



# MiFID II: Impact on LME members

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# 1 Summary

The Markets in Financial Instruments Directive (MiFID) and Markets in Financial Instruments Regulation (MiFIR) (together MiFID II) form the largest consolidated package of financial services legislation to govern the European financial markets.

MiFID II will impact all participants in the European capital markets. It is therefore important that you take time to understand the changes that MiFID II is introducing and consider the modifications to existing business practices that may be required in order to manage the new regulatory standards. This paper offers a snapshot of key MiFID II issues, which may be relevant to LME Members in relation to their business on our market.

## 2 Enhanced reporting requirements

### 2.1 Transactions reporting and order record keeping

Members will be subject to a variety of enhanced reporting and order record keeping obligations in relation to orders received and trades executed on the LME (and other EU trading venues). This is intended to give Regulators greater opportunity to monitor the financial markets and investigate cases of suspected market abuse. Therefore the volume of information and granularity of detail that you provide to the regulator and that you receive from your clients will greatly increase. The key areas of impact are set out below:

### 2.2 Legal Entity Identifier (LEI)

An LEI is a globally unique code used to identify each legal entity. All allocated LEIs are included in a global data system which allows the relevant entity to be identified irrespective of the jurisdiction in which it is located.

Members subject to the MiFID II transaction reporting and order record keeping obligations will not be able to execute a trade on behalf of a client that is eligible for an LEI but does not have one. It is therefore important that you obtain an LEI for your own trading purposes and ensure your clients are taking steps to obtain an LEI in order to avoid any interruption to your ability to accept orders from them.

### 2.3 Personal details of the “investment decision maker”

National and European regulators will be provided with significantly more information in relation to the genesis of an order/transaction. In particular, MiFID II requires that the individual(s) responsible for making investment decisions can be readily identified by regulators. This is intended to ease regulators' ability to investigate suspected manipulative or abusive behaviour in the markets.

Transaction reports and order records will therefore need to include personal details of certain front office staff members who are the “responsible investment decision maker”. This applies both in relation to your own firm and in relation to client firms. The relevant details include the individual's first name, surname, date of birth and passport/National ID numbers. In cases of decisions made by committee the chair of that committee will be deemed to be the relevant individual and where an investment decision has been made by an algorithm, details of the algorithm will be required.

If you are located outside the EU, the same information will nonetheless be required as the obligation to report will simply pass to the LME (or other relevant trading venues).



## 2.4 International Securities Identification Number (ISIN)

MiFID II introduces the requirement for trading venues to identify instruments traded on its venue with ISINs. LME will purchase ISINs from the LSE Group (the designated UK National Numbering Agency). An ISIN will be assigned to individual instruments by prompt date and option strike price. The LME will create a tradeable instruments file twice daily: once at the opening of electronic trading and once at the end of trade registration each day. This file will be accessible through LMEselectMD and on [lme.com](http://lme.com).

## 2.5 Details of positions held in commodity derivatives

MiFID II introduces a new regime governing the size of positions that may be held in a commodity derivative as well as imposing daily reporting requirements in relation to the size of positions held in such instruments. Please refer to the position limits and position reporting section below for further details on these new requirements.

# 3 Position limits and position reporting

## 3.1 Position limits

MiFID introduces limits on the maximum size of a net position that entities and groups can take in commodity derivatives traded on an EEA trading venue and in Over The Counter (OTC) contracts deemed to be equivalent economically. In case of a breach of the prescribed limit, the regulator will contact the position holder directly to ensure that it reduces its position. If a client were to breach a position limit, it would be subject to the discretion of your clients to advise you of such breach – you would not be advised by the regulator.

## 3.2 Exemption for hedging positions

Non-regulated firms may be able to apply for an exemption from the position limit regime where they are able to demonstrate that a position in a commodity derivative is directly risk-reducing. The reporting obligations will continue to apply but the limitation on net positions will not. The FCA has suggested that firms should only apply for this exemption where they believe their positions will be approaching the pre-set limits.

## 3.3 Position reporting

Details of long and short positions held on the LME will need to be reported directly to the LME (and positions held on other venues will need to be reported to those venues). You are also required to provide details of the long and short positions held on the Exchange by your clients and their clients. Reports of OTC positions are only required in certain, very limited, circumstances and must be reported directly to the regulator.

# 4 Algorithmic trading

MiFID II introduces a raft of obligations on trading venues and member firms intended to ensure markets work efficiently and in an orderly manner. If you employ algorithmic trading techniques, you will not only be subject to enhanced requirements in relation to your internal governance structure, you will also be subject to additional requirements in relation to your trading activities. Such obligations include:

- pre-deployment testing (the LME's testing environment is currently live and can be found [here](#))



- controlled deployment
- stress testing
- kill functionality for unexecuted orders.

- **Direct Electronic Access (DEA)**

Member firms providing DEA will be subject to both increased due diligence obligations by the venues on which they provide such access and to additional requirements relating to the risk controls that must be in place. Trading venues (including the LME) will also be subject to new obligations relating to the conditions on which members are able to provide such services.

