

# LME Discussion Paper on Market Structure

## Overview

January 2021



SETTING THE GLOBAL STANDARD



# Why is market structure being discussed now?

## The metals market landscape is evolving



- There is a transition towards digitisation and a greater demand for transparency
- The LME must consider how it can continue to adapt to remain the trusted market of choice for global metals

### Transparency and fairness



Growing demand for greater transparency from a regulatory and governance perspective as well as from society more broadly



The LME has a role to play in maintaining the highest standards and operating a fair and orderly market while seeking solutions for evolving market dynamics

### Digitisation



Commodities trading: physical market is increasingly embracing digital solutions to lower operational costs and increase distribution to clients



Increase in digital metals trading solutions responding to growing desire to find digital solutions for security and custody challenges

## COVID-19

Highlighted and accelerated the need for new ways of working and modernising existing processes



LME Discussion Paper on Market Structure



# We remain committed to our strategic principles

Strategic principles set out in the 2017 Strategic Pathway (SP17)

## Serve the physical market

- Core mission of the LME is to provide pricing, risk management and terminal market services to the global physical metals industry
- Physical market linkage ensures LME prices appropriately reflect real world supply and demand, and maintains the broad ecosystem desired by all LME participants

## Ensure fairness

- The LME's primary responsibility is to ensure fair and non-discriminatory access to its market
- The value of the LME market is maximised by allowing the broadest possible range of participants to hedge and invest, and ensure that all those participants have fair access to information

## Increase user choice

- The LME's market structure should be suitable to meet the varied needs and preferences of its users rather than provide a model that forces all participants to trade in the same way

## Maximise trading efficiency

- It is in the mutual interests of participants, the LME and the broader market that customers be able to trade as extensively as they wish, unencumbered (as far as possible) by the frictional costs of trading



# We have delivered a number of changes since SP17



## Ecosystem

- Reshaped incentive programmes to encourage traders (including algorithms) to provide beneficial liquidity to the market
- Reviewed tick sizes, but concluded that no changes were necessary



## Trading and booking structure

- Delivered implied pricing on LMEselect, providing better electronic liquidity across our date structure – 3W implied volume up 87% in 2020 vs 2019
- Trialled electronic closing prices on nickel – vital in providing electronic pricing during COVID-19



## Clearing structure

- Progressing value-at-risk project, with significant margin saving modelling well-received by members
- Enhanced monthly averaging product to support client clearing



## Delivery and physical structure

- Warehouse reform well-embedded, with 2019 reform implementation underway
- Off-warrant stock reporting delivered and well-received as first step to improved transparency over “shadow” stocks



## Membership

- Successful launch of Registered Intermediating Broker (“RIB”) proposition with 8 registered RIB members, trading 1,480 lots per day in 2020
- Delivered an electronic platform for B share trading to facilitate new memberships and price discovery



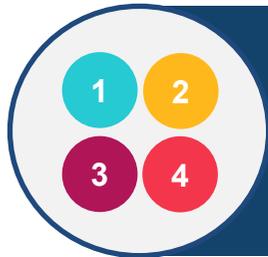
## Volumes, competition, fees and growth

- Delivered a balanced fee structure – across venues, dates and exchange/OTC
- Positive growth in new products, especially ferrous where ADV has continued to grow in a challenging market, up 10% in 2020 vs 2019



# Contents of the Discussion Paper

The Discussion Paper on Market Structure proposes several changes to the LME



The proposals focus on four main topics:

1. The Ring and reference prices
2. Enhancing liquidity
3. Realised variation margin
4. Additional market conduct considerations



The proposed changes are designed to allow the LME to modernise and evolve into a metals market for the future, achieving:

- Increased transparency
- Greater digital presence
- Structurally fairer and more efficient marketplace



Proposals also designed to protect and maintain certain features of market structure, which closely align to our core principles:

- The date structure
- Member-client trading structure, to ensure end users maintain the required flexibility in trade execution



The LME is inviting feedback from all market participants who wish to respond. Feedback will be reviewed and considered before any proposals are implemented



