

Managed Funds Association

The Voice of the Global Alternative Investment Industry

Washington, D.C. | New York | Brussels



June 8, 2022

Via electronic mail: complaints@lme.com

The Complaints Officer
The London Metal Exchange
10 Finsbury Square London
EC2A 1AJ

Re: Complaint with Regard to Nickel Contract Cancellations

Dear Sir/Madam,

Managed Funds Association (“MFA”)¹ respectfully submits this letter of complaint (our “complaint”) pursuant to the Complaints Procedure of the London Metal Exchange (“LME”). Our complaint relates to the recent suspension by LME of trading on its Nickel market and, more particularly, the manner in which certain transactions in Nickel contracts were subsequently cancelled by the LME. Specifically, MFA believes that, in cancelling executed Nickel contracts, the LME failed to perform its regulatory functions, as described in our *Particulars of Complaint* set out in the Annex to this letter.

MFA welcomes the Notice published by LME on April 4, 2022 (the “Notice”), in which LME states that it will commission an independent review of events in the Nickel market leading to the suspension. MFA believes this is an important step in regaining the trust and confidence of participants in the metals markets. However, we note as a preliminary matter that the suggested scope of the independent review set out in paragraph 21 of the Notice does not address some of the points we make in our *Particulars of Complaint*, including the proper relationship between LME and LME Clear.

In addition, we note that, as at the date of this letter, LME has yet to make any announcement on when the market can expect the independent review to commence, or any date by which the market can expect the results of the independent review.

MFA believes that there are a number of factors with regard to the impact of LME’s actions on market participants which must be addressed in order to ensure that MFA members and other market participants can continue to engage in LME markets with confidence. MFA members, and the asset management community more broadly, provide an important source of liquidity in the UK commodities markets, and the ability of MFA members to continue to trade with confidence on the LME is therefore important for maintaining the LME’s depth of trading interest.

¹ Managed Funds Association (MFA) represents the global hedge fund and alternative asset management industry and its investors by advocating for regulatory, tax, and other public policies that foster efficient, transparent, and fair capital markets. MFA’s more than 150 member firms collectively manage nearly \$2.6 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time. MFA has a global presence and is active in Washington, Brussels, London, and Asia.

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Context

Managed Funds Association (MFA) represents the global hedge fund and alternative asset management industry and its investors by advocating for regulatory, tax, and other public policies that foster efficient, transparent, and fair capital markets. MFA's more than 150 member firms collectively manage nearly \$2.6 trillion across a diverse group of investment strategies.

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Nearly 40 percent of MFA members have offices in the United Kingdom. A significant number of MFA members trade actively in metals markets on both UK and non-UK trading venues as well as on an "OTC" basis with global dealers, investment firms and systematic internalisers.

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We would be very happy to discuss our complaint with you or to provide further information. Please do not hesitate to contact the undersigned at +1 (202) 730-2600.

Respectfully submitted,

/s/ Jennifer W. Han

Jennifer W. Han
Executive Vice President
Chief Counsel & Head of Global Regulatory Affairs



ANNEX **Particulars of Complaint**

Background

1. On 8 March 2022, LME suspended trading on its Nickel markets (the “**Suspension**”), citing the effects of the situation in Russia and the Ukraine on contract prices, and stating that its decision to suspend trading was based on “orderly market grounds”².

Subsequently, also on 8 March 2022, the LME announced that it would cancel all physically-settled trades in Nickel contracts executed on or after 00:00 UK time on 8 March 2022 until further notice (the “**Trade Cancellation**”). In one of a further series of notices, the LME stated that its decision to cancel trades had been “*in the interests of market stability and integrity*” and, specifically, that the LME and LME Clear (its group CCP which centrally clears LME Nickel contracts) “*had serious concerns about the ability of market participants to meet their resulting margin calls, raising the significant risk of multiple defaults and a consequent reduced ability for market participants to continue to access the market and manage their risk*”.

