2 September 2022

FIA Response to the Independent Nickel market trading review – (a) voluntary market-wide engagement

Dear Oliver Wyman,

On behalf of FIA[1] and its members, we express our appreciation for the opportunity to comment on the voluntary market-wide engagement exercise (*LME Notice reference 22/181*). We view this independent review and fact gathering as an important step toward understanding and addressing the shortfalls leading to such a significant market disruption.

Our comments outline the importance of having robust volatility control mechanisms in place but also robust and efficient risk management process such as the ability to promptly reassess market conditions and potential risks when new events could materially impact fundamental supply and demand dynamics, to appropriately monitor concentration and adjust margin levels in a timely fashion amongst other things.

Our members also have raised other topics of interest beyond the four proposed from the notice, highlighting the importance of efficient and effective communication as well as improved transparency of rules regarding trade cancellations provisions.

You will find in Annex 1 below our comments, and we welcome the opportunity to discuss with you any of these should you require additional information.

Respectfully submitted,

Jacqueline Mesa

COO and SVP, Global Policy

FIA

[1] FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C. FIA's membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from more than 48 countries as well as technology vendors, lawyers and other professionals serving the industry. FIA's mission is to support open, transparent, and competitive markets, protect and enhance the integrity of the financial system, and promote high standards of professional conduct. As the principal members of derivatives clearinghouses worldwide, FIA's member firms play a critical role in the reduction of systemic risk in global financial markets

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Physical market and contract specifications		
Potential contributing factor	**Topics of interest to the Independent Review**	**FIA Comments**
Supply and demand in the underlying Nickel market, concentrations, and susceptibility to shocks	1. Overall supply and demand trends in the nickel market 2. Concentration of producers and consumers of Nickel, across regions, countries, and companies 3. Susceptibility of the physical nickel market to shocks, impacts of geopolitical events, in terms of price, availability of supply Impact of macroeconomic factors and supply/demand patterns during Q1 2022 4. Critical differences between Nickel and other non-ferrous metals	*'The world's top ten nickel producing countries together accounted for 93% of the global nickel output in 2021'* and Russia ranked 4 in 2021[2]. Higher demand for Nickel (Stainless steel and batteries) and the Ukraine invasion with its potential sanction to Russia led to rising concerns of supply shortage. Given the concentration of producing countries and uncertainty around Russian sanctions, LME should have been aware of potential upcoming issues in the Nickel market in late February/early March and considered prompt mitigating actions. These could have included i) reviewing eligibility criteria for physical delivery and assessing the contract specifications; ii) implementing volatility control mechanisms to manage anticipated price volatility; iii) analysing member and client account level positions to identify concerns and react with mitigating measures.
Alignment between the LME Nickel contract and the wider physical nickel market	1. Products included in the specification of the LME Nickel contract (i.e., refined Nickel) and products excluded (e.g. nickel matte, iron-nickel, NPI)	The LME Nickel contract is the primary pricing benchmark for this asset, used by a broad set of participants from producers to consumers. A proportion of the physical contracts will not be held to

[2] Global Nickel Market Trends - Mining Technology (mining-technology.com)

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	2. Fungibility of different grades of physical Nickel, ability to arbitrage between markets 3. Usage of LME prices for Nickel products not included in delivery specifications 4. Availability of physically deliverable LME Nickel and wider physical 5. Nickel stock levels in late 2021 - 2022	delivery, being rolled, or closed for hedging purposes. A broader set of deliverable specifications, purity, and shape would help with better price discovery and liquidity.
Delivery rules and requirements, lending rules and backwardation limits	1. Warehouse loading/delivery rules, transparency of ownership of warrants 2. Physical metal lending rules (i.e. dominant position obligations which impose that lending is required on all holdings of 50% or above of total LME live warrants) 3. Backwardation limits (i.e. restrictions on tom-next carries on any venue at a price in excess of 1% of relevant metals' previous day's cash official price)	Enhanced transparency in LME stocks, rents and warehousing may incentivize higher exchange activity. Warehouses should report all metal holdings that meet LME specifications, and that data should be published real-time. LME inventory data should show all potentially available stocks – not just warranted metals. We are in support of backwardation limits.
Trading limits, controls and rules		
Potential contributing factor	**Topics of interest to the Independent Review**	**FIA Comments**
Position reporting, position limits and accountability levels	1. Large position reporting and limits / accountability levels across i) LME venues; ii) uncleared OTC derivative transactions referencing LME Nickel prices, and; iii) other transactions referencing LME Nickel prices 2. Degree of market transparency provided by position reporting, and its relative importance 3. Level of control afforded by LME's position limits / accountability limits, their calibration, investigation, and enforcement	ETD and OTC positions are key factors that should be monitored and mitigated if concentration or large build-up of positions occurs across one or a limited number of market participants. Note that LME rules already have provisions to reduce positions (Part 3 Para 20 "Position Limits") and to request any additional information including OTC positions (Part 2 Para 12 "Provision of information and obligations of Members" section 10.3). However, it is unclear how these measures are implemented. We

