

To: All members, warehouse companies and their London agents and other interested parties

Ref: 17/052

Classification: Consultation Warehousing

Date: 03 February 2017

Subject: **DECISION NOTICE – CONSULTATION ON PROPOSED AUTOMATIC PENALTY CHARGES FOR DELIVERY OF RENT UNPAID WARRANTS IN THE PERIOD PRECEDING THE ANNUAL RENT PAYMENT DATE IN EACH YEAR**

Summary

1. Following a consultation, the LME is today announcing that it intends to implement automatic penalty charges for delivery of rent unpaid Warrants in the period preceding the annual rent payment date on the last Business Day of March in each year.

Defined Terms

2. Capitalised terms not otherwise defined herein shall have the meaning ascribed to them in the rules and regulations of the LME (the “Rules”).

Background

3. On 7 December 2016, the LME issued Notice No: 16/375 : A368 : W112, which sought responses on a proposal to introduce penalty charges for the delivery of rent unpaid Warrants, which the LME considers will strengthen, enhance and make more efficient the procedure of rent endorsement in the period preceding the last Business Day in March in each year (the “Proposal”).

Automatic Penalty Charges

4. The new requirements for automatic penalty charges for delivery of rent unpaid Warrants in the period preceding the annual rent payment date on the last Business Day of March in each year are set out in paragraphs 5 to 9 below. The



new requirements are substantively unchanged from those put forward in the Proposal.

5. Any Member who delivers Warrants, which are not endorsed as “rent paid” from any of its accounts in LMEsword pursuant to a cleared transfer on the last Business Day in March of each year or the two (2) Business Days immediately preceding such date will be subject to an automatic penalty charge as set out below:
 - £50 per Warrant, subject to a minimum penalty charge of £500 for unendorsed Warrants delivered two (2) Business Days prior to the last Business Day in March of a particular year; and
 - £100 per Warrant, subject to a minimum penalty charge of £1,000 for unendorsed Warrants delivered one (1) Business Day prior to the last Business Day in March of a particular year; and
 - £250 per Warrant, subject to a minimum penalty charge of £2,500 for unendorsed Warrants delivered on the last Business Day in March of a particular year.
6. For the avoidance of doubt, each day shall be treated separately so that, for example, if a Member delivered a number of rent-unpaid Warrants one Business Day prior to the last Business Day in March, and a further number of rent-unpaid Warrants on the last Business Day in March, the rates of both £100 and £250 per Warrant would be payable, subject to a minimum penalty charge of £3,500.
7. Promptly after 31 March in any given year, the LME’s Market Operations Department shall write a letter to each Member that delivered unendorsed Warrants setting out the number of unendorsed Warrants delivered by such Member that are rent unpaid: (i) two (2) Business Days prior to the last Business Day in March in any particular year; (ii) one (1) Business Day prior to the last Business Day in March in any particular year; and (iii) on the last Business Day in March in any particular year. The letter will also set out the automatic penalty charge that is payable by each Member, giving the Member thirty (30) calendar days to pay the automatic penalty charge, and the Member shall pay such automatic penalty charge, unless such charge is disputed (in which case the process set out in paragraph 8 below shall be followed). Once the undisputed automatic penalty charge has been paid, the LME shall issue a notice to the market setting out details of each Member and the amount of the automatic penalty charge paid by each Member.
8. A Member wishing to dispute the imposition of an automatic penalty charge may do so by giving notice to the LME in writing within thirty (30) calendar days of receiving a letter from the LME detailing the automatic penalty charge. In the



event that a Member disputes the automatic penalty charge, the disciplinary process set out in Part 2 of the LME Rules shall apply. This would mean that, broadly: (i) the LME shall prepare a report for the Enforcement Committee (which would take account of any representations made by the Member in the course of disputing the charge); (ii) the Enforcement Committee shall consider such report and may institute disciplinary proceedings against the Member; (iii) the Member would be required to serve a defence; (iv) there would be a hearing before a Disciplinary Committee; (v) the Member would also have the right to appeal the decision of the Disciplinary Committee to an Appeal Committee.

9. Failure by a Member to pay an undisputed automatic penalty charge within thirty (30) calendar days of receiving a letter detailing the imposition of automatic penalty charges shall constitute an act of misconduct pursuant to Part 2 of the LME Rules and may result in the institution of disciplinary proceedings.

