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

Ref: 22/240

Classification: General Updates Brands

Date: 06 October 2022

Subject: **LME DISCUSSION PAPER ON RUSSIAN METAL**

Summary

1. Since Russia invaded Ukraine on 24 February 2022, specific sectoral sanctions and related measures against Russia have been introduced; however, there has been no comprehensive government-led action to prevent the widespread use of Russian metal[1]. In parallel, the LME has been closely monitoring the usage and throughflow of Russian metal on the LME, to ensure that LME warehouses do not see a significant inflow of unwanted Russian stocks, posing a risk of creating a disorderly or unfair market. Through 2022, the LME's understanding is that consumers have broadly been willing to take deliveries of Russian metal (which is supported by data as to the flow of Russian stocks both into and out of LME warehouses). However, as the current negotiation period for 2023 supply agreements progresses, the LME understands that an increasing number of consumers may be expressing an unwillingness to accept Russian metal in 2023. As a result, and in light of the potentially changing market landscape, the LME now considers it appropriate to gather further data and views. This paper considers the role of the LME in this scenario, provides background and data on the subject, and asks for market feedback on possible routes forward.

Background and action to date

2. The Russian invasion of Ukraine that started on 24 February 2022 led to a range of sanctions and associated actions adopted against Russia, as well as Russian individuals, companies, and goods. In addition, a number of international companies across multiple industries have opted to "self-sanction" – imposing self-determined restrictions on their own activity in Russia, or with Russian-origin companies or individuals.

3. The LME has closely monitored developments, and in particular has continually assessed the appropriateness of the continued listing of Russian metals brands. The Exchange has applied three key lenses to such analysis, namely (i) ethical considerations, (ii) compliance with government sanctions, and (iii) usage trends of Russian metal. Each topic is considered in further detail below.

(i) Ethical considerations

4. At the outset, the LME fully acknowledges the complex ethical dimensions of the use of Russian commodities. The Exchange notes that market participants will reach their own determinations on these matters, and respects the right of participants to do so. If, for example, a metal-consuming company

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[1] Throughout, "Russian metal" or "Russian stocks" refers to metal where the production site (usually a smelter) at which the LME brand is produced is located in Russia

wishes not to accept Russian metal, that is a matter for that company, with consequent impacts (positive and negative) which that company will be best-positioned to assess and manage.

5. However, and by contrast, when the LME takes action in changing its brand lists, it gives rise to an impact not just on its own business, but on other participants across the metals market. For example, if the LME removes a particular brand from its brand lists, then holders of that metal will be limited in their ability to sell that metal on the LME, and hence to use the Exchange as the market of last resort. Similarly, the producer of that brand may find it more difficult to sell the metal in the physical market, given that certain physical supply arrangements stipulate that metal delivered must be of an LME-approved brand. And, more broadly, users may find themselves pressured to not consume that brand as a result of the delisting, thereby affecting their sourcing strategy and costs.

6. As such, the LME considers that its decision-making should be based on its responsibilities to the broader market, as covered in the following two topics.

(ii) Compliance with government sanctions

7. As a general observation, the LME conducts business operations globally, and compliance with applicable sanctions is a central component of its overall compliance programme.

8. To date, financial sanctions have not directly targeted Russian metals companies. However, sanctions on individuals associated with Russian metal, as well as economic and trade sanctions, have been imposed on Russian metal, including:

- In March 2022, the UK government introduced 35 percentage points additional duties on imports of Russian and Belarusian copper, lead and aluminium. In response, on 1 April 2022, the LME issued a suspension (see notice 22/097) on placing Russian brands on warrant in UK listed warehouses unless exported from Russia prior to 25 March 2022. At that time, the LME did not have Russian metal on warrant in LME-listed UK warehouses, but the additional duties would have meant that any Russian metal delivered into LME-listed UK warehouses could not then be removed from warrant and imported into the UK or shipped elsewhere without significant additional costs, which could introduce significant risk of price dislocation.