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		recommend that their implementation ensure proactive management of positions by participants.
Trading rules and real-time trading controls	Rules and controls intended to prevent disorderly and / or manipulative trading behavior for LME contracts, including Nickel, on LME venues, e.g.: • Order size restrictions • Volatility controls such as price bands and speed bumps • Message throttles	FIA believe adequate Volatility Control Mechanisms (VCM) such as price bands or size order limits, as well as adequate short market halts would have minimised the impact of this event. This would have allowed market participants to pause to reassess the fundamentals of the market versus the current price. It is understood that such mechanisms were not in place at the time of the event, which might have exacerbated this market disruption event. Regarding order size restrictions, the monitoring of positions close to expiry and notification to reduce such positions ahead of expiry if warrants suggest there is a shortage of supply, should be considered appropriately (i.e. executed in an orderly fashion). Any control mechanisms and their criteria should be clearly disclosed to participants and such controls should be designed to limit market disruption. Furthermore, calibration of these controls should be dynamic i.e., increase/decrease with market volatility. FIA Members also commented that: • Some Market Participants were unclear on the details of how the price limits would operate when the market reopened. In particular, there was some

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		uncertainty around the highest and lowest option strikes that would be within the price limits. • Market Participants had limited information and background in relation to any VCM mechanism and its implementation. • Market Participants were unclear as to what prompted the decision to keep the market open on the 8th of March and close it shortly after. By COB 7th of March, data already suggested potential market disruption.
Suspicious or anomalous trading activity	1. Identification of manipulative / abusive trading practices, e.g. front-running, wash trading, others 2. Identification and remediation of erroneous orders, to the extent they create anomalous market behaviour 3. Effectiveness of controls and governance in minimizing the above	Market surveillance is key to ensure the integrity of the market operated by the exchange. Some of the automated controls mentioned above will help ensure identification of potential suspicious or erroneous transactions, followed with appropriate and timely remediation actions (such as position reduction or order on hold). Controls should be established, documented, reviewed & tested periodically by the local regulator.
Risk management, clearing & collateral models of LME, LME Clear and Members		
Potential contributing factor	**Topics of interest to the Independent Review**	**FIA Comments**
Margining methodology and margin call practices	1. LME Clear margining methodology and impact of design choices on the market, incl. margin model methodology (SPAN vs VaR) and margining approach (e.g. Contingent VM vs. Realised VM) 2. Key elements related to the LME Clear process of margin calls (e.g. price signal to	The choice of SPAN vs. VaR was not a key factor. However, in the case of either methodology, one would have expected margin to be higher prior to the event. The calibration and implementation of the model parameter should be reviewed. For example, the LME should consider whether: (i) the anti-pro cyclicality measure incorporates sufficient historical stress events;

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	margin call transmission, timeliness and fulfilment criteria, intra-day practices) 3. Member and end-client level margin methodologies. Key elements related to the Member to end-client level process of margin calls (e.g. timeliness and fulfilment criteria, intra-day practices)	(ii) a 2-day margin period of risk is appropriate for Nickel; and (iii) margin should be based on a relative basis rather than in absolute dollar terms. Contingent VM vs Realised VM should be reviewed, especially in the context of industry standards for futures contracts and risk management. Prioritising transition to proposed Realised Variation Margin (RVM) model would alleviate potential systemic liquidity issues due to the asymmetric nature of CVM which calls for cash to cover VM losses, but not paying out cash for VM gains. It is not clear if LME Exchange and LME Clear have an overnight market risk surveillance, control, and management system. Limits and controls over overnight trading are an important part of intra-day risk management. The Exchange and CCP should revisit its processes to ensure it has sufficient controls for market trading during this overnight time. This could include a levy to mitigate against activity during periods of low staffing oversight. IM on a relative basis reduces the manual intervention needed to adjust to rising volatility. APC controls should consider significant periods of market stress to the underlying i.e., price movements in Zinc (Oct. '21 to Dec. '21) and Copper (Oct. '21). It does not capture the price movements observed during 2008, which were material for Aluminium and Copper.

