Response Paper on Options Market Structure

November 2020

LME
An HKEX Company

SETTING THE GLOBAL STANDARD

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1 INTRODUCTION

On 1 July 2020 the London Metal Exchange ("**LME**") published a Discussion Paper on Options Market Structure (the "**Discussion Paper**"). The Discussion Paper document laid out a future pathway for LME options, based on the development of an active electronic options market to complement the existing inter-office market activity. It also asked some questions on certain aspects of the LME options market structure, and how participants might like to see those areas developed.

1.1 Purpose of this Findings Paper

This document (the "**Response Paper**") summarises the views that the LME received in response to the Discussion Paper, and lays out how the LME believes it is best to proceed in various areas of development. This LME view is informed by the responses to the Discussion Paper, other interactions the LME has had with market participants, and the LME's own view on how best to develop its options markets when considering the needs of all participants and the market as a whole.

This Response Paper should be read alongside the Discussion Paper, which laid out the general path of travel for LME options markets, and the technical deliveries which will allow for the development of the electronic options market.

1.2 Next steps

This Response Paper lays out the high-level direction of travel and key areas of development for LME options markets. While it does provide some level of detail, many of these developments will require further detailed planning work, and potentially further engagement with stakeholders, in order to identify optimal solutions. Certain of the developments may also be subject to further formal market consultations (including, for example, on any rules required to give effect to them) and subject to regulatory approval. The measures set out in this Response Paper should be read in this context.

Some of the developments proposed will be delivered within the programme of work that the LME is undertaking to upgrade its electronic trading platform, LMEselect. Other developments are largely stand-alone, but will still need to be appropriately sequenced, with participants afforded adequate timelines for development. As such, the full implementation of the programme of works discussed within this Response Paper will likely take a number of years, delivering incremental improvements for LME options markets over time within the broader development framework set out here.

The Discussion Paper focused on USD "**Metal Options**", which are the most widely traded type of LME option. These are American style options, which expire on the 1st Wednesday of each month, and deliver the 3rd Wednesday futures contract.

This Response Paper similarly focuses on the USD Metal Options (hereafter simply referred to as "**LME options**"). Some of the proposed developments may have indirect impacts on other options contracts offered by the LME, for example in different currencies, or on Traded Average Price Options ("**TAPOs**"). The LME will also take these option types into consideration to ensure the optimal outcome for the market as a whole. Again, these changes may be subject to further consultations.

2 RESPONSES TO THE DISCUSSION PAPER

The LME received 36 responses to the Discussion Paper from a range of both member and client participants. The vast majority of responses were supportive of the LME's general efforts to develop its options markets, and specifically of developing an active electronic options market. That said, it is worth noting that there were a small minority of respondents who questioned the need for development of the LME options market, and in particular questioned whether developing an electronic options market would be a positive benefit for the market as a whole.

Sections 2.1 and 2.2 below summarise the LME's proposed path forwards for LME options markets, given the feedback received and the LME's view on each of the key topics. Section 3 then provides a summary of the responses received to each question, alongside the LME's views having taken account of these responses.

2.1 Developing electronic options markets for the LME

Based on the majority of the feedback received, the LME continues to believe that it should proceed to develop an electronic options market as it will be a positive development for the market as a whole. The LME will continue to engage with the whole community of options participants to ensure that LME options markets will offer the appropriate balance of venues and execution methods, and flexibility for the participants that wish to use it.

As described within the Discussion Paper, the LME's new trading platform is a key requirement to deliver the technical capability for development of an electronic options market traded in premium terms. It will enable the LME to deliver a number of the new developments such as strike rules and tick size refinements. Developments in these areas will be communicated to participants through the normal channels as the new trading platform is delivered. Once the new trading platform has been launched, the LME will work with the market to develop a dedicated liquidity provider programme (subject to obtaining any regulatory approvals) that will support the development of on screen liquidity.

