

To: All members, warehouse companies and their London agents and other interested parties

Ref: 21/111 (LME Notice Reference)
21-039 (LME Clear Circular)

Classification: General Updates Trading

Date: 08 June 2021

Subject: **OUTCOMES OF DISCUSSION PAPER ON MARKET STRUCTURE**

Summary

1. This Notice announces the outcomes of the Discussion Paper on Market Structure (the “**Discussion Paper**”), which was published on 19 January 2021 (LME Notice 21/011, LME Clear Circular 21-005). This Notice includes a Response Paper on Market Structure (the “**Response Paper**”) in Appendix 1 that summarises feedback received by the LME, and lays out the decisions taken by the LME and resulting next steps.

Background

2. On 19 January 2021 the LME published the Discussion Paper, which detailed a number of potential structural changes designed to allow the LME Group to modernise, thus enabling the LME to adapt and service the market as effectively as possible. The Discussion Paper covered four main topics:
 - (a) the Ring and reference prices;
 - (b) enhancing liquidity;
 - (c) realised variation margin; and
 - (d) additional considerations concerning market conduct.
3. The LME undertook a wide-ranging market engagement programme on the basis of this Discussion Paper, running from 19 January 2021 to 19 March 2021.
4. The LME received 192 responses from a diverse set of stakeholders, and is grateful to all these respondents for taking the time to share their views. The LME has undertaken a detailed process of analysis to ensure that all responses have been fully considered and that decisions have been informed by relevant considerations and are in the best interests of the market as a whole.

Response Paper

5. Appended to this Notice is the Response Paper (see Appendix 1), which summarises all of the feedback the LME received in relation to the Discussion Paper. The Response Paper gives details of the LME’s views, informed by the responses, on the topics within the Discussion Paper and lays out a set of outcomes that the LME believes to be in the interest of the market as a whole, and best reflects the LME’s strategic principles – serving the physical market, ensuring fairness, increasing user choice and maximising trading efficiency.
6. Due to the complex nature of the topics contemplated and the large number of responses, this Response Paper is necessarily detailed. As such, the LME has also laid out a summary of the outcomes below, and the decisions that it has taken in relation to each area at this stage.



The Ring and reference prices (section 3 of the Response Paper)

7. It is clear from the feedback received to the Discussion Paper that there is a wide range of views regarding the Ring and how the LME should undertake reference pricing. The outcomes below take account of views from market participants and the wider population of users of the LME's prices, and represent what the LME believes to be the most appropriate way to modernise and evolve its market structure and continue to act in the best interests of the market as a whole.
8. In the Discussion Paper, the LME consulted on proposals to move to the electronic determination of reference prices (including both the Official Prices and the Closing Prices), and on a proposal to close the Ring in the event that a decision were taken to move reference prices permanently to electronic determination. The LME has considered all feedback carefully. Following the period during which the Ring has been suspended, and in light of feedback to the Discussion Paper, the LME's view is that electronic pricing for reference price generation will result in improvements to the integrity of the reference price, through an increase in direct participation and enhanced transparency. The LME also considers that the longer term direction of travel for financial markets is towards electronic trading and pricing. The LME notes, however, a specific preference from many smaller physical participants who use the LME to hedge their physical supply contracts, to retain Ring trading and pricing.
9. Taking account of this preference, and considering the LME's strategic principle of user choice, the Exchange has made the decision that the Ring will reopen for trading. Details regarding the arrangements for reopening the Ring are set out in Notice 21/113.
10. The LME's overriding objective is to act in the best interests of the market as a whole, rather than of any particular stakeholder group. The LME notes the importance of ensuring a deep liquidity pool to support robust pricing, and ensuring that the LME continues to serve the physical market, in order to maintain the linkage between the physical market and LME contracts.

