

To: All Members

Ref: 17/184

Classification: Membership Technical

Date: 25 May 2017

Subject: **UPDATE TO CATEGORY 4 MEMBERSHIP MODEL & TRADE REGISTRATION REQUIREMENTS**

Summary

1. Pursuant to LME Notice 17/116 (the “Decision Notice”) confirming changes to the LME Rulebook and Matching Rules which take effect from 5 June 2017¹, and the LMEsmart upgrade implemented on 15 May 2017, changes are required to LME Notice 15/300 : A292 entitled “Confirmation of Certain Aspects of the LME Category 4 Membership Model”. This Notice (a) revises certain terminology and functionality in LME Notice 15/300 and (b) confirms a change to the trade registration requirements for the Category 4 operating model. This Notice supersedes LME Notice 15/300 A292 with effect from 5 June 2017.
2. Terms not otherwise defined in this notice shall have the meaning given in the Rules and Regulations of the London Metal Exchange (“LME”).

Explanation of the Changes

3. In order to comply with straight through processing requirements set out in Article 29 of the Markets in Financial Instruments Regulation (“MiFIR”), changes were required to the LME Rulebook regarding the formation and execution of Contracts, particularly to Part 3, Trading Regulations. Under the new Rules, the LME and LME Clear are moving from a novation model to an open offer model. Under the open offer model, there is no initial LME contract (i.e. what was previously called an “Exchange Contract”) between the trading parties. Instead the CCP will make an offer to each party to the trade and on acceptance of the CCP’s offer by each party (which will now occur on the relevant venue of execution), two Cleared Contracts will be formed: one between the CCP and the seller; another between the CCP and the buyer. The derivative Contract will therefore be created at the time of execution, being the moment of acceptance

¹ See Notice 17/175 dated 18 May 2017 which confirmed the postponement to 5 June 2017



by the relevant venue of execution, and will be automatically and immediately cleared upon execution.

4. As a result of the changes set out above, certain changes are required to the description of the Category 4 membership model set out in 15/300. In addition, LME Notice 15/300 confirmed that Category 4 Members are eligible to become LMEselect Participants and set out the trade registration methodology for Category 4 Members and their clearers. This Notice introduces an amendment to the trade registration methodology for Category 4 Members who operate as brokers, an explanation of which is set out in paragraphs 10 - 12 below.

Category 4 Membership Requirements

5. The LME recognises that non-clearing members may wish to operate as proprietary traders and/or brokers. Trading in futures and options on the LME is likely to be a regulated activity whether the entity trades in a proprietary capacity or as a broker. As with all LME membership categories, an entity applying for Category 4 Membership will need to demonstrate at the application stage that it either has the required regulatory authorisations, it is exempt from the need to be authorised, or that it benefits from an exclusion to the UK regulatory regime which permits it to undertake the proposed regulated activity. Where an applicant is not authorised, the LME reserves the right to request a valid legal opinion confirming the applicant is permitted to carry on their proposed activities without needing to be authorised by the FCA or other relevant regulatory authority.
6. The annual subscription fees for Category 4 Members are \$30,000 for Members who operate a proprietary trading model, \$75,000 for Category 4 Members who operate a broker model and \$75,000 for Category 4 Members who operate both a proprietary trading and broker model.
7. In order to satisfy the eligibility criteria for membership, applicants for Category 4 Membership must hold the minimum number of B Shares in LME Holdings Limited prescribed by the Board of Directors from time to time. Information on the membership application process and how to acquire B Shares is provided by the Client Advisory and Membership Services Department ("CAMS") (Client.Advisory@lme.com). The eligibility criteria for Category 4 Membership is set out in Part 2 of the LME's Rules and Regulations.