2.2 Other developments for LME options markets

The LME will start planning both the development of a fully automated option expiry process, and the approach to transitioning all LME options contracts to this new expiry process. The LME will develop an appropriate expiry price calculation, and will consider the most appropriate expiry time. As part of this development the LME intends to formally change its options to be European style. At this stage the LME does not intend to introduce a contrary instruction window. It is expected that this development will take some time, but the target is to deliver a robust process which all market participants have ample time to test and implement in order to ensure a smooth transition. The LME will start its early planning in 2021 but as noted above, a full transition of LME options markets is expected to take a number of years.

Once the LME has launched electronic options markets, it will look to incorporate electronic prices into the Closing Price process. The LME will take a cautious, phased approach in order to ensure market participants are comfortable with the process, and that prices are consistently reliable. The LME believes that over time it is likely that electronic prices will form the primary inputs for price discovery for the most liquid options contracts. The LME believes it will be important to maintain a volatility submission process, both to ensure consistency of pricing, and to allow for pricing of less liquid instruments.

Alongside these other developments, the LME will seek to amend the reporting for large-in-scale ("LIS") options to 19:00 on the day of trade (rather than the current process of delaying until 19:00 on the day following the trade). It is not possible to make this change immediately as it requires appropriate system planning and regulatory engagement, but the LME intends to start the planning of this change in 2021.

Finally, the LME will consider what form of block rules might be appropriate in order to enhance electronic liquidity provision. The LME intends, subject to appropriate consultation, to implement these rules some time after the new trading platform has launched. The LME expects that these rules will initially have relatively light restrictions, to allow electronic liquidity to build and participants to adapt their trading processes. In time it may then be appropriate to strengthen the rules, dependent on further market engagement.

3 DISCUSSION PAPER TOPICS

The below areas of potential development were laid out in the Discussion Paper. In each section below the original question is shown, along with a summary of the views given by respondents to the Discussion Paper. Given these responses, the LME has also laid out its views.

3.1 Options expiry process

3.1.1 Manual vs. automated expiry

1) Do you think that the LME should consider transitioning its existing expiry process to an automated expiry process?

The vast majority of respondents were supportive of at least some changes to the LME expiry process to introduce more automation. Some respondents believe that the process should be as automated as possible, citing that any manual process adds operational risk and is a barrier to entry to new participants.

Other respondents felt that while some form of automation would be helpful to reduce operational risk, such as automatically exercising strikes that are deep in the money, ultimately they would like to preserve the optionality of the manual expiry process, and do not want to lose the trading opportunities this affords them.

Some respondents that are supportive of significant automation highlighted that any form of manual choice for long options position holders must mean that the short position holder cannot deterministically rely on the published expiry price to determine the result of option expiry. As such all participants would need to maintain manual processes and understand the nuances of the expiry process.

Given all the feedback received, the LME is minded to pursue a move to full automation of the option expiry process. The LME acknowledges that this will mean some trading practices might need to change over time (such as some participants choosing to close out options positions ahead of expiry to avoid pin risk). The LME believes that only full automation of this process will deliver the deterministic outcome preferred by the majority of respondents.

This will also allow for the removal of the majority of manual processes around the option expiry, reducing operational risk for all participants.

Some respondents did highlight the need to work closely with the market, in the event that full or partial automation is implemented, to consider the impact on existing positions entered into before a change to the option expiry process was considered. The LME very much recognises this need, and as such does not see a change towards an automatic expiry process as something to be delivered immediately, but a longer-term development. Over the coming year the LME will commence its internal planning to consider how a change to an automated expiry process can be implemented, and will then work closely with market participants to appropriately plan for this transition.

2) If the LME did transition to an automated expiry process, do you think there should be a contrary instruction window? Please explain the reasons for your response.

Alongside the answers to question 1, responses here were relatively balanced, with some respondents again looking for maximum simplification and automation, while other respondents saw value in being able to choose to give contrary instructions to enable them to trade around the expiry process in some circumstances.