The decision to move Closing Prices¹ permanently to electronic determination

11. In respect of the question posed in the Discussion Paper, the LME has decided that, in light of the LME's strategic principles and feedback from the market in response to the Discussion Paper, a permanent move to electronic pricing is preferable to the option of keeping all pricing determinations in the Ring, and is in the interests of the market as a whole. The reasons for this are explained in detail in the Response Paper. Principally, the LME is confident at this stage that electronic pricing processes are more transparent, promote broader participation in the market, reduce barriers to entry, strengthen market liquidity and provide more reliable pricing outcomes than pricing in the Ring. The LME also believes that electronic pricing methodologies represent the long-term direction of travel for the market.
12. However, the LME has noted the preferences of physical users, who in practice are the principal users of the LME's Official Prices. The preferences of physical users are important to the market as a whole and it is consistent with the LME's strategic principle to serve the physical market to seek to address them. As a result, at this stage, the LME has made a decision to move only Closing Prices permanently to electronic determination (whether or not Official Prices stay determined on the Ring is subject to further consultation, as described below). The transition to the permanent electronic determination of the Closing Prices will take place on the basis of the current calculation methodology (being the business continuity methodology). In this way, the LME wishes to ensure as little disruption to users of these prices as possible, given that this calculation methodology has been in use now for over a year.
13. The LME intends to update its UK Benchmarks Regulation ("**BMR**") documentation in due course to reflect the decision to move to permanent electronic pricing for the Closing Prices². The LME is aware that a number of users of its benchmarks have implemented systems that consume BMR methodology and benchmark statement documents for analysis. The LME therefore intends that, rather than updating these documents to reflect the decision to permanently move to the electronic determination of Closing Prices, these documents will instead be updated holistically to reflect the outcome of the consultation that the LME intends to publish during H2 2021 (see paragraphs 24-26 below). In the interim, the LME can confirm

¹ The term Closing Prices should be understood to include both Closing Prices and Unofficial Closing Prices throughout, unless stated otherwise.

² Not including Unofficial Closing Prices as they are not benchmarks.



that these changes shall not result in members, clients and other participants on the LME's execution venues becoming "contributors" for the purposes of the BMR and they shall not therefore be subject to a BMR code of conduct by participating in trading activity on these execution venues, including trading during LMEselect pricing windows.

Further consultation on keeping Official Prices in the Ring

14. While the LME believes that, from a transparency and market liquidity perspective, Official Prices generated with the electronic methodology would have the same benefits as Closing Prices, the LME is now considering a further alternative option with respect to the Official Prices given the preferences of physical users outlined above. As such, the LME believes it is possible that the interests of the market as a whole will be best served by maintaining Official Price discovery in the Ring (once it reopens), even as Closing Prices are determined electronically.
15. Although, as explained above, the LME has decided on the basis of the Discussion Paper that moving all pricing electronic would be better than retaining Ring price determination for all prices, in the light of the Discussion Paper feedback received, the LME now wishes to consult on the further option of leaving Official Prices on the Ring in circumstances where Closing Prices move to electronic determination (as per the LME's decision outlined above). For the avoidance of doubt, the alternatives on which the views of market participants are sought in this second phase of consultation are: (i) a split approach whereby Official Prices remain in the Ring, with Closing Prices determined electronically; or (ii) moving both Official Prices and Closing Prices permanently to electronic determination.
16. As explained above, regardless of the outcome of this second phase, the LME has already decided, based on the first phase of consultation, to move the determination of Closing Prices permanently to the electronic venue. The LME is of the view that this split approach (Official Prices in the Ring, Closing Prices electronic) could secure a clear modernisation step for the Exchange that could benefit the market as a whole while also taking account of the needs of the more traditional physical users of the Exchange in order to best serve the physical market, and ensuring a balanced market ecosystem, which is one of the core qualities of the LME. As such, this approach, in the LME's view, could also balance, to the greatest extent possible, the LME's strategic principles to serve the physical market, ensure fairness, increase user choice and maximise trading efficiency.
17. The LME considers that, with the continued support of Category 1 members, this split approach has the potential to be a sustainable and balanced solution providing increased user choice for participants. That said, the LME is mindful that Category 1 business models may change over time, and it is important to give the market clarity on the continual robustness and representativeness of Official Prices. The LME also recognises that over many decades, and in the midst of great technological changes, LME participants have demonstrated their ability to adapt, innovate and find new ways to service their clients' needs. The LME believes that this will continue.
18. While the LME believes that liquidity and robust pricing on the Ring will continue, the LME must make provision for the alternative. Maintaining the robustness and reliability of Official Prices remains of paramount importance to the market and to the LME and in respect of ensuring compliance with the LME's regulatory obligations under (amongst other things) the UK Benchmarks Regulation. As such, the LME believes that, if Official Prices do remain on the Ring, it would be important to establish a mechanism whereby, if one or more of a set of published and objective criteria are met, the LME would be empowered to decide whether to move Official Prices to the electronic venue in order to ensure their ongoing reliability, without the need for further consultation. The LME is therefore consulting on this mechanism, in particular on the criteria which, if met, would permit the LME (at its absolute discretion) to permanently move Official Price calculation to the electronic venue. The criteria being consulted on are detailed in the consultation and summarised here for ease:
 - (a) fewer than six Category 1 members continue to support Official Prices on the Ring; or
 - (b) Category 1 members representing less than 75% of the second Ring volume (as calculated on the basis of the last full calendar year's trading) continue to support Official Prices on the Ring.