Category 4 Operating Model

8. Category 4 Members may enter into LME trades with other Members and Clients, and issue Client Contracts, but they are not members of the LME's



clearing house, LME Clear. As non-clearing members of the LME, Category 4 Members must appoint a Category 1 or Category 2 Member to clear their trading activity at LME Clear. Category 4 Members may hold clearing accounts with more than one Category 1 or Category 2 Member at LME Clear but in order to give certainty to the matching process, a Category 4 Member must appoint one default clearer (an “Administrative Clearer”), to act for them for trade matching and registration purposes whether they choose to undertake the matching/registration function themselves or outsource the activity to their Administrative Clearer. For the avoidance of doubt, a Category 4 Member can only appoint one Administrative Clearer but an Administrative Clearer may act for more than one Category 4 Member. Category 4 Members may additionally choose to outsource their position reporting functions to their Administrative Clearer; however, the obligation to meet the Exchange’s matching and reporting requirements within the specified deadlines remains with the Category 4 Member.

9. When a Category 4 Member trades in the market on behalf of a Client, the resulting trades can be submitted to the Matching System, LMEsmart, by the Category 4 Member using Category 4 trade entry functionality, or transmitted to the Category 4 Member’s Administrative Clearer for trade input into LMEsmart. Under LME Notice 15/300, the Member to Member trade matched by the Administrative Clearer, and the Category 4 Client trade registered by the Administrative Clearer on behalf of the Category 4 Member, were additionally required to be crossed to the Category 4 Member’s account within the Administrative Clearer’s account set up at LME Clear in order for the Category 4 Member to benefit from its trading activities.
10. Effective from 5 June 2017, where the Category 4 Member to Member trade and the Category 4 Client trades are at the same price level, the requirement to register the back-to-back trades to the Category 4 Member’s account can be waived because there is no economic benefit in registering these additional trades and LME fees are not applied (see paragraph 26). This change may introduce operational efficiencies in respect of Category 4 trade registration for the Administrative Clearer.
11. This amendment to the Category 4 trade registration methodology for entities operating as brokers assumes that the Category 4 Member is remunerated for its trading activities through the application of a post trade commission.
12. For the avoidance of doubt, when a Category 4 Member, acting as a broker, trades in the market on behalf of a Client and the resulting Client trade is not at the same price level as the Member to Member trade due to a commission adjustment, such as the application of a mark-up/down in the price, the Member to Member trade and the Client trade will have to be crossed through the



Category 4 Member's account by the Administrative Clearer in order to realise the commission.

13. Category 4 Members are reminded of the importance of submitting their trades to LMEsmart either directly utilising Category 4 trade entry functionality or via the Administrative Clearer in a timely manner in order for both Members to be able to meet applicable matching deadlines.
14. All Members are reminded of the importance of maintaining a full audit trail for executed orders and administrative transactions. In addition, Administrative Clearers are reminded of the importance of maintaining a full audit trail for all Category 4 Member activity in order to be able to demonstrate traceability of transactions registered to the Category 4 account and Category 4 client accounts.

Trading in the Inter-Office Market

15. Category 4 Members wishing to undertake their own trade entry can access LMEsmart using LME provided software and by connecting to the LME Wide Area Network (WANTM) through an LMEnet connection or via an approved ISV (that supports Category 4 functionality) through the FIX API. Under such functionality, the Category 4 Member will be allocated a three letter matching mnemonic in the system linked to their Administrative Clearer. Trade halves and Client trades executed in the inter-office market and entered into LMEsmart under the mnemonic of the Category 4 Member via the LMEsmart GUI or FIX Member Interface will, following matching and registration, appear as matched trades under the mnemonic of the Category 4 Member in LMEsmart, but will be transmitted to LME Clear under the mnemonic of the Administrative Clearer.
16. Alternatively, a Category 4 Member can choose to outsource the trade entry function to its Administrative Clearer. Under this arrangement, all Category 4 trades will be entered into LMEsmart under the Administrative Clearer's matching mnemonic. The Administrative Clearer must include a three letter mnemonic in the Public Reference Field of LMEsmart to identify Category 4 executed trade halves from its own. When submitting Client trades to LMEsmart for the benefit of the Category 4 Member, the Administrative Clearer must distinguish between its direct Clients, which include the Category 4 Member, and the indirect Clients of the Category 4 Member in the LMEsmart Client ID field. Where a Category 4 Member operates as a broker and additionally executes trades in a proprietary capacity, the Category 4 Member must distinguish between trades entered into as a result of facilitating Client orders, i.e. where there is a back-to-back market trade, and those trades that are the result of proprietary trading, when transmitting trades to the



Administrative Clearer for trade input in order to benefit from the fee rebate set out under paragraph 26 below.