2. On 14 March 2022, the LME announced that trading on its Nickel markets would resume on 16 March 2022. In this notice, LME cited large short positions stemming from the OTC markets as being a factor in the Suspension, as well as the geopolitical situation previously cited in its initial notice of the Suspension.
3. The notices issued by the LME do not refer to the specific powers which the LME sought to rely on in connection with the Suspension and Trade Cancellation. The first notice issued refers to LME’s actions being “*on orderly market grounds*”. Trading Regulation 1.3 of the LME’s Rules and Regulations state the following:

“The [LME] may, at its absolute discretion and acting reasonably suspend trading on one or more of the Execution Venues for such period it considers necessary in the interests of maintaining a fair and orderly market. Trading will be resumed as soon as reasonably practicable following any such suspension of an Execution Venue.”

4. We note that Trading Regulation 22.1 further states as follows:

“Notwithstanding, and without prejudice to, the general power set out at Trading Regulation 1.3, the Exchange may temporarily halt or constrain trading in accordance with the relevant procedures established by Notice if there is a significant price movement during a short period [...]. Where the Exchange considers it appropriate, the Exchange may cancel, vary or correct any Agreed Trade or Contract”

5. Given that the initial notice, and several subsequent notices issued in connection with the Suspension, refer to a Special Committee, we understand that the LME has been seeking to rely on its powers with respect to “Emergencies” under Trading Regulation 17.1 either

² LME Notice 22/052.



alternatively, or in addition to, its powers under 1.3, although this is not clarified by the LME in those notices.

Particulars of Complaint

1. MFA believes that, by (i) failing to apply appropriate price limits prior to 8 March 2022 and (ii) proceeding to cancel trades retrospectively, the LME was acting outside of its regulatory functions and contrary to its regulatory obligations to maintain an orderly market so as to afford proper protection to investors, as required by UK law.
2. As a recognised investment exchange (“**RIE**”), LME must, on an ongoing basis, meet the requirements applicable to RIEs as set out in:
 - a) The Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges, Clearing Houses and Central Securities Depositories) Regulations 2001/995 (the “**Recognition Requirements Regulations**”); and
 - b) The FCA’s Recognised Investment Exchanges Sourcebook (“**REC**”).
3. MFA recognises that, under the Recognition Requirements Regulations, an RIE is subject to an overarching requirement to maintain adequate, effective and appropriate systems and controls *and* a fair and orderly market, and that RIEs must be able to cancel transactions “*in exceptional cases*”.³ Nevertheless MFA is concerned that LME has not acted in a manner which was compliant with the LME’s regulatory obligations to:
 - a) maintain adequate systems and control and conduct its facilities in an orderly manner and so as to afford proper protection to investors, in accordance with Paragraphs 3 (1) and 4 of the Schedule to the Recognition Requirements Regulations (the “**Schedule**”);
 - b) ensure that its management body “act[s] with honesty, integrity and independence of mind”, in accordance with Paragraph 2A(2) of the Schedule; and
 - c) identify and manage conflicts of interest between the LME and its owners, so as to avoid adverse consequences for the operation of the trading venue, pursuant to Paragraph 4(2)(ea) of the Schedule.

Inadequacy of LME’s pre-trade controls

4. Firstly, MFA is concerned that the inadequacy of LME’s pre-trade controls with respect to its Nickel markets exacerbated the market disorder which led to LME deciding to implement the Suspension and Trade Cancellation.
5. Specifically, the LME failed to effectively apply its dynamic price-banding limits and no-cancellation range (“**NCR**”) in the period prior to the suspension of trading in Nickel, pursuant to its own policies and procedures. It should have been evident to the LME from the extreme fluctuations in the price of Nickel during trading on 7 March 2022 (the trading day prior to the

³ Paragraph 3B of the Schedule to the Recognition Requirements Regulations.



date of the suspension and date of execution of the cancelled trades) that LME's Nickel market was becoming disorderly, and it would have been appropriate for LME to have taken action on 7 March 2022 to adjust its price limits and NCRs for Nickel contracts accordingly.

