



LONDON METAL EXCHANGE

-----From Executive Director: Regulation and Compliance

To: ALL MEMBERS
Ref: 01/122 : A122
Date: 23 March 2001
Subject: **CONCENTRATION OF WARRANT HOLDINGS**

Introduction

Market Aberrations: The Way Forward was published by the Exchange in October 1998. Section 13 of the document dealt with the Exchange's policy regarding dominant positions. In particular, paragraph 13.24 set out specific Exchange guidance covering lending obligations applying to dominant position holders. The lending obligations result once a person's aggregated warrant holdings, cash today and cash positions exceed certain proportions of total LME stocks. The guidance is aimed at preventing abuse of dominant positions, not at preventing dominant positions themselves.

2 Section 9 of the Market Aberrations document considered the publishing of information on concentration of large positions and warrant holdings. It also discussed the reasons why either positions or warrant holdings across brokers and/or clients might need to be aggregated.

3 In particular, paragraphs 9.5 and 9.6 dealt with types of connected holdings where the LME would aggregate positions. Such connected holdings could include warrant-financing arrangements. Paragraph 9.5 observed that warrant-financing can encompass a wide variety of both arrangements and objectives: under some financing arrangements, the relevant warrants are available to be lent by the party holding the warrants, but under other arrangements, the warrants in practice are not readily available to the market.



4 The LME has recently become aware that new forms of warrant-financing type arrangements have been developed which have the effect of restricting the availability of the relevant warrants to the market. These arrangements create a connection between the warrants being held by one person under the warrant-financing type arrangement and other warrant holdings of the other party to the warrant-financing type arrangement.

5 This notice deals with the treatment of connected warrant holdings, particularly in relation to financing arrangements, and how these affect the lending obligations of dominant position holders under the market aberrations guidance. It gives additional detail on how the LME will determine whether warrant holdings are connected and hence the basis on which the LME will aggregate holdings both for the publication of large positions and for the lending obligations guidance.

6 The LME's purpose in aggregating connected warrant holdings is to reflect the effect on the market that these holdings may have. It is not, in any way, to discourage commercial arrangements for the financing of warrants.

Effective Control

7 The main principle which will guide the LME in determining whether warrant holdings are connected, is which party effectively controls the availability of those warrants to the market. If effective control of the warrants is with a party other than the party holding the warrants, the LME will aggregate those warrants with all other holdings of the party in control of the warrants in questions.

8 There are a number of ways in which a person can achieve effective control of warrants held by another. The LME's concern is not so much with the mechanism but with the result. The relevant characteristics are:

- a the holder of warrants has an obligation such that he will retain the warrants while the obligation is outstanding;
- b the person to whom the holder of the warrants owes the obligation is aware that the warrants are being held against the obligation; and
- c the person to whom the obligation is owed has effective control over whether those warrants can become available to the market.



9 One mechanism which would have this result is where a person sells warrants to another while at the same time buying from him an American-style call option over warrants for the same metal, at the same location and of the same brand. The surrounding circumstances of such an arrangement can confirm that both parties expect that exercising the option will result in the same warrants being returned to the person exercising it. While the option is in force, the buyer of it has effective control of the warrants held by the seller of the option and those warrants are not freely available to the market.

10 Another mechanism which would have the same result is where the buyer of an American-style call option knows that the seller of the option is holding warrants against the option and will continue to do so during the exercise period of the option. Again, the surrounding circumstances of such an arrangement can confirm that both parties expect the warrants, or that number of warrants, to remain unavailable to the market during the exercise period of the option. Where the circumstances demonstrate that that is the understanding of the parties to the arrangement, the LME will, in the absence of special circumstances, aggregate the affected warrant holding with the other holdings of the buyer of the option. These particular mechanisms may not be the only ones that have the effect of giving control of warrants to persons other than the holder. The LME will continue to monitor its markets carefully and to aggregate warrant holdings for reporting purposes and the market aberrations guidance where appropriate.

11 Where the LME believes that a person's degree of control is sufficient to require the controlled warrants to be aggregated with any other warrants held by or to his order, the LME will notify that person. This is in line with the LME's policy to inform the member of all non-automatic aggregations (see Notice 99/075 : A075). The result of such notification will be that the total number of warrants will be counted towards that person's warrant holdings, cash today and cash positions, for the purposes of the lending guidance set out in paragraph 13.24 of the Market Aberrations document.

Warrant Reporting

12 LME Notice 99/520 : A505 : R40, issued on 11 November 1999, deals with large position reporting of warrants. The purpose of that notice was to ensure that reporting of warrant holdings was accurate and in particular that reporting avoided double counting of warrants; in particular that the warrants held under financing deals were not reported twice. This notice does not alter the provisions of Notice 99/520.



Members holding warrants held under a financing arrangement should continue to report those warrants. In addition, however, warrants which are held against an obligation having the characteristics set out in paragraph 8 above, should be separately identified as such, together with the identity of the party to whom the obligation is owed. This will prevent the lending obligations being incorrectly placed on the holder of the warrants and allow the LME to aggregate holdings properly.

13 The LME also requires members to inform the LME compliance department of arrangements to which they are parties where either they or their counterparties/customers do not hold but have effective control over warrants. Such notification should be at the start of such an arrangement and should indicate for how long the arrangement is expected to last. The member should also notify the LME when the arrangement ends. Members with effective control over warrants should not report such warrants in their daily warrant position reports. Daily reporting continues to fall to the member holding the warrants. This notice clarifies the obligation of members to disclose connected holdings, which was set out in paragraph 9.6 of the Market Aberrations document.

A WHITING

cc: Board directors