- From 9 April 2022, the EU adopted measures which prohibited the purchase, import, or transfer (directly or indirectly) of "unwrought lead", amongst other items, into the EU if they originated in Russia or were exported from Russia. Given the potentially broad application of this regulation, the LME suspended all deliveries of LME-listed Russian lead brands into LME warehouses worldwide. At that point in time, there were no warrants in the LME's electronic warrant transfer system related to lead, either of Russian origin or exported from Russia; the LME does, however, have one listed Russian lead brand.

- On 29 June 2022, the UK government imposed financial sanctions on Vladimir Potanin, including an asset freeze and travel ban. This followed similar such action by Canada in April 2022. As the Chief Executive and main shareholder of Norilsk Nickel, it was anticipated that these sanctions could extend to Norilsk Nickel. However, the LME assessed the detail of the asset freeze and their impact on LME, its participants, and Norilsk brands and, based on the information available, determined that the better interpretation was that the sanctions did not extend to Norilsk Nickel itself.

- In July 2022, the UK government expanded its additional duties of 35 percentage points to include Russian nickel. In response, the LME suspended (see notice 22/200) the warranting of LME-listed Russian nickel brands at LME-listed warehouses in the UK unless exported from Russia before 20 July 2022. No such metal was warranted in UK listed warehouses at that point in time.

- In September 2022, the UK government imposed sanctions on Iskander Kakhramonovich Makhmudov, as a result of which, Mr Makhmudov is subject to asset freeze measures in the UK. In accordance with UK sanctions law, asset freeze measures extend to entities that are owned or controlled directly or indirectly, by a person to subject to sanctions. Given the LME understands that through a corporate structure, Mr Makhmudov majority owns the holding company which in turn majority owns the holding company which owns more than a 50% share in Ural Mining and Metallurgical Company ("UMMC"), and its subsidiary Joint Stock Company Chelyabinsk Zinc Plant ("Chelyabinsk"), the LME introduced on 5 October 2022 (via notice 22/239) a temporary imposition of conditions on placing UMMC and Chelyabinsk branded metals on warrant. Under this suspension, the UMMC or Chelyabinsk branded metals shall only be capable of being placed on warrant if the metal owner can demonstrate to the satisfaction of the LME that placing UMMC or Chelyabinsk branded metal on warrant will not constitute a breach of the sanctions.

(iii) Usage trends of Russian metal

9. For the LME, the priority in any challenging geopolitical situation is to ensure that an effective, fair and orderly market is maintained, which includes providing a reliable price reflective of global market conditions.

10. As such, for as long as Russian metal is acceptable to a broad spectrum of global consumers (and is not sanctioned, as noted in the analysis above), then the interests of an orderly market are likely best to be served by the continued presence of Russian brands on the LME's brand lists, as this will ensure that the LME's warehouse stocks continue to reflect the global physical market.

11. If, on the other hand, a significant number of consumers opt to "self-sanction" (for example, through ending business activities in Russia, refusing delivery of Russian metal, or no longer trading with Russian counterparts – even in the absence of wider sectoral sanctions adopted against Russia), then a real risk exists that Russian metal cannot be sold into the physical market. This, in turn, could create the risk of the loading of large amounts of metal of Russian metal into LME warehouses (and sale of that metal on the LME), given the LME's status as the "market of last resort". This could then result in a significant accumulation of Russian metal in LME warehouses. It could also be expected that the value of Russian metal could fall below the price of metal from other jurisdictions, and that LME warrants representing Russian metal could become the "cheapest to deliver" on the LME market. Accordingly (all else being equal), the LME price could be expected to fall to the price of Russian metal, and the various surveyed premiums could (depending on the methodology used, and in particular if the compiler excludes Russian metal) be expected to rise, representing a higher premium between the LME (representing, under this scenario, primarily Russian metal) and the physical market (representing, under this scenario, non-Russian metal given widespread self-sanctioning activity).

12. Such developments could threaten the orderly nature of the LME's markets, and in particular its key role in price discovery for the global physical industry.