The two questions are of course intrinsically linked, and several respondents who did want to see some level of automation, again highlighted that they do not want to lose the ability to make a manual decision to exercise an out-of-the-money option, or abandon an in-the-money option.

Some participants pointed out having the ability to partially exercise options which are close to at-the-money at expiry allows a trader to offset their (50) delta hedge against the options position.

Alongside the views put forward above, the LME believes that if an automation strategy is pursued, it would be unhelpful to have a contrary instruction window. Such a window would add complexity to the expiry process, reducing the deterministic outcome mentioned above, which is the key benefit of automation. Short position holders in options would still be impacted by manual decisions of other participants. Furthermore, it would mean that trading participants would have to maintain manual operational processes.

Again, the LME does understand that this will require some changes to trading practices, at least for certain participants, in some scenarios, but the LME believes that options traders will be able to adapt. It believes the level of certainty provided by an automated solution will be an overall benefit to all participants.

3.1.2 Expiry price calculation

3) If the LME did transition to an automated expiry process, do you have a preferred methodology for the expiry price to be determined?

There was a large range of views on this topic, with a great deal of informative detail provided in respect of specific ways in which the LME could look to derive an expiry price.

It is clear that the LME's unique venue structure, combined with the date structure, gives rise to some complexity in deriving an expiry price, as the monthly contracts are not always themselves liquid.

The following key issues were raised by respondents as important factors for the LME to consider in determining an appropriate expiry price:

Liquidity – it is important that the expiry price is derived in a liquid market, both to ensure that the prices are reflective of current trading, and to allow participants to be able to effectively hedge against the expiry price without inadvertently influencing the market.

Transparency – the prices used to determine the expiry price need to be transparent, as does the calculation methodology, so that traders are able to clearly understand how the expiry price will be determined, how they can appropriately hedge their positions, and how they should react to price moves.

Reliability – the process needs to produce a reliable and trusted expiry price. This is largely achieved by ensuring the other factors are appropriately addressed.

Speed of publication – it is important that the expiry price is published immediately after calculation to give participants certainty of the result of option expiry and the ability to appropriately hedge their positions before the market has moved.

There seemed to be general agreement by respondents that an expiry price needs to be derived from electronic trading, to ensure maximum transparency for participants.

Given the above factors, and the current liquidity seen in LME markets, the LME believes the best approach would be to determine a 3-month price, and separately determine a price for the relevant 3rd Wednesday to 3-month carry. These components can then be combined to create the expiry price for the relevant 3rd Wednesday future. The LME will consider both a VWAP and TWAP methodology for establishing the component parts, but is currently minded to select a TWAP methodology, which will be less influenced by single large trades and is more reflective of prevailing prices over a period of time.

As the LME progresses with plans around transitioning the options expiry process to be automatic, it will continue to work with participants to establish a trusted method for determining the expiry price.

4) Do you think that the LME should look to change the current option expiry time? If yes, what factors should the LME take into account in determining an appropriate expiry time? Do you have a preferred time for option expiry to take place and if so, why?

There was a large variety of suggestions of possible expiry times from respondents. In general, it was clear that respondents felt the expiry time should be one which would be convenient to the majority of participants in LME options markets, rather than giving preference to a specific region or time zone. One other important factor, raised by the majority of participants, was that the expiry should be at a time of maximum liquidity for the underlying markets. This is directly linked to the comments on liquidity and transparency of the expiry price, as discussed above under question 3.

The most common suggestion by respondents was moving the expiry price to the London afternoon. There was lots of detailed input by participants around specific times to avoid (such as busy periods on other markets), and/or specific times that would be optimal from their perspective.

When the LME undertakes the work to move to an automated expiry process, it will consider this feedback in determining the appropriate time for expiry. In particular the need to select a time when liquidity is adequate.

3.1.3 American vs. European options

5) Do you think that the LME should change its options to European style?

The majority of responses in this area confirmed that the market generally treats LME options as European style options, despite them technically being American style.

