

Pre-trade transparency in the LME inter-office market

Information for LME members and their clients

LME Business & Service Development

November 2020



SETTING THE GLOBAL STANDARD



Executive summary

- The MiFID II / MiFIR transparency regime substantially expanded the pre-trade and post-trade transparency regime for financial instruments traded in the European Union
 - Pre-trade transparency (“PTT”) is designed to provide market participants with near real-time broadcast of basic trade data around firm quotes
 - Operators of trading venues are required to make public current bid and offer prices, the depth of trading interest at those prices and actionable expressions of interest which are advertised through their systems
- After extensive market consultation, the LME decided on implementing a “Systematic Fixed Price Auction” (“SFPA”) preferred solution in 2020.
 - This preferred solution will require LME members to enter inter-office trade details into the LME matching system (LMEsmart) in order for a fixed price auction to be initiated
 - A number of exemptions and waivers to pre-trade transparency are available and when a directed bid/offer meets these criteria, it will not require an auction to be run
 - For trades which are required to be made pre-trade transparent, members will be unable to provide a firm price to clients until the price has been made transparent to the market by using the SFPA

Introduction

Background to pre-trade transparency (“PTT”)

MiFID II / MiFIR introduced substantially expanded requirements for pre and post trade transparency in order to minimise “dark pools”

The Ring and LMEselect are considered to be compliant with the pre-trade transparent requirements, and post trade transparency is not currently under review

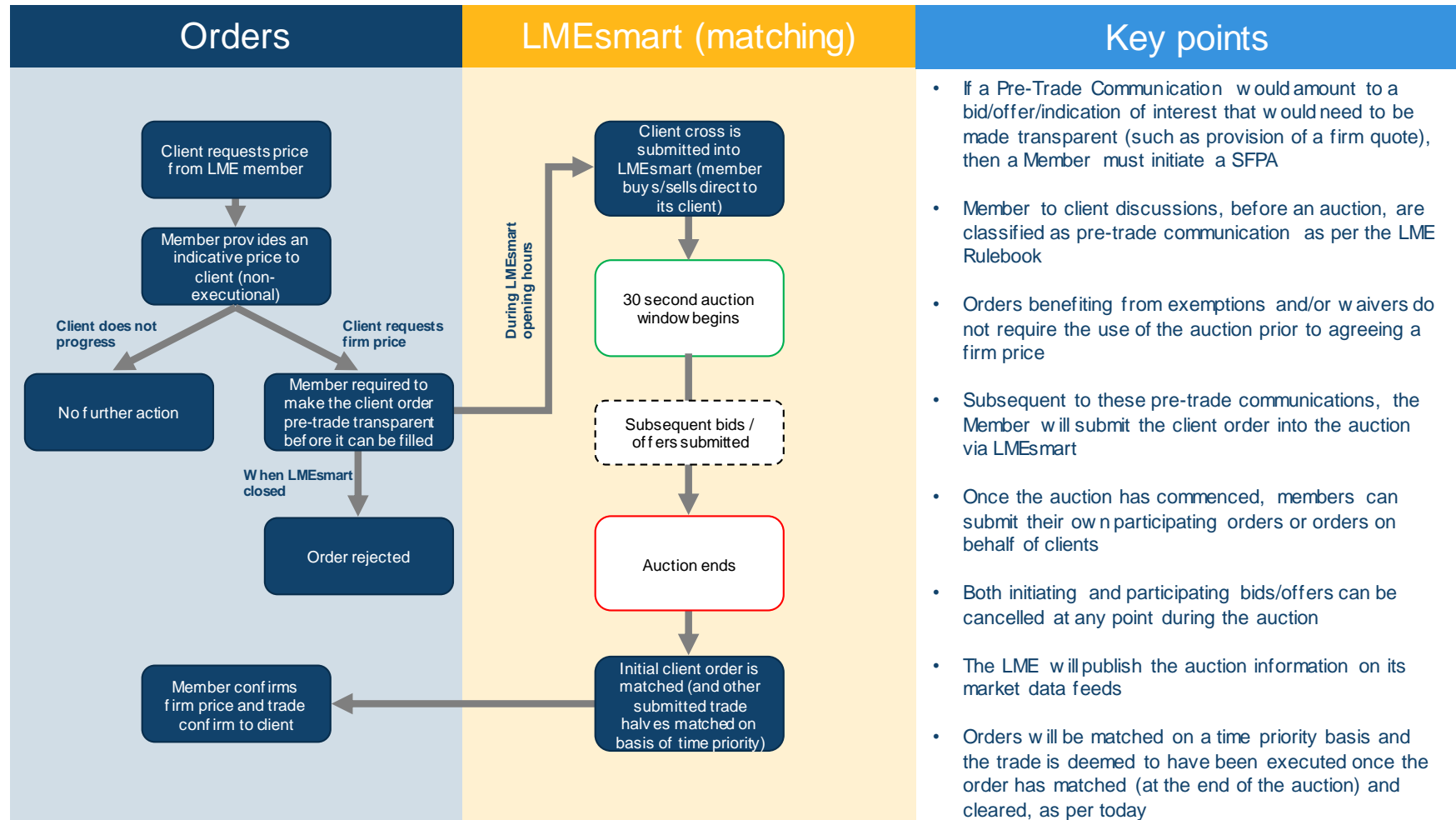
The inter-office (telephone) market has been deemed non-compliant, therefore the LME is required to implement a new solution in order for pre-trade transparency to be achieved

