FCA LME FINE HIGHLIGHTS DISORDERLY MARKET CONTROL WEAKNESSES

The FCA has imposed its first ever fine on a recognised investment exchange, London Metal Exchange ("**LME**"), for failing to ensure its systems and controls were adequate to deal with severe market stress. This followed an unprecedented period of volatility in the nickel market in March 2022 in which, over the course of less than two days, the price of nickel on LME's electronic trading platform rose approximately 250%.

Background facts

Against the backdrop of elevated metal prices, driven in part by Russia's invasion of Ukraine and the threat of sanctions embargoes or supply issues affecting Russian-sourced commodities, on 7-8 March 2022 LME's nickel market underwent a "short squeeze": a price spiral arose as market participants with significant short positions were increasingly required to meet margin calls and to cover their short positions, driving up prices even further.

The LME market comprises a physical 'open outcry' venue called the Ring, an electronic trading platform called LMEselect, and an 'inter-office market'. LME's most liquid futures contract is the 3-month ("**3M**") contract which is physically settled by delivery of the metal in three months' time. Based on approximate prices as reported in the FCA's notice, LME's 3M nickel contract price rapidly escalated on LMEselect over 7-8 March 2022, such that by 6:08am on 8 March it had increased by approximately 250% compared to the closing price on 4 March. Unsurprisingly, in view of the rapid escalation in price, at various points during the day on 7 March 2022 LME considered whether the market had become disorderly and whether to impose an upper price limit or suspend trading altogether.

By 7:16am on 7 March, the nickel price had increased almost 28% against close on 4 March, a larger single day move than had taken place in the past 30 years, with an LME manager noting around this time that it was "*extraordinary and its got the potential to get out of control if we don't act proactively*". At 12:35pm on 7 March LME urgently updated the FCA on the situation including that some LME members had missed margin calls.

At 4:00pm on 7 March, an LME Special Committee considered whether to implement an upper price limit for nickel. Prices had risen approximately over 60% since the last day's close by this time and ultimately the volatility during the day on 7 March, "*was so extreme that it was outside the maximum limits which had been hard coded into LME's* *systems to calculate its closing prices*". Despite this, the LME Special Committee decided against an upper price limit, on the basis that it could have "*unintended consequences*", while deciding to implement a 'backwardation limit' (a limit to prevent a delivery squeeze in very short-dated contracts).

The Special Committee's decision was rapidly reversed on the morning of 8 March 2022 when LME senior management woke to further significantly increased nickel prices driven by trading in the Asia market overnight. LME suspended the market at 8:15am, subsequently cancelling the trades placed since 1:00am that day. The aggregate notional value of all cancelled trades was approximately USD 13.37 billion.

What were LME's obligations in relation to preventing market disorder?

LME had obligations to ensure its systems and controls were adequate, effective and appropriate to ensure orderly trading under conditions of severe market stress (derived from Articles 47/48 of MiFID 2, and Paragraph 3(1) and 3(2)(h) of the Schedule to the Recognition Requirement Regulations, as reflected in section 2.5.1 of the Recognised Investment Exchanges Sourcebook (REC)).

In respect of its electronic trading platform, LMEselect, it was also required to have appropriate volatility control mechanisms at all times during trading hours, to automatically halt or constrain trading in situations of sudden and significant price movements (Article 19, Commission Delegated Regulation (EU) 2017/584 ("**RTS7**")). It was also required to have in place, and to publish (Articles 18(3) and 18(4), RTS7), appropriate policies and arrangements with respect to its volatility controls.

The FCA found the LME breached its obligations to have adequate systems and controls to ensure orderly trading, and its obligations and to have policies and procedures in respect of its volatility control mechanisms, and to publish those policies and procedures.

What volatility controls did LME have?

LME's automatic volatility controls were its dynamic and static "price bands". These were price channels bounded by an upper and lower limit, linked to a reference anchor price. The bands restricted trading to prices within the price channel, which was intended to slow down excessive market movements within specified periods of time.