Consultation feedback

10. A table detailing the feedback to the Proposal, together with the LME's responses to the feedback, is set out at Appendix 1 of this Notice. The LME would like to thank all Members and other interested parties that responded to the consultation.
11. The LME has carefully considered all of the feedback. The fact that any particular issue raised in any particular response is not expressly included in Appendix 1 to this notice, does not indicate that the LME has not considered it.

Summary of Findings and Implementation

12. Having reviewed and analysed the feedback received in respect of the Proposal, the LME is today announcing that it will be implementing the Proposal as set out in paragraphs 4-9 above in full.

General

13. If Members or any other interested parties have any questions or requests for further clarification regarding the implementation of the Proposal in this notice, please do not hesitate to contact Stuart Sawyer at stuart.sawyer@lme.com.

Stuart Sawyer
Head of Post Trade Operations

cc: Board directors



Appendix 1 – Summary of Feedback and Responses to Notice No: 16/375 : A368 : W112

Question 1 – Do you believe that the proposed automatic penalty charges will deter Warrant holders from failing to ensure that rent is paid to Warehouses in a timely manner and ensure that Warrants are not delivered through clearing as rent-unpaid in the run-up to 31 March? If not, why not?

Respondent	Comment	LME Response
Respondent 1	The respondent is generally in favour of this proposal, but believes the automatic penalty charge should only apply to the last Business Day in March.	Noted. However, the LME believes that the application of automatic penalty charges over a 3 day period is expected to encourage Members to pay the rent in advance of any applicable automatic penalty charges.
Respondent	Comment	LME Response
Respondent 2	<p>The respondent is generally in favour of the proposed automatic penalty charges and believes the automatic penalty charges will go some way to deterring Members from delivering unendorsed Warrants in the period leading to the last Business Day in March. The respondent does not believe that the automatic penalty charges will deter delivery by parties with a small number of unendorsed warrants.</p> <p>The respondent proposed that those delivering Warrants on the last Business Day before the end of March in any given year should receive a higher penalty than that proposed by the LME and that the penalty should not be determined per warrant, but</p>	Noted. However, the LME believes that the automatic penalty charges are reasonable and proportionate. The LME believes that it is appropriate to determine the charges based on the number of Warrants delivered, given that the market impact is higher where a larger number of Warrants are delivered rent unpaid.



	as a fixed total penalty.	
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Question 2 – Do you agree with the Proposal to introduce automatic penalty charges?

Respondent	Comment	LME Response
Respondent 1	The respondent is in favour of the Proposal	Noted.
Respondent	Comment	LME Response
Respondent 2	The respondent is in favour of the Proposal	Noted.

Question 3 – Do you agree with the proposed level of automatic penalty charges?

Respondent	Comment	LME Response
Respondent 1	The respondent is in favour of the proposed level of automatic penalty charges.	Noted.
Respondent	Comment	LME Response
Respondent 2	The respondent is generally in favour of the proposed level of automatic penalty charges. Please also refer to the answer given by Respondent 2 to Question 1.	Noted.



Question 4 – Do you agree that failing to ensure that Warrants are delivered through clearing as rent-paid in the run-up to 31 March should be a strict liability offence?

Respondent	Comment	LME Response
Respondent 1	The respondent is not in favour of this part of the Proposal.	Noted.
Respondent	Comment	LME Response
Respondent 2	The respondent is in favour of this part of the Proposal.	Noted.

Question 5 – Do you agree that there is an adequate process to dispute the imposition of the automatic penalty charge in appropriate circumstances?

Respondent	Comment	LME Response
Respondent 1	The respondent is in favour of this part of the Proposal.	Noted.
Respondent	Comment	LME Response
Respondent 2	No opinion stated.	



Question 6 – Are there any other matters which you believe the Exchange should take into account in relation to the Proposal?