Regulatory requirement as per MiFIR Article 8 (1) for non-equity instruments

“Market operators and investment firms operating a trading venue shall make public current bid and offer prices and the depth of trading interests at those prices which are advertised through their systems for bonds, and structured finance products, emission allowances and derivatives traded on a trading venue. That requirement shall also apply to actionable indication of interests. Market operators and investment firms operating a trading venue shall make that information available to the public on a continuous basis during normal trading hours.”

Systematic fixed price auction (“SFPA”)

The LME’s chosen solution for pre-trade transparency ensures compliance with regulation as well as minimising impact to our end users



High level description of SFPA process

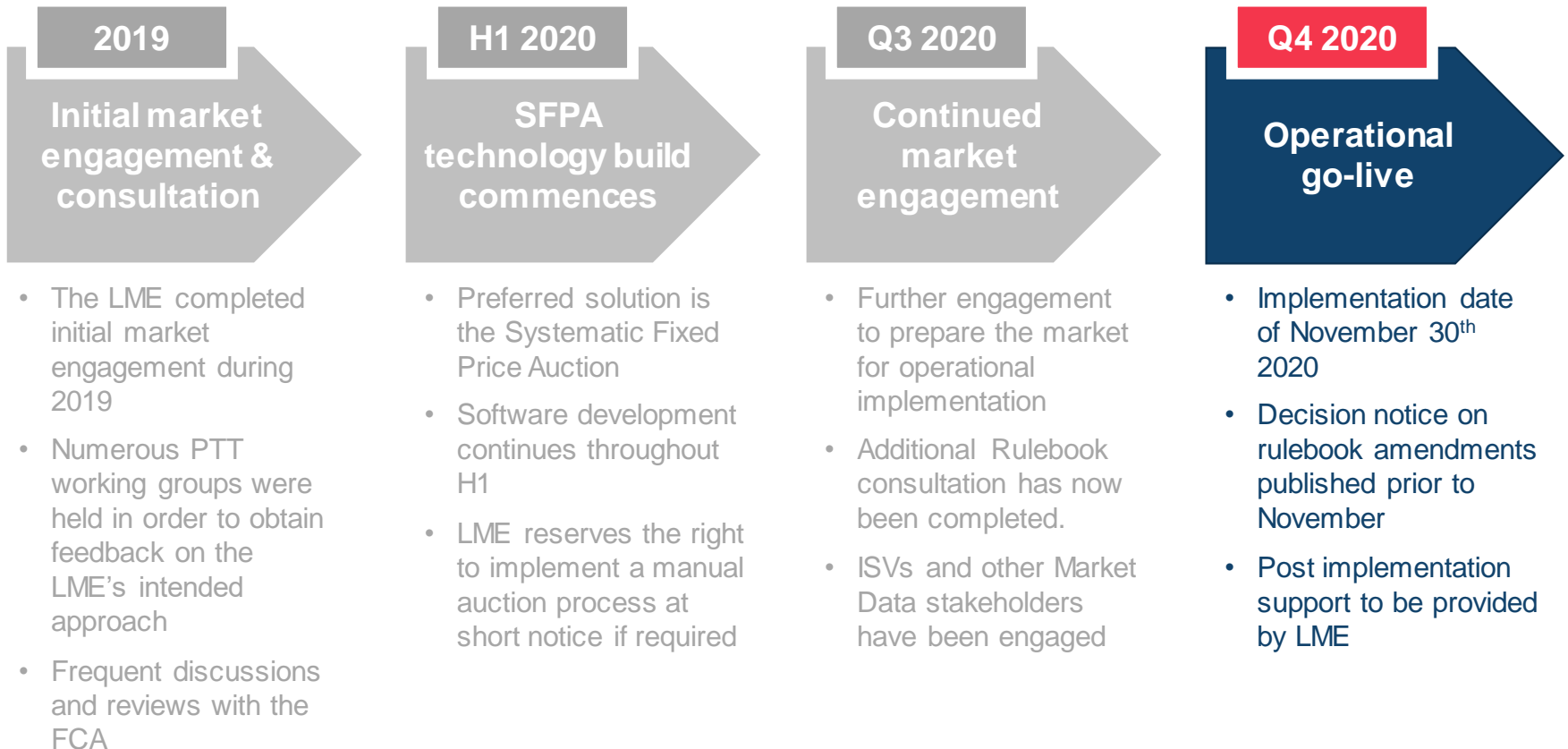
Both member to member, and member to client transactions are detailed below