# The proposed changes deliver modernisation

1

## The Ring and reference prices

- Electronic pricing has served the market well since the Ring was temporarily closed in March 2020 due to COVID-19 – including Official Prices for the physical market
- It is time to consider moving to an electronic pricing structure and closing the Ring, giving all participants certainty over the future of pricing and allowing all stakeholders to make business decisions with confidence

2

## Enhancing liquidity

- No plans to change LME client servicing models or the date structure, which is fundamental to the physical market
- Proposing to incentivise trading in the central electronic venue – by rebalancing electronic and inter-office fees – which will help increase liquidity for all participants while ensuring transparency and trading efficiency
- Introducing a new Enhanced Transparency Cross trade to allow members to bring the benefits of inter-office pricing to the electronic market

3

## Realised variation margin

- Consideration of a move to a Realised Variation Margin (“RVM”) model given its benefits: greater trading efficiency, standardisation, potential regulatory cost savings, and the removal of a barrier to market entry
- The benefits have to be balanced against the potential consequences, particularly regarding the risk of impacting the provision of credit by some clearing members

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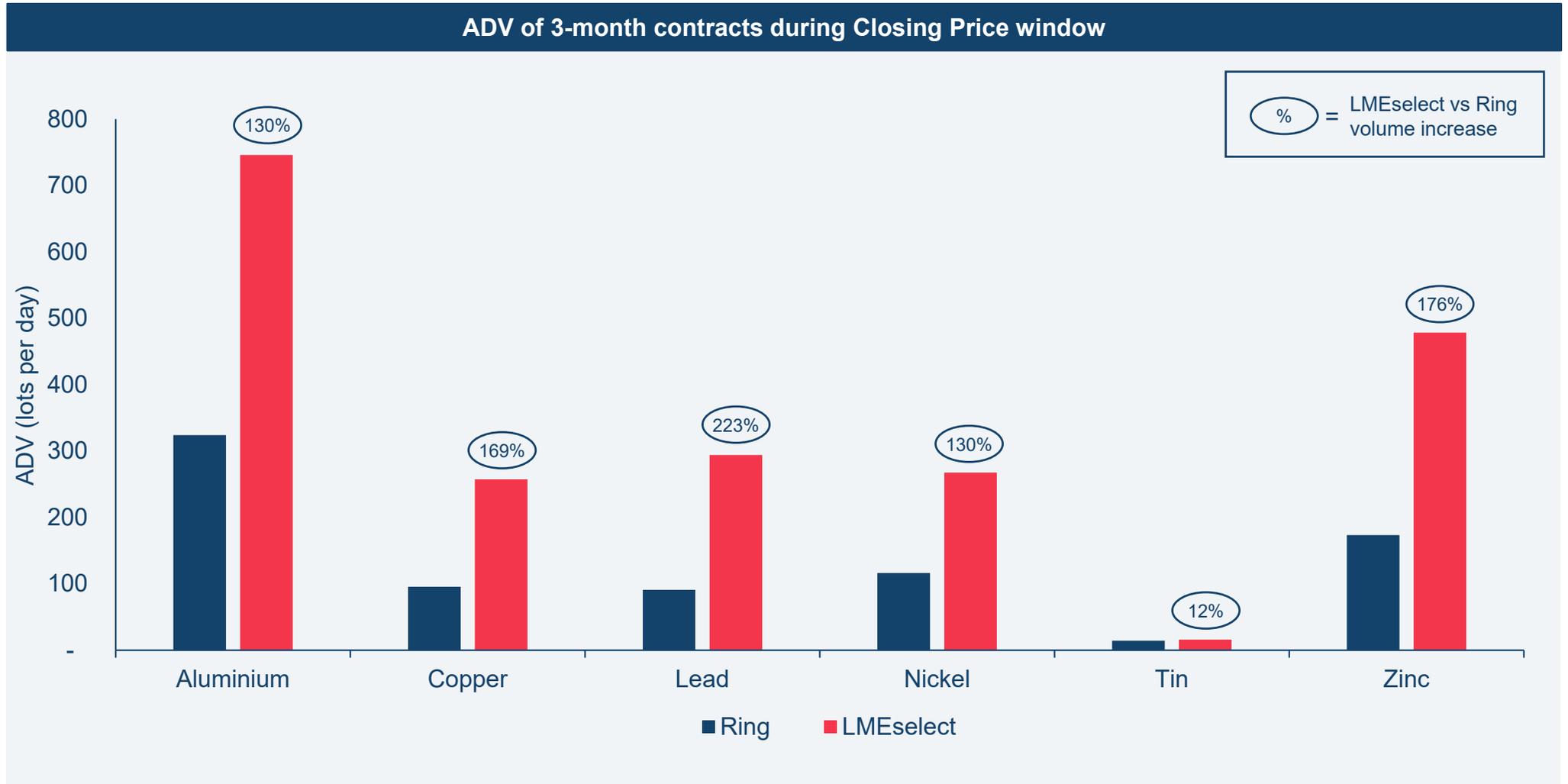
## Additional market conduct considerations

