LME (for contracts that trade 123 months forward).

50. ESMA considers the adjustments made under Article 18 of RTS 21 as appropriate given their application is in accordance to a proportional methodology following cross-class analysis of all LME metal contracts.

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) MiFID II.

53. ESMA considers these position limits to have been set in accordance with the above mentioned objectives and fully take into account that the liquidity profile of the copper contract is one of the most liquid on LME. The long term structure (123 months) reduces the impact of the other months limit. Accounting for this, and the market profile, ESMA considers these limits suitable for the market conditions within which they will be active.

54. Overall, the position limit set for the spot month and the other months, in conjunction with the position management powers of the trading venue, 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 copper market and the liquidity of the LME Copper futures and options 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. In addition, the other months' position limit, complies with the methodology established in RTS 21 and is consistent with the objectives of Article 57 of MiFID II.

Done at Paris, 23 October 2017

Steven Maijoor

Chair

For the Board of Supervisors