Member to member	
1	Each member may submit a “directed bid” or “directed offer” to any other member
2	Should a “directed bid” match with a “directed offer”, a 30 second public fixed price auction would be created, with all bids and offers being made pre-trade transparent. “Direct bids and offers” can be cancelled at any point during the auction window by either or both members
3	During the 30 second auction, any member can submit further bids or offers into the auction at the fixed price (i.e. the same price as the initiating order with no price improvement) for their selected volume. Submitted orders will be made pre-trade transparent. The submitted bids and offers can be cancelled at any point during the auction window
4	Upon completion of the auction, bids and offers are matched with a time priority algorithm
5	Trade arises following the final matching process

Member to client	
1	Member enters both the bid, and offer as a single entry (a “client cross”)
2	This bid and offer will match therefore creating a 30 second public fixed price auction with both the bid and offer being made pre-trade transparent. The initiating client cross can be cancelled at any point during the auction window. Both halves will be cancelled as an atomic unit
3	During the 30 second auction, any member can submit further bids or offers into the auction at the fixed price (i.e. no price improvement) for their selected volume, with all of these being made pre-trade transparent. The submitted bids and offers can be cancelled at any point during the auction window
4	Upon completion of the auction, bids and offers are matched with a time priority algorithm
5	Trade arises following the final matching process

Path to implementation

SFPA is the chosen solution but this may be replaced with a manual solution if required by external factors or updates to its analysis of regulatory requirements



Further details

The LME is on hand to provide further information on how pre-trade transparency affects our market

Members, clients, and other interested parties are invited to contact the LME's Business & Service Development team with any questions or queries on:

Business.Development@lme.com

Appendix

Waivers and exemptions from PTT

Many types of inter-office trades will be waived or exempt from PTT requirements

		Description	LME application
Waivers	Illiquid contracts	Derivatives which are not required to be traded on RMs, MTFs or OTFs for which there is not a liquid market	✓
	Large in scale	Orders that are LIS compared with normal market size and	✓
	Order management facility	Orders held in an order management facility of the trading venue pending disclosure	✓ <i>Only applicable to LMEselect</i>
	Packaged orders	Packaged orders that meet certain criteria	✓
	Size specific to the instrument	Actionable indications of interest in request-for-quote and voice trading systems that are above a size specific to the financial instrument (“SSTI”) which would expose liquidity providers to undue risk	✗ <i>Inter-office market is considered a hybrid of an RFQ and voice trading system and does not meet the SSTI criteria</i>
	Exchange for physical	Orders for the purpose of executing an exchange for physical (“EFP”)	✗ <i>Narrow EFP description does not apply to the LME</i>
Exemption	Hedging	PTT requirements shall not apply to “derivative transactions of non-financial counterparties which are objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of the non-financial counterparty or of that group”	✓