Some respondents suggested that due to this nuance, there was no need for the LME technically to change the option, as it would make no difference to the market. Other respondents felt that it would be better for the LME formally to change its option style to be European, so that the contract specification reflected the way the market treats the options.

In line with the LME's views that it would be beneficial to the market to seek as much automation and determinism around the option expiry process as possible, the LME believes that it would be helpful formally to change the LME's options to European style. This will allow for full automation (as the only exercise possible is against the automated process), and achieves a simplification for the market as they contract specification will fully reflect the way the options are treated for practical purposes.

6) Is there anything else that you think the LME should consider regarding the option expiry process?

There were several other topics that respondents brought up regarding the expiry process.

One area was the manual process of matching trades within the inter-office market, and the considerations that must be given to this around the timings of the expiry process. The LME will certainly consider the requirements in this area when designing the detail of its automated expiry process.

Several respondents suggested operational process improvements that could be investigated by the LME should the manual option expiry process be maintained, and gave some detailed examples of problematic operational processes. These included comments relating to the current process for generating a suggested expiry price, and the remediation process should a participant accidently make an expiry declaration that they then seek to reverse. In many of the examples given there may be some small changes the LME can make to assist participants, and the LME will consider whether any of these can be implemented in the short term. However, the LME believes the appropriate solution is to remove the need for these operational processes entirely by moving to an automated expiry process.

One other comment made by some respondents was that they felt it is not possible to satisfy all participants entirely. They thought the most important thing was that once the LME had come to a decision, it should ensure that the resulting process was easy and clear to all the whole market, participants will then be able to adapt.

3.2 Strike listing rules

7) Do you believe it would be beneficial for the LME to limit the strikes that are automatically listed on LMEselect as being available for trading?

Some respondents wanted to see few restrictions in the strikes automatically listed on LMEselect. Many felt that LMEselect and the inter-office market should have exactly the same set of strikes available.

However, the majority of respondents did see value in limiting the electronically available strikes somewhat in order to pool liquidity on a core set of instruments. There were several different suggestions as to how this could be implemented, with most respondents asking for a relatively simple graduation for ease of understanding. Some respondents mentioned having an upper and lower strike threshold. Several thought that the strike graduations on LMEselect could be set as somewhat wider than in the inter-office market, such as $50 strikes for copper (where the inter-office market allows $25 intervals for strikes up to $10,000). Some also highlighted that it would be valuable to have more strikes for closer expiries, and fewer strikes for longer expiries (as the delta on the option is less sensitive to movements in strike the longer the expiry).

In addition, some respondents suggested that only strikes with open interest should be automatically listed on the electronic market, or that a standardised set of strikes should be automatically listed, plus any strike with open interest.

In the LME's view, there is clearly a balance to be struck between having fewer strikes available and pooling liquidity, and having more strikes available to give greater choice to traders. The LME will take all the feedback into consideration and endeavour to create a relatively simple strike listing structure for the new trading platform.

It is likely this will have fixed strike graduations, and a fixed number of strikes for each expiry month, though fewer strikes (at wider graduations) for longer dated expiries. Full details will be communicated in due course as the platform develops.

8) Do you believe the LME should allow participants to create strikes on LMEselect outside of those that are automatically listed?

Most respondents did want some form of “user-created” strikes, either by allowing a user to create those strikes on LMEselect during the day (if they had not been automatically listed), or by allowing participants to request-for-quote new strikes.

Some respondents reiterated concerns that this may create too many strikes for traders to be able to easily process on trading screens or within trading systems, and suggested some method was required to prevent the list of strikes becoming onerous, such as removing strikes without open interest, or periodically clearing out user-created strikes.

The LME does believe some form of user creation of strikes is important, particularly if the number of strikes that are automatically created on a daily basis is relatively restricted. Again, the LME will determine a solution within the development of its new trading platform, and communicate this in due course.

9) Do you believe the LME should implement some limited restrictions on what strikes can be traded inter-office, such as having a maximum and minimum strike? If so, how should these parameters be set?