- Further measures could be introduced to increase transparency on stocks and physical movements
- Additional policies and procedures could be introduced to further reduce the risk of market squeezes



# 1 Electronic pricing has worked

Electronic pricing has led to broader direct participation and increased volume during the price discovery periods



- Ring volumes for period 23 Sep 2019 to 20 Mar 2020 (127 days), the period after kerb was extended
- LMEselect volumes for period 12 Jun 2020 to 9 Dec 2020 (127 days)



# 1 The Ring and reference prices summary

## LME position

- The LME feels it is now time to consider the case for a permanent move to an electronic pricing structure and closure of the Ring. This could give all participants certainty over the future of pricing and allow all stakeholders to make business decisions with confidence.
- Any decision to permanently move to electronic pricing and/or close the Ring will be based on the potential long-term benefits to the market of this pricing evolution, irrespective of the current Ring suspension.
- The LME is of the opinion that additional TAS contracts are not necessary at this time, as this type of service is provided by members directly to their clients.

## Benefits

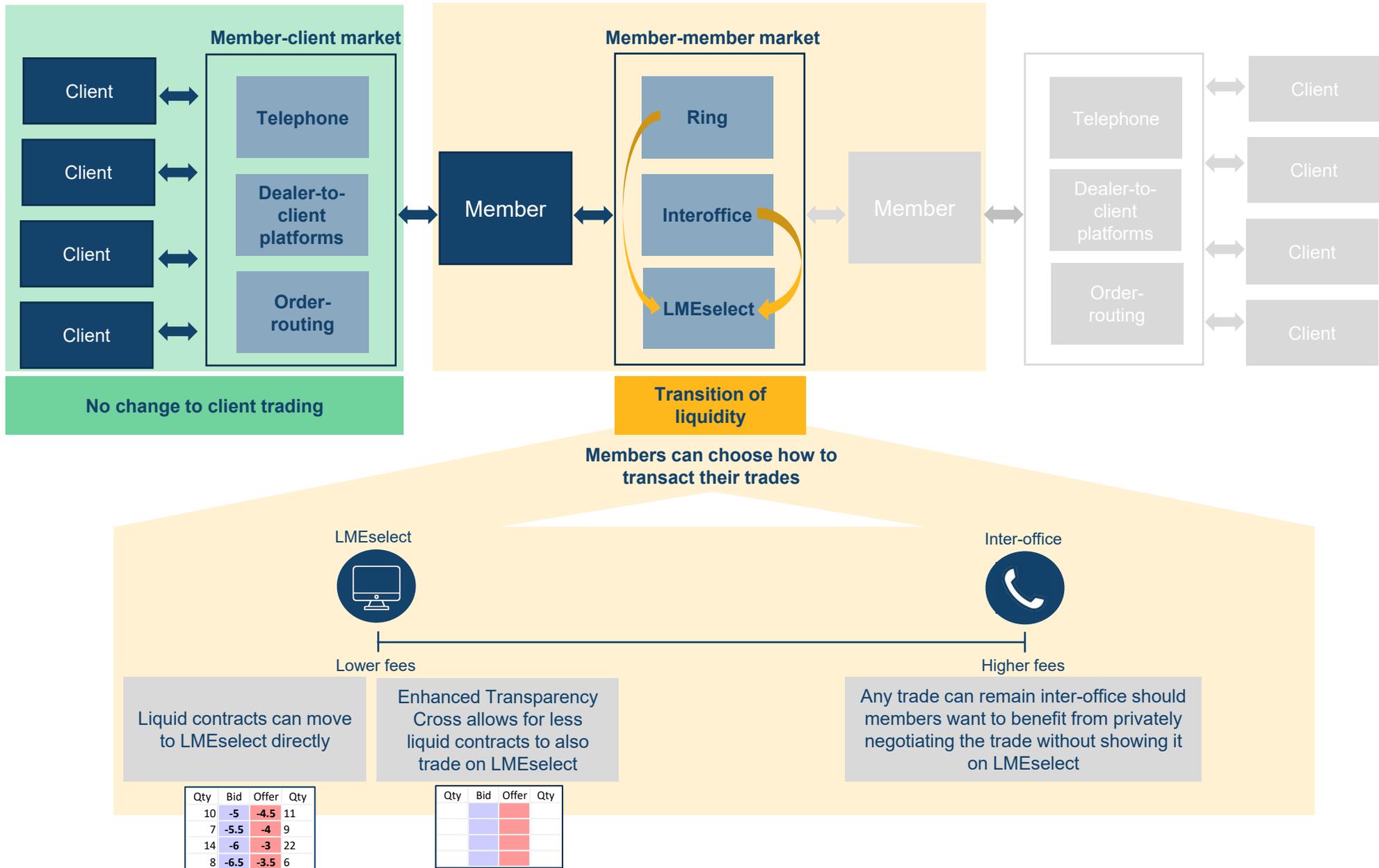
- ✓ Increased direct access to the reference pricing process, with fair access for all participants
- ✓ Increased transparency of orders and trades contributing to reference prices, and increased transparency of the pricing methodology
- ✓ Opportunity to evolve the pricing processes over time in order to further improve pricing