- For the dynamic bands, the anchor price adjusted frequently through the receipt of each new order and as such they primarily operated to prevent large gaps between consecutive orders, and as "*a fat finger error or rogue algorithm related control*". But the dynamic bands would not necessarily prevent dramatic price moves over the course of, say, a day because the bands would update and move with the market.
- In contrast, the anchor price of the static price bands refreshed once an hour, and the bands were set at a wider (5:1) ratio compared to dynamic price bands. As such, the static price bands were intended to protect the market from sharp price spikes in one direction caused by a wider range of circumstances than the dynamic price bands, for example multiple limit or triggered stop limit orders. They too would update and move with the market, but more slowly than the dynamic bands.

The LME's volatility control mechanisms were adjusted/suspended by its Trading Operations ("**TO**") team (discussed further below), which the FCA found allowed the price of nickel to increase much more quickly than it otherwise would have. The FCA did not need to expressly opine on whether LME's volatility controls would have been appropriate or sufficient, had they been working as intended, or whether the LME should also have had additional controls in place. It is notable, however, that after the incident, LME implemented a new daily price limit of 15% from the last day's closing price. In its response to the FCA's Final Notice, the LME specifically noted that "*while there is no finding by the FCA that the specific controls (including price bands) were capable of preventing the underlying market disorder of March 2022 the LME is confident that its enhanced controls and processes now in place further bolster the resilience of its markets*".

What factors contributed to the outcome?

Suspension/circumvention of the price bands

In the early hours of 7 March, the price rise had been extreme enough to trigger the nickel static price band for the first time since its implementation in 2018. LME Hong Kong TO team responded by expanding the maximum width of the nickel static price band a number of times, ultimately to a width that enabled the nickel price to move by up to $6,000 per hour (far greater than intended when the bands were originally calibrated). During the day on 7 March, the London TO team suspended and reapplied the bands several times, in order to keep up with rising prices.

On 8 March, at 03:38am the Hong Kong TO team further widened the dynamic band to a width that enabled gaps between consecutive nickel trades of up to $540. However, despite this, attempted trades were still being rejected as too high. Consequently, at 4.49am, the Hong Kong TO team suspended the dynamic and static price bands altogether, having exhausted the manual adjustments that could be made. This left the nickel market without any automated protection at all against extreme volatility. By 6:08am, the 3M nickel price rose to $101,365, an increase of 44% in 24 minutes, doubling since market close on 7 March.

Calibration of the price bands

The TO team's conduct in suspending the bands reflected a practice that had evolved in periods of high volatility since 2021. An incident report in 2021 identified that this had arisen because it was "*operationally unmanageable to manually react to sharp moves and update [the price] bands accordingly*". If the bands were regularly preventing genuine price discovery in periods where the market was volatile, but not disorderly, they may have been set too tightly, leading to this work around being adopted by the TO team.

In contrast to the dynamic bands, since their implementation the LME's static price bands had never been triggered before 7 March. The fact they had never been triggered before appears to have contributed to the general lack of awareness within LME of their existence and distinct function. This in turn contributed to the TO's team judgment that it was appropriate to suspend them.

These findings highlight a challenge that arises generally for firms in calibrating market impact controls appropriately. An appropriate balance needs to be struck between thresholds that are tight enough to protect against significant market moves but which are not so tight that they introduce other types of operational risk or undesirable behaviour such as *ad hoc* workarounds. This challenge is further exacerbated by the fact that the appropriate threshold may change in different market conditions.

Absence of other controls to halt or constrain trading

The FCA did not comment on whether the price bands (if operating as intended) would have been sufficient to prevent the market disorder or would only have delayed its onset. By design, they only operated to slow price movements rather than placing a hard limit on the prices that may be reached (even the static band moved every hour). In circumstances where on 7 March the LME senior management did not consider a 66% price move in a single day justified a trading halt, it is difficult to see why they would have acted any differently had that same price move arisen over the course of several days. Ultimately, given the complex interactions of different factors that contribute to market prices it is difficult to say what would have happened in a counterfactual when the bands were operating as intended (and this difficulty was acknowledged in the independent review LME commissioned into the events).

The TO team's narrow view of the potential causes of a disorderly market

The FCA found that the TO team failed to appreciate the full breadth of circumstances that could constitute a "disorderly market". In particular, they were not trained on identifying and intervening in situations where market disorder might be caused by intentional, non-erroneous trades which were nevertheless creating an uncontrolled price escalation.