If you provide DEA to clients, the terms on which this is provided should be reviewed as it is likely they will require amending. In addition, you will be required to conduct enhanced due diligence on those clients in relation to their corporate structure and expected trading pattern on the venue to which you will be providing access.

- **Market Making**

MiFID II introduces a mandatory “market making” regime that requires any algorithmic trader pursuing a “market making strategy” to inform the trading venue on which it is pursuing such a strategy, and to enter into a market making agreement with that venue.

For the purposes of MiFID II, an algorithmic trading firm is considered to be pursuing a market making strategy when it:

- i. deals on own account and is present on a trading venue for at least 50% of the daily trading hours of continuous trading;
- ii. simultaneously posts two-way quotes where their size does not diverge by more than 50% from each other; and
- iii. posts two-way quotes, which are at or within the maximum bid-ask range set by the relevant venue.

Where you fulfil the above criteria in relation to your trading on the LME, you will be required to notify the LME that this is the case. The LME will advise in relation to the current framework of its MiFID II market making scheme.

## 5 Clock synchronisation

Under MiFID II, trading venues are required to timestamp all reportable events to a certain level of granularity, determined based on the gateway to gateway latency of that market. Trading venues are also required to synchronise their clocks to Coordinated Universal Time (UTC) with a maximum divergence also determined based on the gateway to gateway latency of the venue. For the LME this will be one millisecond in both cases.

Members are subject to an equivalent obligation which mandates the granularity of time stamp and divergence from UTC depending on the type of activity undertaken. For example, activities undertaken using high frequency algorithmic trading techniques are subject to the highest level of accuracy (time stamps of one microsecond, or better, with a divergence no greater than 100 microseconds) whereas activities undertaken on a voice trading platform are subject to broader levels of accuracy (time stamping to one second granularity with up to one second divergence from UTC).



## 6 Market infrastructure

MiFID I divided market infrastructure into Regulated Markets (such as the LME) and Multilateral Trading Facilities (MTF) (generally electronic trading systems run by an investment firm). In order to ensure a level playing field and consistent transparency levels throughout the market, these categories are being revised and expanded. MiFID II will both introduce a third type of venue known as an Organised Trading Facility (OTF) and extend and refine the existing regime for “systematic internalisers”.

### 6.1 Multilateral Trading Facility

An MTF is an alternative trading venue that brings together third-party buying and selling interests in accordance with non-discretionary rules in a way that results in a contract. It may not execute against its own capital and trades are concluded in accordance with non-discretionary rules.

MTFs are subject to pre-and post-trade transparency and order record keeping requirements.

### 6.2 Organised Trading Facility

An OTF is a multilateral system on which trades in bonds, structured finance products and emission allowances can take place.

In addition to the limited range of instruments that may be traded on OTF, these platforms distinguish themselves from MTFs by the existence of the operator’s discretion when determining whether to place or retract an order on the OTF and/or when deciding to match the potential matching orders available in the system. An OTF operator is also permitted to execute against its own capital on a matched principal basis.

OTFs are subject to pre-and post-trade transparency and order record keeping requirements.

### 6.3 Systematic internalisers

Systematic internalisers are investment firms that deal on own account when executing client orders OTC. In order to qualify as a systematic internaliser, the investment firm’s trading activity must either reach a pre-determined volume or the investment firm can choose to opt-in to the regime.

Systematic internalisers are subject to requirements to make public details of their pre-trade quotes.

## 7 Indirect clearing

The final rules relating to indirect clearing have not yet been published and therefore the implementation of these requirements is expected to be delayed. The draft requirements, however, suggest that clearing members will have the option to offer clearing to the clients of their clients.

LME Clear will offer a net OSA account for indirect clearing and a new gross OSA account (available for indirect and direct clearing). In addition, LME Clear will open accounts for indirect clearing where requested to do so by a clearing member.



## 8 Changes to the current exemptions from authorisation

Currently, certain types of firms trading in commodity derivatives are not required to be authorised in order to carry out those activities as they are able to benefit from certain exemptions from the regulatory scope. Under MiFID II, the breadth and utility of those exemptions will be reduced and as such, certain firms may be required to become authorised. This will be relevant in particular for commodity derivative proprietary traders and non-financial entities trading for risk-reducing purposes. If you are a trading firm and are not currently authorised, it would be appropriate to consider how your position will be affected under the new requirements.

## 9 Best execution

The concept of “best execution”, which exists under MiFID I, is being revised in order to address some of the weaknesses perceived to exist in the current framework. The changes impose obligations on trading venues to provide details of the price, cost, speed and likelihood of execution on their venue which is intended to offer members the opportunity to objectively determine where they can achieve best execution for their clients. Similarly, investment firms are required to provide details of the top five execution venues in terms of volumes on which they executed client orders in the previous year.

In addition, when you obtain consent from clients for your best execution policy, you are required to ensure that your client understands how orders will be executed. You may therefore need to consider reaching out to clients in order to provide some further details on how orders will be executed.