Large in scale waiver

Orders that are large in scale compared with normal market size transactions

Large in scale buckets for LME

Underlying metal	Notional currency	Time to maturity bucket	LIS-pre trade threshold (€)
ALUM	EUR	TTM_0_1Y	500,000
ALUM	JPY	TTM_0_1Y	500,000
ALUM	USD	TTM_0_1Y	500,000
ALUM	USD	TTM_1_2Y	4,500,000
ALUM	USD	TTM_2_3Y	4,500,000
COPR	EUR	TTM_0_1Y	500,000
COPR	JPY	TTM_0_1Y	800,000
COPR	USD	TTM_0_1Y	500,000
COPR	USD	TTM_1_2Y	7,000,000
LEAD	USD	TTM_0_1Y	500,000
NASC	USD	TTM_0_1Y	500,000
NICK	EUR	TTM_0_1Y	500,000
NICK	USD	TTM_0_1Y	500,000
NICK	USD	TTM_1_2Y	4,500,000
TINN	USD	TTM_0_1Y	500,000
ZINC	USD	TTM_0_1Y	500,000
ZINC	USD	TTM_1_2Y	3,000,000

Definition of large in scale orders

- Orders that are large in scale (“LIS”) can be waived from the PTT requirements as per MiFIR article 9 1(a)
- The LIS thresholds for liquid products are set using the higher of:
 - The trade size below which lies 70% of the transactions (i.e. the 70th percentile)
 - Threshold floor of €500,000
- ESMA has defined specific time to maturity (“TtM”) buckets per asset class. Based on data submitted by the LME, ESMA determined LIS thresholds for each liquid metal and TtM bucket
- Orders below the LIS thresholds would require PTT, unless subject to another waiver or exemption
- LIS thresholds have been reviewed per ESMA July 2020 updated guidance.

Package order waiver

Transactions where each component is simultaneous and contingent execution of all other components of the package may qualify for the package order waiver

Package orders are defined as:

- a) *a transaction in a derivative contract or other financial instrument contingent on the simultaneous execution of a transaction in an equivalent quantity of an underlying physical asset (Exchange for Physical or EFP);*
- b) *a transaction which involves the execution of two or more component transactions in financial instruments; and:*
 - i. *which is executed between two or more counterparties;*
 - ii. *where each component of the transaction bears meaningful economic or financial risk related to all the other components;*
 - iii. *where the execution of each component is simultaneous and contingent upon the execution of all the other components*

MiFIR article 9 1(e) include a PTT waiver for package if they meet one of the following conditions:

- i. *at least one of its components is a financial instrument for which there is not a liquid market, unless there is a liquid market for the package order as a whole;*
 - ii. *at least one its components is large in scale compared with the normal market size, unless there is a liquid market for the package order as a whole;*
 - iii. *all of its components are executed on a request-for-quote or voice system and are above the size specific to the instrument*
- LME's analysis is that currently no package order type meet the requirements for having its own liquid market and would therefore apply to waive PTT for package orders where at least one leg of the package meet the illiquidity or LIS waivers

Use of the hedging exemption

In addition to the three proposed waivers, a hedging exemption is available for non-financial counterparties

MiFIR Article 8 (1) introduces an exemption for hedging

“[The] publication obligation does not apply to those derivative transactions of non-financial counterparties which are objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of the non-financial counterparty or of that group.”

LME proposal

1

The quote is made to a non-financial counterparty

2

The counterparty is intending to do a trade which is objectively measurable as reducing risks directly relating to its commercial activity

3

The counterparty has confirmed that trade is objectively risk reducing

Observations

- Bids / offers / expressions of interest between most members on the inter-office market would not fall within the hedge exemption, given that members will not qualify as “non-financial counterparties”
- Members or their clients will not have to notify the FCA of the use of the hedge exemption for PTT purposes
- LME reserves the right to audit the use of the hedge exemption through the LME Member Audit Programme

Defined Liquid Markets and LIS Threshold

For the latest defined liquid markets and large in scale (LIS) thresholds, please go to lme.com/ptt

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