

To: All Members and other interested parties

Ref: 21-006

Classification: Consultation Rulebook

Date: 25 January 2021

Subject: **CONSULTATION ON AMENDMENTS TO THE LMEC RULEBOOK
– LOSS ALLOCATION & MISCELLANEOUS (the
“CONSULTATION”)**

Summary

1. LME Clear seeks the views of Members in relation to proposed amendments to the LME Clear Rules and Procedures (the “**Rules**”). The proposed Rule Changes address the following areas:
 - (A) loss allocation for un-auctioned portfolios; and
 - (B) miscellaneous administrative changes and clarifications.

Defined terms

2. Defined terms used in this Consultation shall have the meaning given to them in the Rules, unless stated otherwise.

The consultation process, timing and steps following this Consultation

3. A mark-up of the Rules showing the Rule Changes is available at Appendix 1. The main provisions are summarised below.
4. This Consultation will remain open for responses until 6:00pm (London time) on **26 February 2021**. LME Clear shall be under no obligation to consider responses submitted after this time.
5. All Members with comments on the amendments are invited to respond in writing to the Consultation by email to consultations@lme.com or the Relationship Manager who usually deals with your firm. We would request that comments be made using the template at Appendix 3. Any questions or clarifications can, in the meantime, be raised by contacting Hannah Moulton (hannah.moulton@lme.com), David Wilkinson (david.wilkinson@lme.com) or Elizabeth Monk (elizabeth.monk@lme.com).



6. LME Clear may need to share responses received with regulatory authorities, members of its group, and its legal or other professional advisors, or as required by law. Anonymised responses (verbatim or paraphrased) may be included in any Notice(s). Apart from this, all responses will be treated in confidence.
7. All of the Rule Changes detailed in this Consultation are subject to regulatory approval before they can become effective. Following this Consultation, and once regulatory approval is received, LME Clear will advise Members via one or more Rule Change Notices on when changes to the Rules will take effect. We expect this to be in Q2 2021.
8. Please Note: this is a consultation on the LME Clear Rules only and the LME Rules are not affected by this Consultation. The LME has today published a separate consultation in relation to the LME Rules (notice number 21/013) and which closes at the same time as this Consultation on the LME Clear Rules. The LME and LME Clear are happy to receive a combined response to both the LME and LME Clear consultations, although we would ask that you clearly identify which comments relate to the LME consultation and which relate to the LME Clear consultation.
9. Separately, LME Clear will issue an intervening Rule Change Notice in relation to the electronic warranting initiative (as referenced in LME Notice 20/225). These changes are due to take effect on 1 March 2021 and are not shown in the mark-up at Annex 1.

Section A – Loss Allocation Without an Auction

10. Following the occurrence of a Default Event, Rule 10.4.1(l) gives LME Clear the power to conduct an auction of Open Contracts of the Defaulter. However, this may not always be the most appropriate way for LME Clear to close-out open interest as part of its default management process. For example, in the case of LME Exchange Traded Futures, LME Clear may carry out a perfectly matched hedge transaction that will then settle to market as part of the end of day process leaving the relevant Account flat. The Rules set out a detailed juniorisation process for the allocation of Excess Losses suffered where an auction has taken place (at Default Procedure Part C6.3), but are silent on how losses will be allocated if LME Clear decides not to exercise this power.
11. In order to ensure that LME Clear has the appropriate flexibility to risk-manage the Contracts of a Defaulting Member, Default Procedure Part C6.3 has been amended to provide that, where Contracts have not been subject to an auction, the Default Fund Contributions attributed to such Contracts shall be applied against any losses in respect of such Contracts shall on a pro-rata basis.



12. To facilitate this process, before allocating any Excess Losses, LME Clear will split the Defaulter's Open Positions into any number of "Portfolios" (Default Procedure Part C6.3A). LME Clear will then allocate a proportion of each non-Defaulting Members' Default Fund Contribution which will be at risk for each Portfolio (to determine an "Allocated DFC Amount" for each such Portfolio). This will be calculated based on each Members' activity in the Open Contracts in the Services and Underlying Assets represented in each Portfolio.
13. Any Excess Loss on a Portfolio which has not been subject to an auction will be allocated on a pro-rata basis according to Default Procedure Part C6.6(a). This means that each Member's Allocated DFC Amount will be applied towards the remaining Excess Loss on that Portfolio in the same proportions as the Members' Default Fund Contributions represent of the total Default Fund Contributions of all Members with Open Contracts in that Portfolio.
14. Any Excess Loss on an Auction Portfolio will be allocated according to the existing juniorisation process at Default Procedure Part C6.6(b).
15. In the event that the allocated Default Fund Contributions at Risk are insufficient to cover the Excess Loss on any particular Portfolio, surpluses from other Portfolios will be allocated in accordance with Default Procedure Part C6.6(c) and 6.9. as amended.
16. As a consequence of these changes to loss allocation, the definition of "Auction Portfolio" has been amended and a new definition of "Portfolio" has also been added to Rule 1 (Definitions).