## Challenges

- × The competitive position of Category 1 members may be impacted by the move away from the Ring, which could change the nature of the relationship between Category 1 members, other market participants and the LME itself
- × Some participants may need time to adapt their business models as the changes become permanent
- × The ability of clients to have their orders guaranteed against Official Prices or Closing Prices may be impacted by changes to trading practices
- × As with the Ring, further evolution to the electronic pricing methodology will be important in order to ensure it is as robust and representative as possible, serving the needs of the industry



## 2 Enhancing liquidity in the central electronic venue



# 2 Introducing the Enhanced Transparency Cross (ETC)

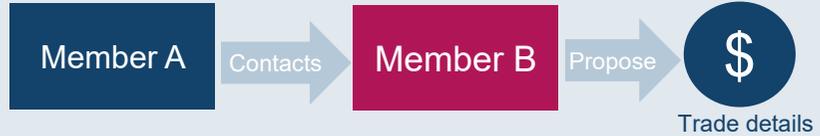
## Process

## Key benefits / considerations

1 Member A looks to trade on LMEselect but there is low liquidity



2 Member A phones Member B and proposes to trade



3 Member A enters their half of the trade onto LMEselect



4a Either Member A's order is filled by natural liquidity on LMEselect...



4b .Or Member B fills the order after 5 seconds as proposed



5-30s later



Allows electronic trades to be booked even when there is low liquidity on-screen



Aligns with pre-trade communication mechanisms on peer exchanges



Guarantees the initiating order always gets filled by requiring it to be entered first



No system change for members as it simply involves entering orders into LMEselect