10) Do you think the LME should have more significant restrictions on the strikes available for trading in the inter-office market?

Some respondents did see the value in restricting the available strikes in the inter-office market, either for simplicity’s sake, or to enable commonality between venues.

However, the majority of respondents felt that the flexibility provided by the strike rules for the inter-office market should be preserved, and did not see any value in adding restrictions. Respondents detailed the types of strategies that are traded, and how significant flexibility in strikes was useful in particular for clients. Some participants also pointed out that any restrictions in the inter-office market may have the unintended consequence of pushing some trading towards OTC markets. These respondents wanted to ensure that the inter-office market provided for as many people as possible and even felt that even finer graduations could be introduced in the inter-office market (such as $1 strike intervals) to ensure maximum flexibility.

The LME is very much aligned to the view that flexibility in the inter-office market should be preserved to meet the varying needs of participants. In a bilaterally negotiated market, such as the inter-office market, there are significantly fewer drawbacks to having this flexibility. This means that the electronic market can operate with restrictions in place to allow for maximum liquidity pooling, while leaving the flexibility in the inter-office market. As such, the LME does not intend to amend any of the strike listing rules in the inter-office market.

11) Is there anything else you think the LME should consider regarding the strike listing rules?

There were no other aspects that respondents raised that were not dealt with elsewhere.

3.3 Tick sizes

12) What do you think would be the best approach for the LME to take regarding tick sizes for options on its electronic market: fixed tick sizes the same as futures; fixed tick sizes at a finer granularity than futures; variable tick sizes; or some other solution? Please provide as much detail as possible as to the reasons for your preference.

The majority of respondents did believe that tick sizes in the electronic market should be wider than the current $0.01 ticks to allow liquidity to be pooled at price intervals.

While a few respondents did highlight the value of a variable tick-size solution in order to allow for finer tick sizes for lower priced options, the majority of respondents felt that a simple solution would be best for the LME, and therefore preferred a single tick size per option contract. Many respondents did support using the same tick sizes as the underlying futures, though some pointed out that this would be more restrictive for options markets due to the lower nominal price.

The LME's broad view is that a simple solution is the best way to proceed. While the LME does see that a finer tick size might be required in future, should electronic liquidity build sufficiently, it believes that keeping the same tick sizes as for the underlying futures markets is a sensible starting point for the electronic options markets. Tick sizes can then be reviewed if it is clear that the electronic markets are regularly one tick wide, and thus would benefit from finer granularity.

13) Do you think the LME should look to amend the tick sizes for options in the inter-office market? If yes, please give details.

Some respondents did see the value in having a common tick size between the electronic market and the inter-office market. The simplicity of this solution was seen as attractive. It was also highlighted that this would help to preserve electronic liquidity by ensuring that trading could not be directed away from the electronic market without a meaningful price improvement.

However, as with other topics, the majority of participants felt that flexibility in the inter-office market should be preserved. Respondents highlighted that many trades in the inter-office market (and particularly the largest trades) are executed in volatility terms. As such, it is important to preserve the finer tick size granularity, to allow the premiums to accurately reflect the volatility traded.

Again, the LME agrees with this viewpoint, and intends to pursue a structure where the electronic market is appropriately standardised to support liquidity, while allowing flexibility in the inter-office market.

14) Is there anything else you think the LME should consider regarding tick sizes for options?

Respondents did not raise any further points regarding tick sizes.

3.4 Closing Price process

15) Do you think that the LME should look to include prices from the electronic options market in the process for establishing Closing Prices? If not, why not?

Almost all respondents felt that prices from the electronic market should be included in the process for establishing Closing Prices. There was a significant number of comments relating to this topic, and suggestions as to how it should work. Some respondents felt that there should be some thresholds around potential orders or trades to be included in the pricing process, such as the size and/or the length of time they were in the market. Many respondents also felt that there needs to be consideration towards electronic market liquidity, and the comparative sizes of the electronic market and inter-office market, among other factors, to ensure that the Closing Price process was not inadvertently influenced by small electronic orders in illiquid conditions.

