



## Re-inventing the London Metal Exchange

*By John Browning, Director, Head of Commodity Ecommerce, Barclays Capital*

**Markets cannot stand still. In this short article, we will look at the impact FIX is making on the transaction methodology of the London Metal Exchange.**

The 127-year-old London Metal Exchange (LME) is the world's premier non-ferrous metals market, with a trade turnover value in excess of US\$2 trillion per annum. Highly influential, its fixing prices form the basis price of most non-ferrous physical metals contracts globally. As with many global exchanges, LME trading is carried out in three ways: open outcry, inter-office telephone market and

electronically, via LME Select. LME Select is the official exchange-operated electronic trading platform of the LME.

The LME provides execution via exchange-cleared or registered trades, but these trades may be regarded as forward physical deals. An LME contract can trade any working day up to three months ahead, then, in the case of

Copper and Aluminium, the third Wednesday in any month up to five years ahead.

To date only Barclays Capital, Dresdner Kleinwort Wasserstein and Sempra Metals have created an order routing product that reaches LME Select. Only two, Barclays Capital and Dresdner, have developed a FIX product for clients. Since introducing FIX, clients have gained the ability to participate directly and electronically in the wholesale marketplace of the LME at the largest liquidity point, the three-month contract. Both GUI and FIX connectivity are offered to clients, enabling them to react in micro-seconds to the changing price environment. Fund managers are now also able to attach their proprietary algorithmic trading models, inevitably increasing electronic trading volumes, and drawing the quasi-OTC LME market further towards the mainstream of fund investment. Having done so, we look forward to the changes that may engender.

**The LME provides execution via exchange-cleared or registered trades, but these trades may be regarded as forward physical deals**

However, electronically attaching to the LME is not without its problems. The LME does not permission an on-line trade cross from a single house. Therefore, once an order from a client is placed, the order must be managed within multiple venues both on LME Select and in the order routers order book. This is a significant divergence from the linear futures model and may be a reason why so few houses have so far offered electronic access to the LME. The order routing house must also know if it has a potential cross and if that cross is the best bid or offer. This has not been an easy task for market participants as the LME does not supply trade information through its API. This has forced clients to use additional data vendors to observe the market.

These issues have led order routing houses to develop necessary solutions significantly different from those seen in the futures market. Barclays Capital in particular has developed a number of unique tools including on-line trade amalgamation, which allows clients with multiple trades to aggregate them into one final "end of day" contract. A date adjustment facility allows the user to ask Barclays trading

desk for a proposal to adjust the prompt date. An adjustment is the basis of the original three month execution price, and if accepted by the client, is automatically reflected in its trade blotter. An allocation facility allows customers to nominate their clearers and the allocation splits online, thus adding efficiency to the allocation and matching processes. LME trading up to this point has relied heavily on manual processes to manage the client's trade capture.

**Transaction volumes on LME Select are doubling year on year and FIX is a significant factor in this phenomenon**

Undoubtedly, the introduction of FIX is a catalyst for a fundamental change in the transaction methodology of the LME market place. Transaction volumes on LME Select are doubling year on year and FIX is a significant factor in this phenomenon. It is estimated that Barclays Capital and Dresdner together probably execute nearly 35% of all three month trades on LME Select, although the LME will not confirm this figure.

The introduction of algorithmic trading into a previously unavailable venue has had two immediately measurable effects. For LME Select, there has been an increase in liquidity. For the clients who have been early adopters of online trading, they have access to a liquid venue uncorrelated to other asset classes, and the added value of margin for their methodology which will continue to exist until further arrivals "crowd out" the market place.

**As simple deals will move to electronic platforms, the order routing houses will encourage their sales forces to concentrate on the high margin delivery of complex products tailored to specific client enquiry**

Internal education within trading houses is as important as the education of the client, as there is a temptation not to fully explore the value of these connected customers. Experienced sales-traders now have the opportunity to move from merely

being the providers of simple pricing, to being able to deliver real value added for clients as providers of commodity advice. As simple deals will move to electronic platforms, the order routing houses will encourage their sales forces to concentrate on the high margin delivery of complex products tailored to specific client enquiry. The transition from transactional-based selling to a relationship-based on problem solving is not an easy one.

**One suggestion is to change the rolling date convention which populates 65 working days between spot and the three month date to one that populates only each Wednesday between spot and the three month date thereby reducing the population to only 13 dates**

The recent decision of the International Petroleum Exchange (IPE) to go fully electronic has led to a renewed examination of electronic trading of commodities by all participants. However, as the IPE is a futures market, a sharp distinction should be drawn. The LME is a forward physical exchange where members' trades only are given up to a central clearing counterpart. It would seem that the rise of electronic trading will lead to pressure to re-configure the date structure of the LME. One suggestion is to change the rolling date convention which populates 65 working days between spot and the three month date to one that populates only each Wednesday between spot and the three month date thereby reducing the population to only

13 dates. This innovation is opposed by some clients and those brokers who largely derive their income from the management of the date structure.

**At the extreme the LME order routers in the future will not need LME Select to conduct their business**

Any institution has two phases to its decline, firstly an inability to engage with the reality of the world and a retreat to core "traditional" values; and, the second phase, when the users of the institution form relationships and methodologies that do not require the institution to exist. The necessary creation of order matching engines by the LME order routing houses has created their ability to supplant the LME offering. Matching as they do with full transparency to the regulators, the trades are given up to the clearing house in real time. At the extreme the LME order routers in the future will not need LME Select to conduct their business. The re-invention of the trading methodology of the LME has in fact already started. **FIX**

*John Browning was an LME Director 2002-2004 and Chairman of its Ecommerce Committee. Formally with Dresdner Kleinwort Wasserstein he left in June 2004 to join Barclays Capital as a Director of Ecommerce with global responsibility for commodities.*

**Any thoughts on this or other articles?**

Please send any comments, referring to this article as Vol 1 Issue 6 GL3, direct to Edward at [edward@fixglobal.com](mailto:edward@fixglobal.com)

## Thomson AutEx

The Best Route to Global Liquidity



Thomson AutEx - Asia contact information:

Hong Kong	+852 2533 5497
Singapore	+65 6879 9838
Tokyo	+813 5218 6632
or email	<a href="mailto:danny.li@thomson.com">danny.li@thomson.com</a>

[thomson.com/financial](http://thomson.com/financial)