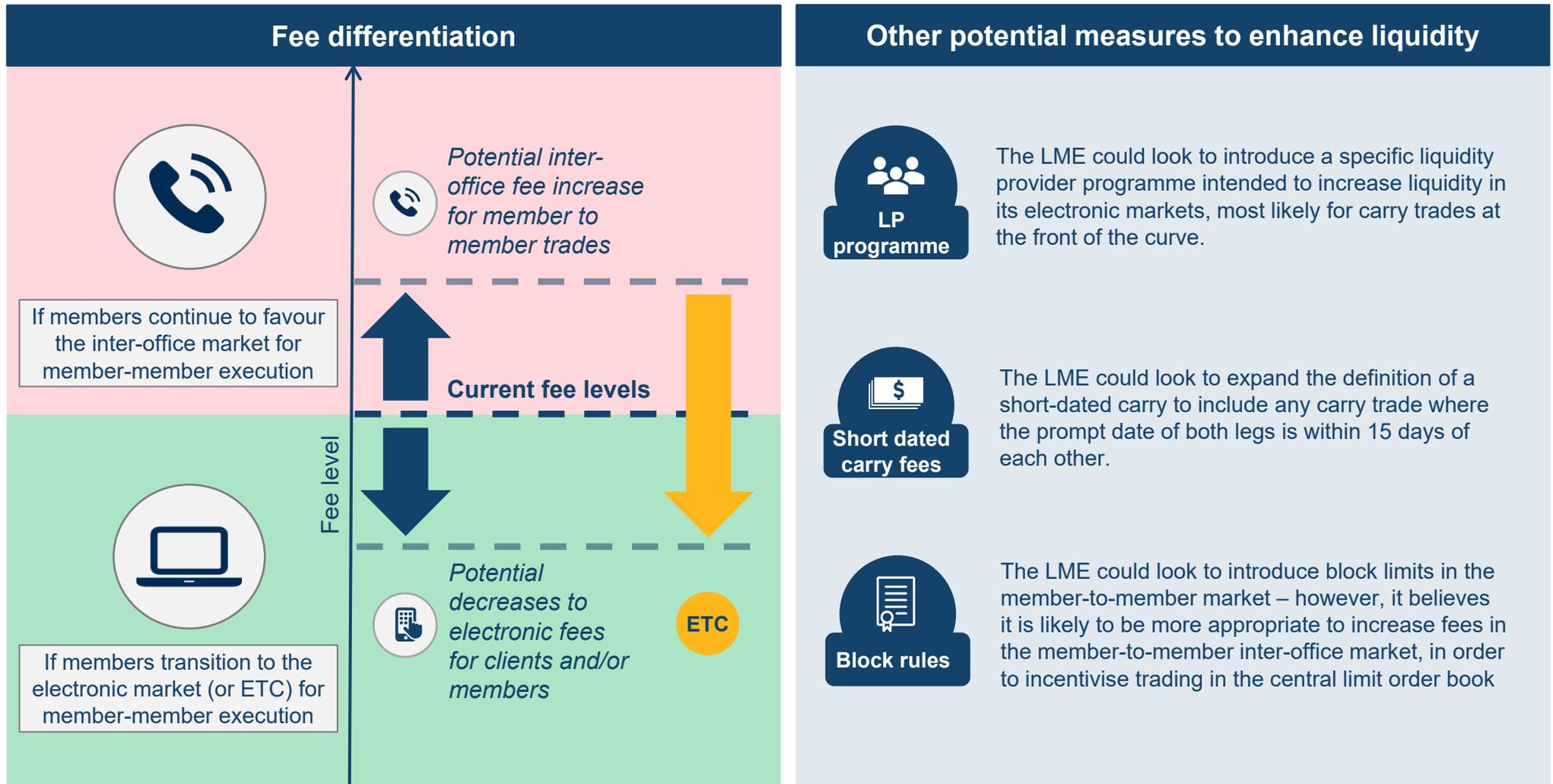
If another trader fills the resting order in LMEselect then Member B may lose the trade



However, in this scenario on-screen liquidity has been generated for the initiating order



## 2 Fee adjustments and other measures to enhance liquidity



Note: the diagram is purely illustrative and the size of the arrows does not represent the magnitude of any potential fee changes



## 2 Enhancing liquidity summary

### LME position

- The LME's position is that trades in the central electronic venue for the member-to-member market exhibit the maximum amount of transparency, efficiency and fairness, while allowing for increased liquidity.
- The LME does not believe it should evolve the date structure, as it understands it to be fundamental to the physical market.
- The client-to-member market should preserve the user choice offered by the current venue structure at the LME.
- Increasing trading fees for member-to-member inter-office transactions would be a straightforward option to incentivise trading in the electronic market. Alongside this, the LME could look to reduce electronic trading fees.
- The introduction of a new "enhanced transparency cross" could help members use the electronic market and increase transparency.
- The introduction of a liquidity provider programme could also be considered to help existing members transition some of the liquidity supply to the electronic market.
- Members who are able to transition some of their liquidity to the electronic market would benefit from a potentially lower electronic fee, and a liquidity provider programme, which would offset the cost of the increased inter-office fee.