17. Any Category 4 trading activity that is matched either by the Category 4 Member or the Administrative Clearer will result in the creation of positions in the house account of the Administrative Clearer at LME Clear. It will require an additional registration between the Category 4 Member's Administrative Clearer and the Category 4 Member to transfer the market risk ("the position") from the Administrative Clearer's house account to the Category 4 Member's account at LME Clear, as necessary (see paragraphs 9 – 12). The trade that is registered to transfer the position from the Administrative Clearer's house account to the Category 4 Member's account is a Client Contract (not a Cleared Contract). As a non-clearing member of the LME, the Category 4 Member account at LME Clear will be in an Omnibus Segregated Account (OSA), which may be the Administrative Clearer's direct client OSA, or an Individually Segregated Account (ISA), depending on the arrangement agreed between the Category 4 Member and its Administrative Clearer.
18. LME trades executed in the inter-office market between a Category 4 Member and its Clients are Client Contracts and must be registered in LMEsmart by the Category 4 Member or the Category 4 Member's Administrative Clearer. Any Client trade executed by the Category 4 Member and registered in LMEsmart will result in the creation of a position in the house account of the Administrative Clearer and in the Client's account at LME Clear. It will require an additional registration between the Category 4 Member's Administrative Clearer and the Category 4 Member to transfer the position from the clearer's house account to the Category 4 Member's account, as applicable (see paragraphs 10-12). A Category 4 Member's clients are in effect indirect clients of the Administrative Clearer. Indirect clients' accounts must be held in a separate OSA to the Category 4 Member's own positions (kept in an OSA or ISA) or in multiple separate ISAs under the Administrative Clearer. Accordingly, a Category 4 Member operating as a broker must maintain at least two accounts with its Administrative Clearer (one for its own positions and another for its Client's positions).

Trading in the Electronic Market

19. An applicant for Category 4 Membership or existing Category 4 Member wishing to become an LMEselect Participant must apply to the LME and, providing the requirements set out in the Rules are met and the applicant receives the requisite approvals from the LME, they will be eligible to connect to LMEselect. Category 4 Members or applicants wishing to become LMEselect Participants should contact Client.Advisory@lme.com to discuss connectivity options. Category 4 Members who choose to become LMEselect Participants can



access LMEselect via the LMEselect GUI and/or the LMEselect FIX API. Category 4 Members who do not want to become LMEselect Participants can opt to utilise the order-routing services of their Administrative Clearer.

20. Under Category 4 LMEselect functionality, Category 4 LMEselect Participants are set up as Trading Members, as opposed to Trading and Clearing Members, in the system. The Category 4 Trading Member is assigned a three letter mnemonic that is then linked to their Administrative Clearer in the system; all LMEselect Participants are anonymous in the system. The three letter mnemonic assigned to the Category 4 Member in LMEselect should be consistent with the three letter matching mnemonic utilised by the Category 4 Member for trade submission in LMEsmart as set out in paragraphs 15 and 16 above. The Administrative Clearer must set overarching pre-trade risk controls for the Category 4 Trading Member in the Pre-trade Risk Management (“PTRM”) GUI. The Category 4 Trading Member will have access to the PTRM GUI and if acting as a broker, must assign Tag 58 codes to its order-routing Clients – this is mandatory. Individual limits can then be set for each Client as may be required, or left as unlimited.
21. A Category 4 trade in LMEselect will result in the creation of a Cleared Contract in LMEsmart between each of the Category 4 Member’s Administrative Clearer and the LMEselect counterparty and LME Clear, and will retain the identifier for the Category 4 Trading Member. The Cleared Contract in LMEsmart is transmitted automatically to LME Clear under the matching mnemonic of the Category 4 Member’s Administrative Clearer and the LMEselect counterparty creating a position in both house accounts. Where applicable, as set out in paragraphs 10-12, the Administrative Clearer can register a Client Contract in LMEsmart to transfer the position from its house account to the Category 4 Member’s account at LME Clear.
22. Trades executed electronically by a Category 4 Member’s Clients utilising the order-routing services of the Category 4 Member’s Administrative Clearer will automatically create Cleared Contracts in LMEsmart and positions in the house account of the Administrative Clearer. The order-routed client trades must be registered in LMEsmart as Client Contracts in accordance with Part 3, Trading Regulations of the LME Rulebook². The positions created in the house account of the Administrative Clearer as a result of the Cleared Contracts created in LMEsmart, and the registration of the order-routing Client Contracts, can be transferred to the position keeping account of the Category 4 Member as applicable, through the registration of back-to-back Client Contracts for the benefit of the Category 4 Member (see paragraphs 10-12).