6. However, LME waited until 8 March 2022 to adjust its price limits and NCRs for Nickel, subsequent to the execution of the cancelled trades. Had LME taken appropriate action with respect to its price limits and NCRs on 7 March 2022, LME could have prevented the market disorder which led to the "significant price moves" on 8 March 2022 which LME has suggested as being a root cause of the Trade Cancellation.
7. MFA is therefore of the view that, in failing to take timely action to apply effective price limits and NCRs to Nickel contracts, LME failed in its regulatory obligation under Paragraph 4(1) of the Schedule to ensure that business conducted by means of its facilities is conducted in an orderly manner and so as to afford proper protection to investors. More particularly, MFA is of the view that LME was in breach of its obligations under Articles 18 and 20 of Delegated Regulation (EU) 2017/584 (as transposed into UK law) to employ price-collars prior to the Trade Cancellation.

Improper cancellation; conflicts of interest

8. Secondly, MFA is of the view that the basis of LME's decision making with regard to the Trade Cancellation was also contrary to its regulatory obligations.
9. In its notice 22/057, LME explained its decision to cancel trades retrospectively as being:

"[I]n part due to the LME's conclusion that the significant price moves during the early hours trading activity had created a systemic risk to the market, including in relation to margin calls, which if LME had not acted would have closed at levels far in excess of those ever experienced in the LME market. The LME and LME Clear had serious concerns about the ability of market participants to meet their resulting margin calls, raising the significant risk of multiple defaults and a consequent reduced ability for market participants to continue to access the market and manage their risk".

10. MFA understands this statement by the LME to allude to the fact that a certain small number of large position holders in Nickel contracts were identified by the LME to be at risk of failing to meet margin calls made by its affiliate, LME Clear, with respect to Nickel (or other) contracts centrally cleared through LME Clear (such position holders, the "**Distressed Participants**"). This risk had arisen as a result of significant movements in the price of Nickel, which in turn increased the margin payable by the Distressed Participants to LME Clear (in order to mitigate the risks of non-settlement of the contracts by the Distressed Participants).
11. As a result of the Trade Cancellation, however, a much broader range of market participants than the Distressed Participants were negatively impacted in terms of economic losses and/or lost profits. This is because, due to the retrospective nature of the Trade Cancellation, market participants continued to manage their Nickel contract positions on the valid assumption that transactions executed on LME Select would settle in accordance with their terms. This retrospective action by LME, therefore, left market participants in a situation where their



Nickel exposures – fluctuating heavily in a volatile market – were no longer hedged, leaving those participants exposed to losses.

12. In determining whether trading on its markets is being conducted in an orderly manner, the FCA may have regard to a number of factors, including abusive and improper trade practices. These factors do not include post-trade risks such as counterparty default risk and the RIE does not have a regulatory obligation to account for this type of risk when ensuring that its markets are orderly. Rather, it is the regulatory function of CCPs to manage counterparty default risk through the maintenance of appropriately calibrated margins and default fund contributions, in accordance with the requirements of EMIR. Indeed, the inability of the Distressed Participants to satisfy margin calls made by the LME Clear – a CCP – is a risk that should have sat squarely with LME Clear.
13. In the event of margin calls not being met by members which were Distressed Participants, LME Clear would have been able to close out those members, and to apply their initial margin contributions and default fund contributions to mitigate any potential losses to other market participants. The instigation of a default management process by a CCP is not directly linked to orderly trading in Nickel and is not an eventuality which the LME is required to take steps to mitigate. Instead, the Trade Cancellation led to legal uncertainty and unmitigated exposure in the OTC Nickel markets for many market participants, including numerous MFA members, and further exacerbated the disorder in the markets.
14. MFA is concerned that, in performing the Trade Cancellation, LME was inappropriately seeking to protect its affiliate, LME Clear, and its members. In other words, LME chose to protect its affiliate rather than to protect market participants from exposures to losses on their trading books. In doing so, LME demonstrated favour over its affiliate and a small number of market participants which was contrary to its regulatory obligations to afford proper protection to investors, generally.
15. MFA is of the view that LME failed to manage a clear conflict of interest between that of investors in Nickel and the interests of its affiliates, as is required under Paragraph 4(2)(ea) of the Schedule. Further, MFA believes that, by acting to protect the solvency of the Distressed Participants, LME was not acting “with honesty, integrity and independence of mind”, as required by Paragraph 2A(2) of the Schedule.