### Benefits

- ✓ Increased liquidity in the central venue available for all participants
- ✓ Increased transparency of pricing driven by more business being transacted electronically
- ✓ Retains flexibility to trade inter-office or electronically, and introduces measures to help business transition to the electronic market
- ✓ Retains current fees and structure for client-to-member trading

### Challenges

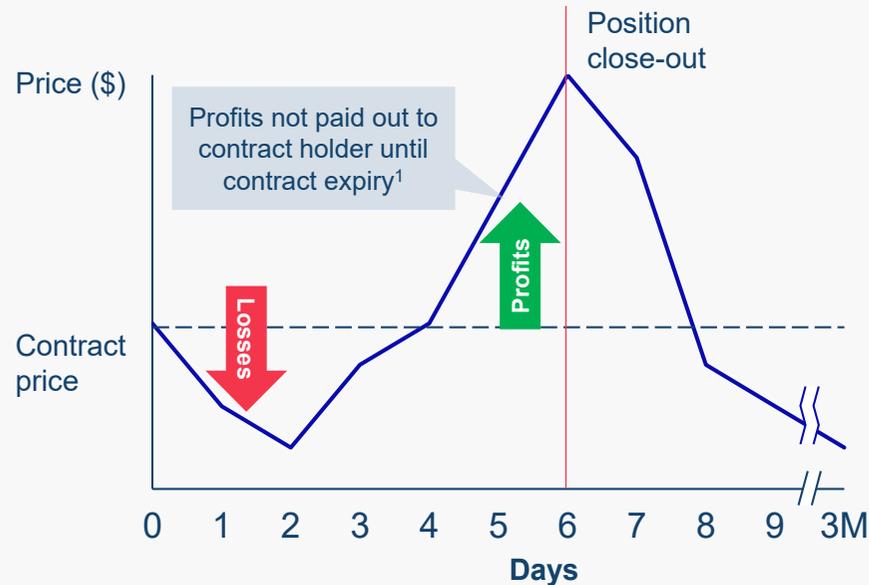
- × Certain trading practices will become more expensive for members
- × Some liquidity providers may end up missing an intended trade when using the enhanced transparency cross mechanism depending on the change in business practices and the trading activity of other market participants



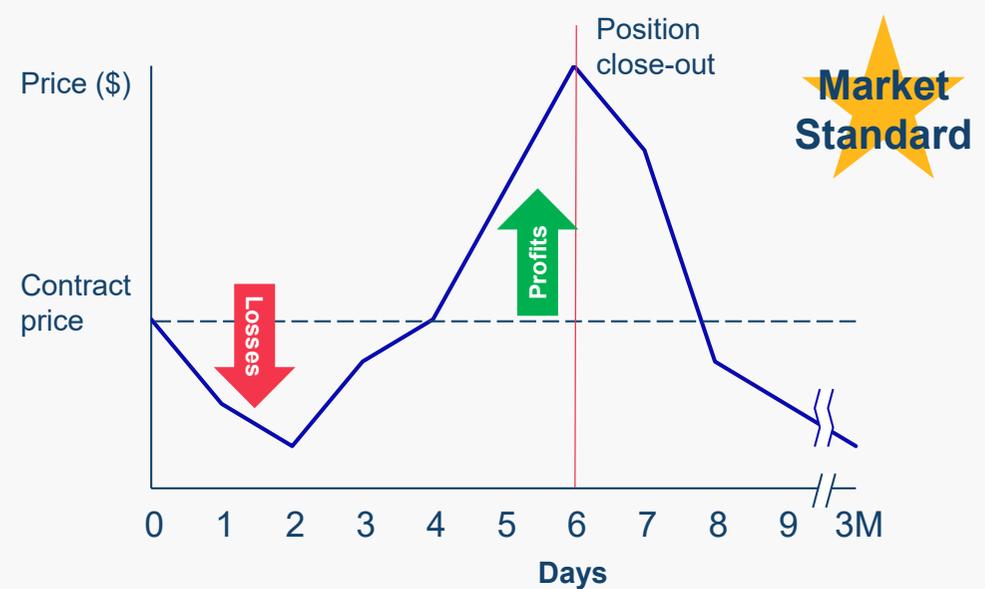
# 3 Realised variation margin

A standard margin methodology would help some new participants connect, and could reduce risk for existing participants