The LME agrees with these views. As the electronic options market develops, the LME will work to include these prices in its Closing Price process in an appropriate manner.

16) Do you believe that an order in the electronic market (with appropriate thresholds of time and size) should be the highest priority when establishing Closing Prices?

A few respondents felt that the electronic market should always take priority, so that the Closing Price is always established between the bid and offer in the electronic market. The majority of respondents, however, felt that there should be a more balanced approach. The consensus view was that some consideration should be given to size of orders and trades, how long those orders are in the market, and other general considerations such as the electronic liquidity, and the proportion of trading that is being undertaken electronically.

Some respondents pointed out that the balance of inputs from the electronic market, inter-office market and submissions was particularly important in the less liquid options markets, such as lead or tin, where electronic liquidity is likely to be less consistent, and where the inter-office market will continue to drive the majority of trading.

The LME believes it is important to take a cautious approach to including electronic prices in its options Closing Price process. It is something that the LME intends to develop over time as the electronic liquidity builds. The LME agrees that it is important to take into consideration order and trade sizes (among other factors), and have appropriate controls to ensure that Closing Prices remain a reliable reflection of market prices, and are not inadvertently influenced by outlying individual orders or trades.

17) If the LME was to move over to using the electronic market as the primary source of data for the Closing Price process, do you believe it would still be appropriate to retain a submission-based process for areas of the volatility surface that are not liquid electronically?

Respondents expressed a range of views in answer to this question. Some respondents wanted to see a full move towards using electronic prices and remove the submission process entirely. This was either because the respondent felt that prices from the electronic market would be more reliable, or because as trading participants they would rather not have to be involved in the submission process themselves.

Other participants, while supportive of largely using electronic prices, did think it was important to retain a submission process. This is to ensure that a range of inputs are taken into account, including from participants in the inter-office market. It was highlighted that this is particularly important for the parts of the volatility surface that have limited electronic liquidity (such as low delta options, or longer maturities).

The LME believes that a form of submission process is likely to remain an important component of the Closing Price process. Initially the current submission process will be able to be combined with prices from the electronic market. In time, it may be possible to refine the submission process to focus on instruments that are less liquid in the electronic market. Overall, the LME believes it is important to adopt a cautious approach to the incorporation of electronic data and reducing the reliance on the submission process to ensure that market participants can continue to depend upon stable and reliable prices.

18) Is there anything else you think the LME should consider regarding the Closing Price process for options?

Some respondents highlighted that they thought the LME should use all trades to input to the Closing Price process (thus including inter-office trades as well as electronic trades). The LME does currently monitor the inter-office market to ensure that the Closing Price process accurately reflects trades undertaken. However, due to the nature of the inter-office market (including delays to trade reporting, inclusion of commissions or credit charges on some trades, and other factors) this is a relatively manual approach where trade are reviewed to ensure the Closing Prices derived from the submission process are appropriately reflective of market activity. The LME expects that this will continue once prices from the electronic market are included in to the process for establishing Closing Prices.

3.5 Liquidity provider programmes

19) Do you agree that implementing a liquidity provider programme for electronic options markets would maximise the success for these markets?

Most respondents agreed that some form of liquidity provider programme was needed to help bring new liquidity providers to the market, and in particular to ensure consistent liquidity for the electronic markets. Some respondents felt that ensuring consistency of liquidity is the most important aspect. They highlighted that some other listed options markets have seen liquidity provision in the electronic market reduce significantly at times of market volatility.

A small number of respondents that felt that the LME should not specifically incentivise new liquidity providers, and should instead rely on existing market makers to provide liquidity in the electronic market.

20) Do you have any opinions on the specific structure of a future liquidity provider programme?

Many respondents gave useful details on structures that they felt would create an effective liquidity provider programme. Some were supportive of a very simple programme such as just reducing fees for liquidity providers, while others felt that a more complex structure would be more appropriate.