For the purposes of determining whether the above criteria are met, each Category 1 member shall be considered to "support Official Prices in the Ring" unless and until any of the following criteria are triggered:



- (a) the member gives written notice to the LME of the resignation of its Category 1 membership or its intent to change its membership category; or
 - (b) the member ceases to attend the Ring for a consecutive period of five business days, without providing a reasonable explanation for such failure, or gives written notice to the LME that it no longer intends to attend the Ring, where “attendance” means having at least one dealer attend the Ring, in compliance with Regulation 11.1; or
 - (c) the member notifies the Chief Executive Officer or the Chief Operating Officer of the LME in writing that the Member no longer supports Official Prices in the Ring. For the avoidance of doubt, notification under this paragraph will not affect the member’s categorisation as a Category 1 member, or its ability to continue trading in the Ring. Such notifications shall be treated confidentially by the LME.
19. Accordingly, the LME has launched consultation Notice 21/112, published 8 June 2021 (“**Pricing Venue Consultation**”). The Pricing Venue Consultation Notice will be open for responses until 9 July 2021. The LME intends to publish its decision Notice on this consultation by 9 August 2021.
20. Irrespective of the outcome of the Pricing Venue Consultation, the LME has also decided (based on the Discussion Paper and the feedback it has received) to close the secondary back-up Ring, and to use the electronic market as the LME’s primary back-up arrangement in any future business continuity scenarios. The back-up Ring will close with effect from 9 June 2021, on which date the LME will formally transition to electronic pricing as its primary back-up arrangement. The LME will contact Category 1 members separately to discuss arrangements for the removal of any Member-owned property from the back-up site.
21. Within the Discussion Paper the LME had considered further TAS contracts unnecessary. However, some respondents saw particular merit in TAS contracts for some reference prices and highlighted that they aligned to the strategic principle of user choice. In light of this, and in order to support the electronic Closing Prices, the LME intends to launch the remaining 3-month TAS contracts (nickel was launched in 2019). Further information will be published in due course.