Actions sought

16. MFA requests that LME takes the following actions in order to remedy the concerns outlined in this complaint:
 - i. That LME acts to ensure that its dynamic price-banding limits and NCRs are adjusted and applied swiftly in response to market fluctuations going forwards, so that they may serve as an effective tool to mitigate the risk that trade cancellations could be considered necessary;
 - ii. That LME acts swiftly to review and develop its policies with respect to the circumstances in which it may cancel trades, limiting such circumstances to



“exceptional cases” to reflect the Recognition Requirements and to reflect this clearly in their Trading Regulations and in publicly available policies and procedures. These revised Trading Regulations and policies and procedures should, in particular:

- amend the final sentence of Trading Regulation 22 as follows, to align with the requirements of Paragraph 3B of the Schedule to the RIE:

~~“Where the Exchange considers it appropriate~~In exceptional cases, the Exchange may cancel, vary or correct any Agreed Trade or Contract”.

- amend Trading Regulation 17.1 as follows:

*“In the event of the Special Committee or the Clearing House having cause to suspect the existence or to anticipate the development or likely development of a corner or undesirable situation or undesirable or improper trading practice which in their opinion has affected or is likely to **have a significant impact on** ~~effect the~~ **fair and orderly functioning of the** market, the Special Committee after consultation with the Clearing House may take such steps as in their absolute discretion they deem necessary to contain or rectify the situation and they may give directions to Members accordingly. **In exceptional cases, such action may include the cancellation, variation or correction of any Agreed Trade or Contract**”;*

- expand on what might constitute “exceptional cases”. Trades should only be subject to cancellation, for example, where they cannot be settled due to market constraints;
- introduce a window in which executed trades may be cancelled by LME, which should be capped at a maximum number of hours;
- make it clear that the default risk of a market participant should not be a sufficient grounds for trade cancellation;
- make it clear that, when considering a trade cancellation on the grounds of exceptional cases, that the LME will act in good faith and taking into account the interests of the range of participants in the market; and
- set out the nature of any other measures which may be used by the LME in exceptional circumstances.

iii. That LME develops a transparency protocol with regard to its communications with market participants where “exceptional cases” arise. This transparency protocol should, in particular:

- commit the LME to early disclosure when it is considering price adjustments trade cancellations, or other actions in response to exceptional cases;
- specify a level of detail which market participants can expect to receive with



regards to the process and timing for the LME's decision making processes;

- identify the communication channels through which market participants will receive information;
- specify the steps that the LME will take to ensure confidential treatment of any sensitive information with regards to market participants; and
- commit the LME to providing detailed reasoning to market participants for the basis of any price adjustments, trade cancellations and related actions and an explanation of how any action is consistent with its regulatory obligations.

The transparency protocol should be subject to a public consultation;

- iv. That LME immediately takes forward the recommendations of the FCA and the Bank of England to appoint independent directors to its board and to its relevant committees. We would strongly support at least one such independent director being a member or representative of the asset management community, in order to ensure that the interests of a range of LME market participants are taken into account in the LME's decision making processes;
 - v. That LME ensures representation from its legal and compliance teams on any Special Committee or similar relevant committees;
 - vi. That LME takes steps to ensure that all market participants using its markets are treated equally. In particular in the course of its own independent review, LME should proactively consult with members of the asset management community including MFA and its members; and
 - vii. That LME provides regular training programmes for market participants to understand key elements of the LME rulebook in this area, and also more broadly.
17. For the avoidance of doubt, the above actions sought and this complaint in general is not exhaustive, and MFA and individual members of MFA reserve their respective rights to take further and independent action against or involving the LME in respect of the matters discussed in this complaint.