Some respondents provided significant details on structures that they felt would be most appropriate. Some preferred programmes that were solely based on volumes traded, and other respondents felt programmes would be more effective if managed using quoting requirements and incentivising participants to meet those requirements.

The LME very much values the input from respondents, and will consider the detailed points raised in designing its future incentive programmes. In general, the LME believes a programme should be relatively detailed, in order to incentivise liquidity provision in specific months and strikes to help pool liquidity. The LME also believes that there is a balance to be struck between measuring LPs solely on their volume traded, and on having some form of quoting requirement. The LME believes that any liquidity provider programme should seek to ensure long term, consistent liquidity provision to the benefit of all market participants.

3.6 Block rules

21) Do you believe the LME should consider implementing block trading rules for LME options markets once the electronic markets are launched? If so, what factors should be considered when setting the block thresholds? Please give as much detail as possible in your answer.

As expected, respondents had a wide range of views on the subject of block rules. Some respondents were strongly opposed to any rules that would restrict what can be traded in the inter-office market, highlighting that not all clients wanted to trade electronically and that existing market practices should not be disrupted. However, many existing LME participants were more supportive of some form of block rules than the LME had expected, suggesting that they were an important part of enhancing and encouraging electronic liquidity. Many of these respondents suggested that the key is to ensure the block threshold is optimal, rather than not having any block rules at all. Furthermore, some respondents were particularly supportive of block rules, suggesting that they should be used to ensure that the vast majority of trading takes place in the electronic market.

Among the responses that suggested an appropriate block size, the trade size suggested ranged from 2 lots, up to 100 lots, with some respondents giving more details about varying sizes by contract. Respondents generally seemed supportive of finding the right balance between enhancing electronic liquidity, and allowing trades to be bilaterally negotiated.

Some respondents did highlight that the speed with which block trades were published to the market was also important, to ensure transparency of data.

Given that the LME received more supportive responses than expected, it will consider whether it might be appropriate to introduce some form of block rules, albeit this is likely to be a longer term development. The LME does see the value in this type of structure to protect electronic liquidity provision, but also sees the need to ensure existing trading practices are not overly disrupted and that clients are able to access the liquidity they need.

3.7 Large-in-scale option trade data

22) Do you think the LME should look to amend the delayed reporting of LIS trades?
23) If a change is desired, considering the above options, what amendments do you think the LME should pursue?

Most respondents felt that the delayed reporting of LIS trades was important in order to protect liquidity provision for larger trades, by giving the liquidity provider time to hedge their risk or restructure their positions. However, there was a large range of views around the size of trades that should be delayed, and over what time period.

Some respondents desired no change to the current delays as implemented by the LME. Others suggested some changes to the current procedure, such as doubling the LIS thresholds so that fewer trades are deferred, or reducing the deferral period. When discussing reducing the deferral period, some respondents suggested significant changes, such as a fixed 5 or 30 minute deferral, with others suggesting less significant changes.

Several respondents requested that the deferral be amended to publish the trades at 19:00 on the trading day (rather than the current situation of publishing at 19:00 on the day after the trading day). It was highlighted that this would have the additional benefit of allowing market participants to be aware of total volume at the end of each day, and would allow fully reflective open interest numbers to be published earlier, as the market has already seen the details of all trades.

The LME believes this suggestion is a good balance between protecting liquidity provision, while ensuring appropriate transparency for all market participants. As the LME develops its electronic options market, and seeks to make other changes, it will also look to implement this change to LIS reporting delays.

3.8 New options contracts

24) Do you think the LME should investigate launching a shorter dated option contract alongside the monthly LME options?

Several respondents highlighted that short-dated options are useful tools for participants in other derivative markets, and could also be valuable for LME participants. However, it was also noted that launching short-dated options could split the liquidity of the existing contracts. As such, many respondents (including some of those that were supportive of short-dated options) also pointed out that the LME should focus on building liquidity in the existing options contracts first, before launching additional contracts.

25) Are there any other options contracts you think the LME should investigate launching?