Evolving the electronic Closing Price methodology

22. Since trading on the Ring was suspended in March 2020, the LME’s electronic Closing Price process has seen increased participation and enhanced transparency. While the pricing methodology is inherently complex due to the number of dates that require pricing, the democratisation of the process itself has, in the LME’s view, ensured a fairer and more representative marketplace.
23. Nevertheless, the LME acknowledges the increase in pricing objections during the period of Ring suspension and electronic pricing and has carefully considered the feedback to the Discussion Paper in this respect. Having undertaken continual analysis of the current Closing Price methodology, the LME believes that the increase in objections is primarily as a result of the increased amount of data, and increased number of both participants and instruments trading in the Closing Price period, leading to an increase in pricing conflicts. As such, the increase in objections is a consequence of the positive impacts of electronic pricing, combined with the Ring-style methodology (attempting to use the “last price” in each instrument to set the Closing Price). Therefore, the LME believes that it is possible to further evolve the electronic Closing Price methodology in order to incorporate more determinism, ensure Closing Prices most accurately reflect prevailing prices at the end of the trading day, and ensure that the Closing Price methodology encourages trading practices that will improve liquidity for participants. For the avoidance of doubt, the LME’s view is that the current electronic pricing methodology is preferable to Ring pricing when considering the interests of the market as a whole, which is why it has decided to move the Closing Prices to the electronic system, but further evolution of the electronic pricing methodology would be better still.
24. As such, the LME plans to consult in due course, in H2 2021, on the evolution of the Closing Prices electronic methodology, in accordance with the LME’s Benchmarks Change and Cessation Procedure³. In the meantime, the LME believes it is appropriate to start the work of developing an evolved electronic

³ https://www.lme.com/-/media/Files/About/Regulation/European-Benchmark-Regulation/LME-Benchmark-Changes-and-Cessation-Procedure_v1,-d-,1.pdf?la=en-GB



Closing Price methodology as quickly as possible in order to ensure that these changes can be made in a smooth and timely manner.

25. In order to evolve the electronic Closing Price methodology, the LME will establish a Closing Price Working Group (“**CPWG**”) of market stakeholders in order to discuss this evolution. In Appendix 2, the LME has laid out a blueprint (“**Pricing Blueprint**”) to use as a starting point for discussion within the CPWG on evolving Closing Prices. The role of the CPWG will be to suggest practical, constructive evolutions or alternatives to this Pricing Blueprint in order to ensure that the future electronic Closing Price methodology is as reliable and representative as possible, reflecting the prevailing market prices around the end of the trading day. Once the CPWG has completed its work, the LME’s proposed changes to the Closing Price methodology will be subject to consultation in H2 2021.
26. For the avoidance of doubt, given that the work of the CPWG relates only to the evolution of the Closing Price electronic methodology, the work of the CPWG is not relevant, and is without prejudice, to the Pricing Venue Consultation dealing with whether the Official Prices should remain on the Ring. Further details on the CPWG (including participation details) can be found within the Pricing Blueprint.

Enhancing liquidity (section 4 of the Response Paper)

27. In general, given the feedback from respondents, the LME believes that a structure designed to build electronic liquidity in certain LME contracts would benefit the market as a whole, ensuring fairness while delivering increased user choice and maximising trading efficiency. However, the mechanism to do this could be more nuanced than simple fee diversification, and this aim should be carefully focused on the most liquid contracts, as many contracts on the LME are initially not likely to be able to have consistent electronic order book liquidity.
28. During H2 2021 the LME will develop a set of measures designed to enhance liquidity for all participants, based on the proposals in the Discussion Paper, and shaped by respondent feedback. The LME is minded to apply these measures only to an identified set of liquid contracts (such as Cash, 3-month, and the front three to four third Wednesday contracts for certain metals), and could include fee increases, and block rules for inter-office trades between members, alongside a new liquidity provider programme. These proposals will be subject to further consultation where required.
29. The LME recognises the importance of “inter-dealer” or “back-to-back” brokers in providing liquidity, and as part of the package of measures, the LME will ensure that this brokerage business model is appropriately supported.
30. The LME will look to establish the appropriate pre-execution communication rules, and an enhanced transparency cross trade, to allow members to communicate bilaterally ahead of executing trades in the electronic market.
31. The LME remains open to amending the definition of a short-dated carry trade in order to capture more varied transactions and support inter-office liquidity daily dates. Further developments in this area may also form part of the package of measures to be proposed during the second half of 2021.
32. Finally, the LME will look to evolve the publication mechanism for inter-office trades to ensure that price forming trades in the inter-office market are published more quickly on core market data feeds, making the appropriate data more clearly identifiable.
33. As mentioned, this package of changes will be developed over the second half of 2021, and will be proposed to the market by the end of the year. The LME expects implementation to begin in 2022, subject to the outcome of any required consultation with the market.