Section B – Miscellaneous Administrative Changes

17. The following is an overview of the main changes proposed. These are set out in the order in which they will appear in the Rules. There may be consequential administrative changes such as updates to cross-references and numbering which are not mentioned here but will appear in the marked-up version of the Rules which accompanies this Consultation.

Rule 1 – Definitions and Interpretation

18. The definition of "Bridge Institution" has been amended to capture the wider range of entities which may be established or appointed by a resolution authority in connection with a recovery or resolution process at a distressed Member. For example, a private sector purchaser may be appointed by the resolution authority to take over the functions of the distressed Member. This is intended to more closely align the definition with the regulators' powers in respect of bridge institutions (which, in the context of the Rules, covers the types of entities that



LME Clear may choose to accept as a Member, in line with our regulatory obligations).

19. The definition of “Default Notice” has been amended to clarify that this term refers to the Notice sent to the Defaulting Member themselves, rather than the Notice to all Members informing them that a Default Notice has been issued (under Rule 10.3.3(b)).
20. The definitions of “General Liquidity Requirement” and “General Working Capital Requirement” have been deleted as they are not used in the Rules.
21. Under Rule 10.7.6(d), Porting Request Notices received by LME Clear are considered “at the end of each Partial Transfer Window”. The definition of “Partial Transfer Window” has been amended to make it consistent with this provision.
22. LME Clear accepts Porting Election Notices from Clients, as well as consents from Member Transferees, during the “Porting Election Period”. The definition of “Porting Election Period” has therefore been amended to reflect this.
23. Currently, the Porting Election Period starts automatically when LME Clear serves the Default Notice on the Defaulting Member. Non-defaulting Members are subsequently informed that a Default Notice has been issued and there may be a time delay between these two Notices being issued. To provide greater certainty, both for Members and for Clients who may wish to submit Porting Request Notices, we propose to give LME Clear the power to specify when the Porting Election Period starts. This will enable LME Clear to notify the public that it has issued a Default Notice (including non-Defaulting Members and Clients) in the Rule 10.3.3(b) Notice.
24. LME Clear recently changed the standard form Porting Request Notice to allow greater flexibility for LME Clear to accept notices without a wet signature (which is particularly important in the current circumstances). Therefore, the definition of “Porting Request Notice” has been amended to clarify that the prescribed form notice may be amended by LME Clear “from time to time”.
25. The definition of “Relevant Rate” has been amended to reflect the regulatory move away from IBORs to risk free rates. This concept of Relevant Rate only applies in relation to certain calculations connected with an LME Clear default. This change has already been made in the Fee Schedule.
26. The definition of Underlying Asset has been corrected in line with other amendments to remove the term “Physically Settled Contract” which was used in



error. As amended, the definition now refers to a “Physical Delivery Contract”, which is itself defined as “a Contract for a Physically Settling Product”.

Rule 2.5.2 – Formalities for delay of options exercise

27. Rule 2.5.1 gives LME Clear the power to amend the timing of options exercise where it is necessary in order to protect the integrity of the Clearing System, the stability of the financial system or the orderliness of the markets it supports.
28. Rule 2.5.2 sets out the governance process which LME Clear will follow in making this decision. LME Clear proposes to delete Rule 2.5.2 as it does not consider it appropriate to set out internal governance processes within the Rules. As with all decisions taken by it, LME Clear will continue to follow an appropriate governance process.

Rule 2.9.2 – Notices

29. References to fax have been removed and this is no longer a valid means of serving Notice.

Rule 7.7.2 – Failure to Settle

30. Rule 7.7 sets out the actions LME Clear may take when Members fail to make the payments and deliveries due on the Settlement Date. This provision has been amended to clarify that failure to comply with the settlement obligations in the Clearing Procedures may constitute an Act of Misconduct on the part of the Member, as well as potentially resulting in action under Rule 10 (Default).

Rule 8.3.2 – Cash Collateral

31. Cash Collateral is provided to LME Clear on an outright transfer basis and is not subject to any security agreement. Cash Collateral is therefore available for LME Clear to use freely and we propose to clarify this by deleting the words “for any purpose contemplated by the Rules”.

Rule 10.3.2 – Default Notice

32. This provision states that LME Clear will notify “the Regulator” before issuing a Default Notice. In practice, LME Clear will notify the Bank of England and will not automatically notify any other Regulator. We propose to specify this in the Rules.
33. Default Procedure Part C3.1(a) has also been amended to align with this provision for consistency.



Rule 10.3.3 – Notification of Porting Request Notices

34. Rule 10.3.3 sets out the notifications LME Clear will make during a Default. LME Clear will be in regular contact with the Defaulter (or their insolvency practitioner) throughout any Default Period and updates on Porting Request Notices would be given periodically rather than in relation to each individual Porting Request Notice. Therefore, this provision has been amended to reflect this.