² See Regulation 2.7.1



23. It is not the LME's intention to set out the registration rules for all Category 4 trading scenarios in this Notice. Category 4 Members and/or Administrative Clearers who are uncertain about trade registration methodology should contact Client.Advisory@lme.com.

LME Fees

24. Trades executed by Category 4 Members will incur LME fees (trading and clearing) depending on the counterparty (Category 1, 2 or 4 Member, or Client) and the fee category i.e. basis ring, non-ring or give-up. LME fees are calculated by an in-house system and automatically debited from the US dollar account of Clearing Members at LME Clear on a monthly basis.
25. Category 4 Members trading in a proprietary capacity will themselves be the recipient of a Client Contract issued by their Administrative Clearer. Proprietary trading activities in the inter-office or electronic market will generally result in the registration of a Cleared Contract and a Client Contract and will incur the associated LME fees.
26. In order to align LME fees for Category 4 Members operating as brokers with those payable by Category 1 and 2 Members, LME fees will not be levied on the back-to-back Client Contracts registered to the Category 4 Member's account at LME Clear. As with Category 1 and 2 Members trading under this business model, LME fees will only be levied on the Cleared Contract and the (non-member) Client Contract executed by the Category 4 Member. From Q3 2017, it is the LME's intention to levy a null fee on applicable Category 4 trades submitted to LMEsmart such that the correct fees are automatically debited on a monthly basis from the US dollar account of the Category 1 or 2 Member acting as the Administrative Clearer. Until then, Category 4 fees will be charged in full and the fees levied on back-to-back trades registered to the Category 4 Member's account calculated and rebated to the Category 4 Member's Administrative Clearer as applicable. Category 4 Members must advise Client.Advisory@lme.com of the codes used to identify their account(s) and their Client accounts in LMEsmart so that the correct fees can be calculated and rebates paid to their Administrative Clearer. LME fees are set out in the fee schedule published at www.lme.com. Where Members remain in doubt as to the fees associated with any LME transaction, they should seek guidance from Client.Advisory@lme.com.
27. By way of an example, a Category 4 Member trading in a proprietary capacity with a clearing counterparty in the inter-office market or electronically via LMEselect will result in two registrations, a Cleared Contract and a Client Contract. These two registrations will (ignoring any rebates from incentive programmes) incur LME trading and clearing fees of \$2.70 payable by the



Administrative Clearer comprising \$0.90 for its side of the Cleared Contract plus \$1.80³ for the Client Contract⁴. Entries 1 and 2 in Figure 1 illustrate the trades that are registered in LMEsmart under a Category 4 proprietary trading model, the fees that are applied to those registrations, and the positions that are created in the house account of the Administrative Clearer and in the Category 4 Member's account at LME Clear.