## Discounted Contingent Variation Margin (DCVM)



## Realised Variation Margin (RVM)



A change in margin methodology would apply to cleared contracts held in accounts at the clearing house. To the extent permitted by law and regulation, the LME would intend to design the RVM rules so that members will be able to make their own arrangements with clients on how their balances from the daily settlement to market process are financed. This would mean that members should be able to continue to operate a model where credit lines can be used.

1. DCVM profits can be used to offset initial margin



### 3 Realised variation margin summary

#### LME position

- The LME is of the view that the RVM margin model should be considered once more given the potential benefits to the market as a whole, including (i) maximising trading efficiency, (ii) standardising the market structure, (iii) reducing regulatory costs, and (iv) removing a key barrier to market entry.
- However, the LME notes the strongly expressed concerns regarding a move to RVM from certain sections of the market, given the potential impact to credit line availability.
- On balance the LME believes that it would be a benefit to the market as a whole to move to an RVM model, and an appropriate timeline would be three to five years, during which the LME will undertake planning and market engagement to ensure a successful transition.

#### Benefits

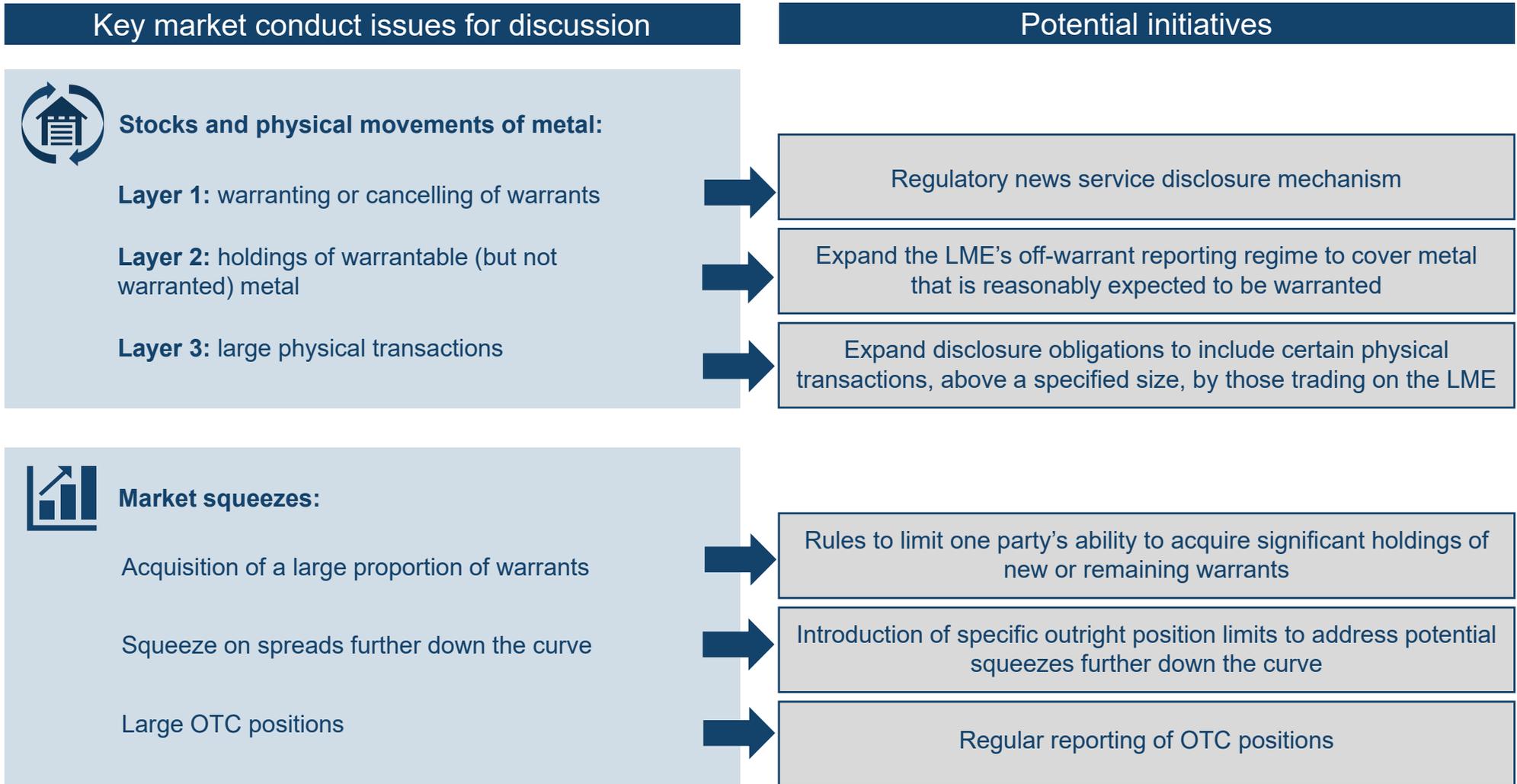
- ✓ Standardisation with peer futures markets, and the removal of a barrier to entry cited by some potential clients
- ✓ Potential for reduced regulatory capital costs for some financial institutions
- ✓ Profits paid out on a daily basis, which may make LME trading more attractive to some participants, and some trading models more efficient
- ✓ Reduced overall credit risk within the LME's ecosystem