The majority of respondents highlighted that the LME should focus on building liquidity in its existing options contracts before launching other base metals options contracts. However, respondents did also provide a number of ideas for the LME to explore at a later date. These suggestions included calendar spread options, variance swaps, and cash settled options.

Some respondents also pointed out that they believe there would be interest in options with other underlying contracts when the liquidity in those underlying contracts builds to a sufficient level. The suggestions included options on the LME's steel scrap contract, and options on the physical premium contracts.

The LME agrees with the viewpoint that it should focus on building liquidity in its existing contracts before looking to launch further base metals options contracts. As liquidity builds, the LME will value further input from market participants regarding which options contracts should be targeted for further investigation.

The LME will continue to monitor its other futures markets, and will explore the possibility of options contracts in markets where there is sufficient liquidity in the underlying contracts.

3.9 Other topics

26) Are there any other topics you think the LME needs to consider in order to maximise the success of the electronic options market?

Respondents highlighted a range of areas here that they felt could help to maximise the success of the electronic market. Some of the suggestions were relatively general in nature, such as desires for standardisation with other markets, a focus on increasing transparency, and ensuring all participants have equal access to the both the electronic and voice markets.

There were also some more specific suggestions, including:

An asymmetric speed bump designed to protect passive liquidity providers by delaying aggressive incoming orders by a short time period. This is very similar to the speed bump that the LME has implemented in its LMEprecious contracts. While there are no immediate plans to roll this out to other markets, the LME will work with new electronic options LPs to determine whether there is interest in such an asymmetric speed bump. It is unlikely that this will be delivered in the short term, but could form part of longer term developments should it be desired by participants.

LME-provided functionality for auto delta hedging, and auto updating volatility orders which would help less technologically advanced participants to trade on the basis of volatility in the premium based electronic market. The LME is engaging with several technology partners in this area. One difficulty so far has been that every participant has slightly different requirements as to how they would like such a system to work. As such, the LME will likely aim to have several providers who are able to connect to LME markets offering this type of service, but not have a specific LME offering. The LME is keen to hear from any participant who would be interested in these services.

Improving electronic liquidity in 3rd Wednesday contracts was highlighted as an important factor by some respondents, in order to allow options participants to hedge their delta as efficiently as possible. The LME will consider whether there is any specific steps it can take to improve this liquidity.

27) Are there any other topics you think the LME needs to consider in order to maximise the success of LME options markets more generally?

Respondents highlighted several areas where they believed that the LME could focus its attention in order to maximise the success of LME options markets. Again, several respondents asked for a continued focus on transparency, standardisation, and ensuring the markets are easy to access and understand for new participants.

Some respondents highlighted the non-standard characteristics of the LME futures markets, and felt that in general this may be a barrier to attracting new participants.

There were some respondents that felt that the LME needs to protect the existing market, to ensure that existing participants were not unduly negatively impacted by the proposed changes. The LME is certainly sensitive to this and believes it needs to take a balanced approach to ensure that LME options markets continue fully function and meet its participants needs.

The subject of fees was mentioned by a few respondents. While there were some that suggested that LME fees should be lower, there was an alternative view put forward that the most important thing was to ensure all participants had equal fees. The LME will continue to consider the appropriate level of fees, and fee structure for its markets to ensure fairness and trading efficiency for all participants.

28) Are there any potentially significant impacts that you foresee from an operational or other perspective on your LME options trading activities as a result of the proposals in this Discussion Paper?

Several respondents highlighted that while they were supportive of the proposals, implementing some of the changes discussed could require potentially significant changes to systems and processes. As such, it is appropriate that the LME continues to work closely with participants on the details of and changes and transition, and gives appropriate time for participants to make the required changes.

One respondent gave their view that the development of electronic options markets would lead participants to move business OTC in order to avoid electronic trading.

One respondent highlighted that they believed that increases in transparency, liquidity and ease of trading resulting from the development of an electronic options market would increase their trading volumes.

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