The FCA found that TO were too narrowly focussed on identifying clearly erroneous trades and technical issues impacting the market and wanted to avoid preventing price discovery. This was understandable to an extent, given their client facing role, which required them to deal with inbound queries from members about genuine orders that had been blocked. The FCA found that they ultimately saw the bands as an impediment to genuine trades which should be allowed to proceed despite the extreme price rises, commenting at the point they suspended the bands altogether that it would be "*decided by the market, decided by the traders, not…us*".

Insufficient understanding of the distinct purposes of the price bands

The FCA found that the TO team failed to appreciate the distinct purpose of the static price bands as compared to the dynamic bands. They viewed both types of bands as purely a control measure against "*error trades, other erroneous order submissions and/or rogue algorithms*" (aligning with their unduly narrow view of market disorder), whereas the static band was designed to address a wider range of circumstances than this.

Inadequate handover/communication between staff

The FCA found that no steps had been taken to brief the incoming Hong Kong TO team of the fact that, throughout the day on 7 March London time, LME senior management had been actively considering whether the market remained orderly, and whether it was necessary to impose a price limit or even suspend the nickel market altogether. This was despite the fact that on the morning of 7 March, the Hong Kong TO team had asked the London TO team whether a "circuit breaker" might be appropriate, and whether it was reasonable to suspend the price bands. The London TO team assured the Hong Kong TO team that doing so would be appropriate, and in its subsequent handover on 7 March informed the Hong Kong TO team that they had resorted to suspending the price bands and reapplying them a number of times during the day, to keep pace with rising prices.

The LME had represented to stakeholders and the FCA late into the evening on 7 March London time, that it would be continuing to closely monitor the nickel market including to potentially suspend it if it became disorderly. This was even though the relevant senior managers were based in London, would be "off-duty" overnight, and no instruction was given to the Hong Kong TO team to contact the senior managers if the price of nickel continued to rise. This appeared to be a blind spot in LME senior management's thinking about the potential impact of continued trading overnight in Asia.

The impact of closed/after-hours markets

The London TO team responsible for monitoring trading between 7:00 AM and 7:00 PM consisted of 20 people. In contrast, the Hong Kong TO team responsible for monitoring between 1:00 AM London time to 7:30 AM London time, usually comprised 1-2 people. There is nothing in the FCA's notice specifically to indicate that the small size of the Hong Kong TO team had any material impact on the events. Both the London and Hong Kong TO teams appeared to share the common misunderstanding of their role in terms of market disorderliness described above, as both took actions during their respective shifts to suspend the bands despite the significant price escalation.

However, the FCA concluded that there was a clear failure to have in place appropriate escalation mechanisms and that the additional risks of overnight trading were insufficiently managed. The LME's established process for escalation from the Hong Kong TO team to the London team involved emails to inboxes that were unmonitored. Although the LME had an overnight telephone escalation procedure under which senior managers were available overnight to answer emergency calls and take decisions, the criteria for telephone escalation were vague. In any event, the Hong Kong TO team were not given any instruction to contact LME senior managers via this escalation procedure in the event of continued price rises.

Impact of the fragmentation across the OTC and exchange positions

The independent review that LME commissioned into the events identified that the largest driver of the volatility was large short positions on the OTC market. It identified that regulatory position limits did not prevent the build-up of these positions, nor were they identified by LME's accountability level investigations. As such, as events were unfolding, LME did not have full visibility of the underlying drivers to the volatility it was experiencing. Various measures have been implemented since to seek to address this, such as LME implementing periodic OTC reporting, and the FCA's reforms in Policy Statement (PS 25/1) "Reforming the commodity derivatives regulatory framework".

Missteps in LME's immediate responses to the regulators regarding the incident

The LME only informed the FCA of a very material fact regarding the incident (that the dynamic and static price bands had been suspended) on 19 May after "protracted correspondence" despite at least some senior managers being aware of this from around 9 March. This failure was treated as aggravating the penalty LME received. This was not characterised in the notice as having been an intentional omission, but it highlighted the fact that "*the operation of the price bands the not widely or well understood within the LME outside of the Trading Operations staff directly involved in manipulating and maintaining the system.*"

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