#### Challenges

- × Clients may face a reduction in credit line availability, and/or an increase in the cost to use a credit line. These changes may also result in a reduced number of members that are positioned to grant credit facilities to physical clients. As a result, some physical clients may find it more difficult to access the LME directly in order to hedge their metals price risk. This may result in some trading moving OTC if that is an easier way to access credit and/or if it obviates the need for daily settlement and the associated operational burden
- × Any transition to RVM would be very complex, both operationally and from a systems development perspective for members and clients



# 4 Additional market conduct considerations



# Additional market conduct considerations summary

## LME position

- Knowledge of warrantable stock holdings can be considered price sensitive information. Introducing more transparency around this may help to maintain a greater balance of access to such information.
- The LME should explore whether to introduce additional disclosure mechanisms to increase transparency, such as a regulatory news service for intentions regarding warranting or cancellation activity.
- The LME may explore requirements to disclose certain physical transactions above specific size thresholds if participants believe this would be of benefit.
- To mitigate potential market squeezes, the LME is interested in participants' views on policies to limit activity, including (i) rules to limit one party's ability to acquire significant holdings of new or remaining warrants, (ii) introduction of specific outright position limits to address potential squeezes further down the curve, and (iii) regular reporting of OTC positions.

## Benefits

- ✓ Increased fairness in access to physical market information for all participants
- ✓ Demonstrating best-in-class disclosure obligations for listed commodities markets
- ✓ Reducing the potential for market squeezes on LME and related OTC markets
- ✓ Ensuring highest standards of market conduct
- ✓ Ensuring that OTC markets are not used as a way to circumvent compliance with rules to ensure market orderliness

## Challenges

- × Complexity of designing and implementing rules which give the desired disclosure, but are practicable. This includes in particular the challenges involved in determining whether a market participant has formed an intention at a particular point in time
- × The need to ensure increased disclosure obligations do not unduly discourage trading on the LME
- × Complexity of designing a position limits regime for positions further down the curve that has the positive benefits desired, without unintended consequences limiting some legitimate trading activities
- × Complexities of implementing rules in the OTC market, where the LME only has limited oversight
- × Risk of unintended negative consequences on OTC trading as a whole



# Next steps

## Key dates

- **19 January 2021 – 19 March 2021:** market participants provide feedback
- **19 March 2021:** feedback period ends
- **By the end of Q2 2021:** indicative timeline to publish the results of the Discussion Paper

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*The LME's mission is to be the trusted market of choice for the global metals industry and we have an important role to play in ensuring the market is fair, transparent and accessible for all who wish to participate.*

*We are committed to collaborating with our stakeholders as the LME evolves into a metals market for the future, and we encourage all market participants to feed back on these proposals and enable us to deliver the best possible solutions for the industry.*

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