28. A Category 4 Member, acting as a broker, executing a client order in the inter-office market or electronically via LMEselect, where the Client trade is adjusted for commission by way of a mark-up/down, will result in four registrations, a Cleared Contract and three Client Contracts (two Client Contracts for the benefit of the Category 4 Member to transfer the positions from the Administrative Clearer's house account to the Category 4 Member's account and a Client Contract for the benefit of the Category 4 Client). Prior to the implementation of the automated Category 4 fee calculator noted in paragraph 26 above, these four registrations will incur LME fees of \$6.30 payable by the Administrative Clearer comprising \$0.90 for its side of the Cleared Contract plus 3 x \$1.80 for the Client Contracts⁵. However, the fees applied to the back-to-back Client Contracts registered to the Category 4 Member's account, will be rebated hence LME fees will only apply to the Cleared Contract and the Client Contract making \$2.70 in total. Entries 3 – 6 in Figure 2 illustrate the trades that are registered in LMEsmart under a Category 4 broker model, the fees that are applied to those registrations, and the positions that are created in the house account of the Administrative Clearer and in the accounts of the Category 4 Member and the Category 4 Client.

Figure 1.

Category 4 Member operating as a proprietary trader + 1 lot in the Inter-Office Market or via LMEselect for own account				
Trade registered in the LMEsmart	Administrative Clearer House Account	Administrative Clearer CAT 4 OSA	Administrative Clearer CAT 4 Client OSA	LME Fees
1. Cleared Contract	+ 1			\$0.90
2. CAT 4 Client Contract	-1	+ 1		\$0.90 + \$0.90 = \$1.80
Position	0	+1		Total \$2.70

³ An LME Client Contract comprises the simultaneous registration of two trade halves, one half is transmitted to the Member's house account at LME Clear and the other half is transmitted to a client account (OSA or ISA) at LME Clear; both sides of the trade are charged at \$0.90, so \$1.80 in total.

⁴ See entries 1 and 2 in Figure 1

⁵ See entries 3 – 6 in Figure 2



Figure 2.

Category 4 Member operating as a broker + 1 lot in the Inter-Office Market or via LMEselect on behalf of a Client ⁶				
Trade	Administrative Clearer House Account	Administrative Clearer CAT 4 OSA	Administrative Clearer CAT 4 Client OSA	LME Fees
3. Cleared Contract	+ 1			\$0.90
4. CAT 4 Client Contract	-1	+ 1		\$0.90 + \$0.90 = \$1.80 Fee to be rebated/waived
5. Client Contract	-1		+ 1	\$0.90 + \$0.90 = \$1.80
6. CAT 4 Client Contract	+1	-1		\$0.90 + \$0.90 = \$1.80 Fee to be rebated/waived
Position	0	0	+1	Total \$2.70

Position Reporting

29. Category 1, 2, 3 and 4 Members are required to report to the Exchange all warrant and trading positions for all house and client accounts as at the close of business by 08:30 the following business day. Additionally, Category 1, 2, 3 and 4 Members are required to report to the Exchange market open interest (MOI) figures by 09:00 each business day⁷. Members must use LME DPRS ("Daily Position Reporting System) to submit these warrant, position and MOI reports to the Exchange. Category 4 Members can outsource this reporting function to their Administrative Clearer but the obligation to report remains with the Category 4 Member. Alternatively, Category 4 Members can submit their own large position and MOI files in LME DPRS where they have connectivity to the LME WAN.

Application of LME fees for the Category 4 operating model

30. The revised Category 4 trade registration methodology set out in paragraphs 10-12 is effective from 5 June 2017. Category 4 Members must contact Client.Advisory@lme.com to discuss their current operating models and account identifiers in order to confirm the trade registration methodology and ensure the correct fees are applied and rebates calculated as necessary. Any interested

⁶ Client trade is adjusted for commission in the price necessitating the registration of back-to-back trades to the Category 4 Member's account.

⁷ See applicable Notices under Reporting and Publication of Information at www.lme.com



parties wishing to explore LME Membership should contact the Client Advisory and Membership Department (Client.Advisory@lme.com). Applicants for Category 4 membership and their Administrative Clearers will need to demonstrate operational readiness in the member test environment for all applicable LME systems before go-live.

Gillian Tovey
Head of Client Advisory and Membership Services

cc: Board directors