Respondent	Comment	LME Response
<p>Respondent 1</p>	<p>The respondent states that rent payments process is not aligned with the daily settlement of LME contracts, thus a proposal for automatic penalty charges does not address the underlying issue.</p> <p>Under the Proposal, Members receiving large numbers of unpaid warrants three Business Days prior to the last Business Day of March will still be required to undertake the rent payment process on short notice (and may be prevented from delivering such Warrants against short positions, resulting in operational inefficiencies, disruption and costs for such Members). Introducing penalty charges, staggered over a two-day period, does not remove the uncertainty around the rent payment process but simply moves the calendar date for which Members must pay rent by.</p> <p>The Respondent foresees that a possible unintended consequence of this proposal will be that Members will cease trading LME warrants in the run up to 31 March, increasing volatility in market prices; reflecting the administrative costs of handling warrants during this period, rather than reflecting market fundamentals.</p>	<p>The LME acknowledges the respondent’s feedback and provides the following response on the two proposals made by Respondent 1:</p> <p>(A) This solution has been discussed internally at the LME. However, this model would not be achievable without further development and changes to the LMEsword system. The proposal would therefore be difficult to implement without significant extra work and cost, none of which could be achieved before 31 March 2017. The LME wishes to implement a solution prior to 31 March 2017, in order to help to ensure a smooth and orderly rent payment process in the lead-up to that date. The LME is happy to discuss longer-term solutions with the market in due course.</p> <p>(B) The LME will review this proposal in order to fully understand the proposed processing model and revert to Respondent 1 if any further information is required.</p> <p>The Proposal is designed to change the behaviour of the market users, and the application of automatic penalty charges over a 3 day period is expected to encourage</p>



	<p>Two alternative solutions proposed by the respondent are as follows:</p> <p>(A) The LME pay the warehouses directly (31 March) for rent owed and subsequently invoice the Members. This may work through the PPS process where LMEC extracts funds and pays the warehouses. The warrants could then be auto endorsed on 31 March alleviating the stress on operations and potential market disruption; or</p> <p>(B) require Members to pay rent upfront, on receiving warrants (as per the method employed by other exchanges).</p> <p>Both above suggestions would ensure a smooth orderly functioning market. Furthermore, the suggestions would also remove uncertainties surrounding the timings for the endorsement of warrants. Once warrants have had the rent paid, Members are at the mercy of the agent to endorse them before the warrants are good for delivery. In the experience of the respondent, it has taken up to 8 days for warrants to be endorsed, effectively rendering the warrants useless for that period. The respondent therefore urges the LME, regardless of the solution selected, to put pressure on the warehouses to endorse the warrants immediately after receiving the rent paid.</p> <p>The respondent would like to emphasise (in the current process) that any penalties imposed on warrant movements of unpaid rents in the run up the 31 March should be limited, as moving the date</p>	<p>Members to pay the rent in advance of incurring any automatic penalty charges.</p>
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	that warrants are effectively required to be endorsed does not alleviate the problem.	
Respondent	Comment	LME Response
Respondent 2	<p>The respondent states that Members who pick up unendorsed Warrants on the last day of the month should have a reduced penalty charge/or be excluded from the automatic penalty charge if the Member fails to turn those Warrants around in the short time available to them. Given that the Member picking up the Warrants will only know that they have unendorsed Warrants at 11:15am and on 31 March, warehouse agents will only accept Warrants for rent payment after 12 pm at their discretion, leaves the Member only 50 minutes to arrange payments or attempt to close out short positions to avoid defaults on their next day market commitments (when they do not have enough endorsed Warrants to cover their market commitments).</p> <p>The LME should also consider that some Members may take advantage of the Proposal by delivering non-endorsed warrants, because they may be happy to pay the penalty on 31 March, if they know they will make more money from trading activities.</p> <p>The respondent believes that the LME should ask Members to start the rent payment sooner so as to</p>	<p>The response is noted. It is intended that the Proposal changes the behaviour of Warrant holders. The application of automatic penalty charges over a 3 day period is expected to encourage Warrant holders to pay the rent in advance of incurring any automatic penalty charges. The LME notes that Members may hold rent unpaid Warrants in the run up to 31 March, with no intention of delivering such Warrants. The LME also accepts that this situation may change at very short notice causing the Warrant holder to deliver out such Warrants.</p> <p>The LME accepts that the Proposal will not guarantee that rent is paid and that Warrants are endorsed before delivery in the run up to 31 March of any given year. The Proposal is merely intended to engender a change in behaviour. The LME proposes that any Member that is likely to take delivery of unendorsed Warrants have the appropriate payment channels set up so that rent can be paid on the same day upon the receipt of unendorsed Warrants.</p>



	have a smoother process and fewer unendorsed Warrants on the last Business Day of March.	
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