Rule 10.7.5 – Porting Request Notices

35. In order to transfer their positions from a Defaulter to another Member, Clients must submit a Porting Request Notice. LME Clear recently updated the standard form Porting Request Notice to allow LME Clear to waive any formality requirements at its discretion. This was intended to facilitate porting during the current pandemic restrictions (should it be necessary). Rule 10.7.3(b) has therefore been amended to reflect this change by removing the requirement for the Porting Request Notice to be “signed” and/or “countersigned” by the Member Transferee and each Client.

Rule 10.7.6(d) – Partial Transfer Windows

36. In the event that LME Clear decides to facilitate Partial Transfers, LME Clear will publish indicative Partial Transfer Windows on its Website. LME Clear will consider all of the Porting Request Notices it receives at the end of each Partial Transfer Window. However, it may not be possible to action all of them. Any remaining Porting Request Notices will be considered in the next Partial Transfer Period and this provision has been updated to clarify this.

Rule 10.10.1(e) – Definition of “Pro Rata”

37. This provision sets out what “pro rata” means in the context of replenishments. As a consequence of the changes to the loss allocation for un-auctioned portfolios (above) LME Clear has added some additional detail on what “pro rata” means to ensure it is clear how the term is used in each instance.

Rule 10.10.2 – Calculation of VM Profits

38. Rule 10.10.2(a) sets out the mechanism LME Clear will use to calculate Total Member VM Profits for the purpose of discharging an Excess Loss on the Defaulter’s Account via Variation Margin Gains Haircutting. This calculation is based on Member margin and includes Member CVM, which does not result in a



daily settlement payment between the CCP and the Member. Therefore this provision has been amended to reflect this.

Rule 10.14.11

39. The reference in this provision has been updated to Rule 10.10.9(d) as Rule 10.10.10(e) does not exist.

Membership Procedure Part B3.1 – Membership Criteria

40. This clause has been amended to make it clear that the Membership Criteria continue to apply to Members at all times. This includes meeting LME Clear's internal credit rating requirements.
41. The formatting in this clause was also incorrect and this has therefore been updated.

New Clause Clearing Procedure Part C5.2 – Delivery Margin

42. Clearing Procedure Part C5.1 gives LME Clear the power to charge Additional Margin to cover the risk that a Member will not fulfil its Delivery Obligation. Additional Margin called by LME Clear to cover delivery risks must be met in Cash and a new provision has been added to this effect.

New Clause Clearing Procedure Part C6.2 – Intra-day Exposures

43. Members who regularly take on intra-day positions and close them out by End of Day bring risks to the CCP which may not be adequately collateralised as part of the End of Day processes. Therefore, it is necessary to require additional collateral to mitigate the additional risks posed by this type of trading activity.
44. Such requirements have previously been documented in the bilateral Membership Agreements entered into with individual Members. For transparency, LME Clear now proposes to list these additional collateral requirements in the Rules and have inserted a new clause to address this.

Clearing Procedure Part D3.6A – Denomination of Collateral Requirements

45. LME Clear has added a provision to make it clear that, where LME Clear requires Collateral to be paid in a specific Eligible Currency, it may notify Members of that requirement and Members will be required to comply with that request.



Clearing Procedure Part D3.18 – Gold Collateral

46. LME Clear takes Gold Collateral on an outright transfer basis, rather than subject to a security interest. Following a routine legal review of our security documentation this provision has been amended to clarify the position.

Clearing Procedure Part E – Pre-lodgements for Bank Holidays

47. Where a call for a currency is issued for a value date that is or subsequently becomes a Bank Holiday, LME Clear may require such payment to be made in an alternative currency under Rule 2.17.
48. To avoid this, Members may elect to pre-lodge additional Collateral in anticipation of an upcoming Bank Holiday. In order to ensure that this Collateral can be invested in good time prior to a Bank Holiday, we propose to amend the collateral lodgement timelines as set out in this Clearing Procedure Part E2.14.

Clearing Procedure Part F2.15 – Delivery Timetables

49. LME Clear has the power to temporarily extend or amend the delivery timetables set out in Annex 7. This enables LME Clear to assist Members experiencing technical difficulties, for example, such that may not warrant a Default Event being called. In this instance, we would like to remind Members that failure to provide LME warrants may still constitute an Act of Misconduct under the LME Clear Rules and this provision has been amended accordingly.

Default Procedure Part B1.2(b) – Default Fund Policy

50. This provision sets out the principles LME Clear uses to calculate Default Fund Contributions. LME Clear publishes a summary of the Default Fund Policy for Members on the Website and we have updated this reference accordingly, in order to refer to the “default fund overview document”.

Annex 1 – Contract Specifications

51. Some minor amendments to the Contract Specifications are required in order to align with the LME Rules. Additionally, Contracts that are not currently available for trading have also been marked for clarity.

Appendix 1

Rules and Regulations of the LME Clear (redline)



Appendix 2

Rules and Regulations of the LME Clear (clean)

Appendix 3

Consultation Response Template

Consultation Proposal	Rulebook Reference	Suggested Amendment	Explanation/Comment	Category (T/C/I) ¹

¹ In this document, “T” means Typing Error, “C” means Clarification sought/required, “I” means Issue.