

To: All members and other interested parties

Ref: 23/007 (LME Notice)
23-001 (LME Clear Circular)

Classification: General Updates

Date: 10 January 2023

Subject: **LME GROUP RESPONSE TO OLIVER WYMAN INDEPENDENT REVIEW**

Summary

1. The LME Group welcomes the report (the “Report”) of the Independent Review (the “Review”) conducted by Oliver Wyman Limited and its sister company NERA UK Limited (together, “Oliver Wyman”). This Notice sets out the LME and LME Clear’s (together, the “LME Group”) initial response to the Review.
2. The LME Group would like to thank both its membership and wider market participants for their cooperation, time and insight in facilitating the Review.

Background and Scope of Work

3. As announced in Notice 22/168, Oliver Wyman was engaged to undertake a comprehensive Review of the events in the nickel market leading up to the decision of LME to suspend the market on 8 March 2022. Oliver Wyman was tasked with identifying the factors that contributed to conditions in the nickel market in the period leading up to and including 8 March 2022, and to provide the LME Group with recommendations for how the LME Group could reduce the likelihood of similar events occurring again.
4. The Review did not cover the LME and LME Clear’s decision-making processes and governance arrangements, which are the subject of the regulatory reviews announced by the Financial Conduct Authority (“FCA”) and the Bank of England (“BoE”).
5. Per Notice 22/168, a key input to the Review was Oliver Wyman’s analysis of trading activity, positions, margin and collateralisation in the nickel market, including on the LME and the broader OTC market. Underlying data is, of course, not presented in the Report due to confidentiality. However, this information has been made available to the LME.
6. More broadly, and as set out in Notice 22/099, the LME has been considering, and will continue to consider, what further steps may be appropriate in terms of its investigatory and/or disciplinary powers. Again, such considerations are not presented in the Report.
7. Accordingly, nothing in the Report should be taken to either acknowledge or exclude the possibility of abusive or other behaviour having also contributed to events in the nickel market. In particular, the enumeration of “contributing factors” in the Report does not rule out the possible contributions of additional such factors.



Overview

8. This Notice outlines the LME Group's immediate response to the Review. The LME Group notes that the Review's recommendations are made in high level terms and that further work (which will commence shortly) will be needed to prepare and communicate to the market a detailed implementation plan, designed to support the long-term health, efficiency and resilience of the market as a whole.

Contributing Factors

9. The Review analysed factors that may have contributed to the events on 7 and 8 March 2022, including the underlying risks, processes and controls, and market structure of the metals market. The events considered by the Review were complex. Multiple factors were at play, at times operating in combination. The Review broadly captures these as follows:
 - a. The existence of large, exposed, short positions:
 - i. Fragmentation of positions across counterparties and between on-exchange and OTC reduced visibility of the risks.
 - ii. Position limits and accountability levels did not prevent the build-up of large, exposed positions.
 - b. The withdrawal of liquidity:
 - i. Nickel is known to be a volatile market, prone to distortion, and exposed to geopolitical risks.
 - ii. The market believed there was pressure on large short positions.
 - iii. Absence of a diverse range of participants willing to take opposite positions.
 - c. The price acceleration and resultant margin calls:
 - i. The LME's price volatility controls did not control price volatility during the events.
 - ii. Eventually, market participants perceived that members may have been insufficiently robust to weather the events.
 - d. Rapid risk reduction by participants:
 - i. Basis risks emerged from the use of LME nickel prices to hedge sales based on Class 2 prices.
 - ii. There was no well-rehearsed approach among members to close-out significant positions.
10. Although many of the factors discussed are structural across all metals markets, it is important to highlight, and ultimately consider, those which are specific to the nickel market. As highlighted above, this includes the inherently volatile nature of nickel given the market size and its heightened exposure to geopolitical risks.
11. The contributing factors identified in the Review recognise and reflect the diverse global nature of the metals market and the risks that exist in such a market, spanning on-exchange and OTC activity. The LME Group is committed to doing everything possible to build resilience and confidence in the market, within the limits of what is in the LME Group's practical ability to control.
12. Notably, the Review has found that the OTC market played a significant role in the events in the nickel market of 7 and 8 March 2022. The LME Group is aware that any additional controls or requirements in relation to the OTC market would need to be considered within the context of existing regulatory frameworks and requirements and, as such the LME Group looks forward to working alongside global regulators to support the wider metals ecosystem.



Recommendations

13. The LME Group welcomes the recommended objectives in the Oliver Wyman report, namely:
 - a. Identify risks and prevent extreme events:
 - i. Extend the mandate of LME's risk and control functions to explicitly cover identification and prevention of market distortions, and upgrade capabilities accordingly.
 - ii. Tighten LME rules and enforcement processes to prevent risks of market distortions
 - iii. Monitor significant risks in the OTC market to manage risks of LME market distortions
 - b. Manage & control extreme events:
 - i. Upgrade volatility controls to slow down extreme price moves
 - ii. Build operational readiness across the market for managing extreme events
 - c. Rebuild confidence:
 - i. Consider tightening rules to improve perceptions of member and LME Clear resilience
 - ii. Provide a clear vision for how the LME Group will respond to events and rebuild liquidity
14. Oliver Wyman's recommendations are understandably wide-ranging and multi-layered, and as such the LME Group intends to consider them carefully to ensure that the full market impact, and any potential unintended consequences of specific measures, are assessed carefully before moving into the implementation-planning phase.
15. The LME Group has already taken proactive steps to reduce the likelihood of a similar event happening in future (including, for example, the introduction of specific tools such as daily price limits and periodic OTC reporting). As the LME Group continues to build on these actions, it anticipates that implementing some of Oliver Wyman's recommendations will involve longer term projects, including engagement and consultation with the market and regulators. Notwithstanding this, there are a number of areas within the report in relation to which the LME Group has already been developing its thinking and the LME Group will continue to engage with the market on these topics. In particular, the LME Nickel Committee will continue to explore whether any changes to the LME Nickel contract, additional Class 2 contracts, and/or alternative Class 2 pricing mechanisms may be beneficial to the market.

Next Steps

16. The LME Group is committed to taking all the necessary steps to rebuild the confidence of the metals market. As such, the LME Group will prepare an implementation plan, setting out how it proposes to deliver against the recommendations in Oliver Wyman's report, which it will aim to publish to the market by the end of Q1 2023. This will allow for careful consideration of the each of the recommendations, and appropriate methods to implement them.

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cc: Board directors
Special Committee
Nickel Committee
User Committee