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Concentration risks and margin lending practices	Ability of market participants (e.g. LME Clear, Member, end-clients) to identify and manage specific risks related to clearing and margining, including but not limited to: • Concentration risk arising from large position sizes in relation to market liquidity • Margin lending and leverage associated with Member and end-client positions	Concentration Risk (client or house large positions vs size of market and volume) margin add-on was perceived to be too low. The calibration methodology should be reviewed to appropriately capture such risk especially if clients are building up positions across different members. The governance and operational implementation of concentration threshold should be clearly documented and communicated. In addition, stress add-ons i.e., additional margin based on participants large stress losses, should also be considered. We would recommend enhancing the client level risk management framework to monitor, measure and mitigate against pockets of concentration at a client level. There should be a reassessment of the position limit thresholds to ensure they are capturing low levels of concentration and attributing corresponding margin add-ons and progressively increasing this requirement as the level of concentration increases.
Capitalisation and liquidity levels across the market and exposure limit setting	Capitalization and liquidity levels of Members and end-clients, including: • LME Clear Membership and Member requirements, e.g. $10 MM min capital requirement for members • Controls, such as exposure limits (e.g. caps and/or add-ons to margin requirements in relation to available liquidity of counterparty)	FIA members raised concerns regarding LME's members' credit risk oversight, specifically: - Member capital monitoring especially in the context of client business. - The nature of assets being considered and eligible as member's capital.

	related to margining practices of LME Clear vis-à-vis Members and Members vis-à-vis end-clients • LME Clear collateral requirements (e.g. eligible collateral types, haircut methodology) and any implications for ability of Members to meet margin calls • Ongoing reporting performed by the Member to LME Clear regarding activity on OTC/non-cleared market and potential relevant implications of such activity	- The appropriateness of liquidity stress testing to ensure members can meet margin calls during stressed periods. - Enhancing credit quality margin add-on to consider both the capital and liquidity profile (liquid assets or liquid capital) of its members We would recommend to regularly review members' portfolio risk especially when there are new developments significantly impacting risk profile of cleared contracts and products. Such review could be presented and discussed with members in a way which maintain confidentiality. For example, tools such as stress testing and prompt implementation of 'what if' scenarios could be used.
Loss sharing structures and associated incentives (including client segregation levels)	Loss sharing structures and associated incentives within the LME Clear framework and at the Member and end-client level, considering: • Size of default fund and stress testing mechanisms • Calibration of loss sharing structures in the default waterfall ("skin-in-the-game") • Use by Members and end-clients of client segregation models (e.g. ISA, Net OSA, Gross OSA)	CCP equity needs to be sized to incentivize appropriate prioritization in addressing deficiencies in i) the management of a member default and ii) non-default scenarios, without reliance on member funds. This should be reflected in both prefunded capital in the waterfall (tranche 1 and 2 of skin-in-the-game) as well as the available CCP equity in the event of a default/non-default scenario(s).
Market structure and the roles of institutions		
Potential contributing factor	**Topics of interest to the Independent Review**	**FIA Comments**
Distribution of liquidity across venues	1. Distribution across venues (The Ring, LMEselect, and the inter-office telephone	

	market, and the uncleared OTC market), of orders, trades, and available liquidity in Nickel 2. Extent to which this distribution effectively matches offsetting buying and selling interests or inhibits their matching	
Opening hours and available liquidity	1. Opening hours and available liquidity in Nickel on LME venues throughout the trading day and its impact on the distribution of orders and trades 2. Extent to which this distribution creates sufficiently deep liquidity and reliable price formation or leads to periods of insufficient liquidity or unreliable price formation	As mentioned above, having automated volatility control mechanisms and trading halts with appropriate intraday risk monitoring and margin calls covering the entire day are robust risk mitigants. These controls and mechanisms would have most likely been beneficial prior and during this disruption event.
Opening hours and available liquidity	1. Manner in which orders, trades, and available liquidity in LME Nickel on LME venues are distributed across the LME Nickel prompt dates 2. Extent to which this distribution effectively matches offsetting buying and selling interests or inhibits their matching	
Depth of liquidity and client order routing	Ability, or otherwise, to agree and execute transactions of sufficient size with reasonable and predictable market impact / slippage on LME venues	
Price benchmark timing & methodology	1. Representativeness and robustness of prices across LME venues for the purposes of: • Official price publication, e.g. open / close • Calculating intraday margin calls 2. Resilience of prices across LME venues to manipulation and erroneous order entry	

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