Realised variation margin (section 5 of the Response Paper)

34. There was a wide range of views expressed on the topic of variation margin methodology. The current contingent variation margin (“**CVM**”) methodology can be helpful for smaller physical users as it facilitates the provision of credit from members to their clients. As such, smaller physical clients and Category 1 members broadly supported the maintenance of CVM, while larger physical clients, financial clients and Category 2 members generally supported a transition to the market-standard realised variation margin (“**RVM**”) model.
35. Given the clear advantages of the two models for different stakeholders, the LME will investigate the development of an approach that intends to recreate, or enable the recreation of, the cash flows of a



CVM model for RVM contracts, which could support the provision of credit for smaller physical participants. The LME would then look to prove the concept for its ferrous contracts, which are already margined using RVM.

36. A market-wide move to RVM will not be proposed until the feasibility of the new approach has been assessed, and after the successful introduction of a value-at-risk (“**VaR**”) initial margin methodology. The LME plans to introduce VaR, which is intended to increase margin efficiency for physical and financial clients alike, following the delivery of its new trading platform. The LME does not expect to introduce VaR before 2024.
37. More details on the likely timeline for any changes to margin methodology will be communicated in due course.

Additional considerations concerning market conduct (section 6 of the Response Paper)

38. On the basis of responses received to the Discussion Paper, the LME intends to enhance its Off Warrant Stock Report (“**OWSR**”) to be a more comprehensive and accurate record of off-warrant material, which will provide greater transparency on physical stocks to all market participants. The LME plans to evolve the report to publish on a near real-time basis, and move the disclosure responsibilities from warehouses to metal owners, supported by members. As part of this evolution, the LME intends to limit the warranting of metal which had not previously been disclosed on the OWSR.
39. The LME will undertake further analysis of the appropriate rule structure in order to effect these enhancements, and will seek to implement these changes from 2022, subject to consultation where appropriate.
40. In respect of the other topics within the Discussion Paper relating to stocks and physical movements, the LME does not intend to extend its regulatory scope into pure physical transactions by way of introducing reporting obligations. Clearly, this limits the LME's ability to proactively monitor for physical market anomalies affecting trading activity; however, the LME believes that its focus for the time being should be on using its enhanced investigatory powers to undertake any required retrospective action where necessary.
41. On the subject of market squeezes, the LME does not at this time intend to further investigate rules either limiting the ability to acquire a significant holding of warrants, or limiting the positions of market participants in either warrants or futures. The LME believes that its lending rules remain the most effective tool to prevent market squeezes, and should be the focus of the exchange in this area.
42. Regarding OTC transaction reporting, while the LME has taken account of concerns regarding the complexity of wide-reaching OTC reporting rules and associated potentially high operational costs, it believes there would be significant market benefits to ensuring that OTC trading – in instruments very closely aligned to LME contracts – is closely monitored. As such, the LME will investigate a potential solution of using existing LME infrastructure in order to allow the reporting of certain OTC contracts, and rules which would require members to report these contracts, where they are substantively similar to LME contracts.

Additional information

43. Any market participant wishing to discuss any of the outcomes of the Discussion Paper or any aspect of the further consultation issued today in more detail should contact the [Market Structure](#) or [Relationship Management](#) teams.

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cc: Board directors
User Committee
Physical Market Committee
All metals committees



Ring Dealers Committee
Traded Options Committee
Warehousing Committee