13. With this in mind, the LME has closely monitored the usage trends of Russian metal and in particular, for each metal, (i) the absolute levels of Russian metal in LME warehouses and (ii) the percentage of LME stock represented by Russian metal. For metals where this percentage demonstrates material increases, the LME also tracks (i) inflow of Russian metal, (ii) cancellation of Russian warrants (indicating an intention to take delivery), and (iii) actual outflow of Russian metal. More broadly, the LME undertakes market discussions to understand the willingness of consumers to take delivery of Russian metal under their physical supply agreements.

14. To date, the LME's broad understanding is that global metals consumers have, under their 2022 annual supply agreements, been willing to accept Russian metal. Accordingly, the LME has not felt it necessary or appropriate to take unilateral action in respect of delisting Russian brands.

15. However, over the past few weeks, it has been suggested to the LME by certain market participants that, during initial discussions around 2023 supply agreements, a significantly greater number of metals consumers are expressing an unwillingness to accept Russian metal in 2023. At this stage, the LME understands that few binding agreements have been entered into, and therefore at the current point in time, a full view of 2023 consumer behaviour is not yet available. However, given this situation, the Exchange now considers it appropriate to initiate a market discussion exercise, in parallel with the negotiation of 2023 physical supply contracts, to ensure that the LME can make an informed determination as to the continued listing of Russian metal brands, in relation to 2023 consumer behaviour.

Function and responsibility of the LME in respect of the physical network

16. Broadly speaking, the LME undertakes three core functions in support of the global metals market: providing pricing of metals; facilitating hedging to mitigate exposure to price movements; and operating a global physical market which underpins the Exchange's physically deliverable contracts.

17. To support this global physical market, the LME provides two key services:

- **LME-approved warehouses.** The LME authorises and audits a physical network across 34 global locations to warrant and store metal on behalf of metal owners. Any market participant taking delivery of warrants through the settlement process will know that the underlying brands of metal are stored in one of these warehouses around the world; this warranted metal can be used for the settlement of maturing trading positions on the LME.

- **LME brands list.** The LME physical network relies on the buyer being guaranteed a consistent standard of a specific metal. To ensure reliable quality, all metal delivered into LME-approved warehouses must be of an LME-approved brand and conform to specifications on quality, shape, weight, and responsible sourcing[2], as set out in Parts 6 and 7 of the LME Rulebook. Furthermore, because the LME's brand list is frequently referenced in bilateral physical supply contracts, it fulfils a broader role across much of the metals industry in identifying the "acceptable" brands of metal in the market.

18. At present, a number of Russian brands across multiple metals have been approved as meeting the LME's requirements. With the exception of metal under sanction, as outlined above, this metal is therefore eligible to be warranted (i.e. stored at an LME warehouse location, in an LME-approved warehouse), and to be used in settlement of a contract of the relevant metal traded on the Exchange.

19. One of the primary functions of the warehouse network is to act as the storage facility for the deliverable metals under LME contracts, which is a market of last resort for such metals; accordingly, to store metal that is not otherwise required for physical use at that point in time. As a result, it could be argued that the LME warehouse network – in the event that demand for Russian metal reduces – should stand ready to absorb that metal on behalf of the market.

20. However, as set out above, the LME must balance this with the need to ensure that its markets remain orderly. The considerations around this action are set out below.

[2] Noting that the requirements for responsible sourcing have been recently introduced, and while the first reporting deadline passed on 30 June 2022, full compliance across all LME-listed brands will not be achieved until December 2023

Current concerns and market impact

21. As outlined above, the LME's position to date has been to follow government-issued guidance in respect of sanction-related activity, and to monitor the usage trends of Russian metal, but not to take additional self-led action unless circumstances pose a threat to market orderliness.

22. However (and notwithstanding the LME's position to date), through bilateral meetings and LME metal committees, the LME is aware of a growing concern around both:

- **Ethical considerations.** It is clear to the LME that a sizeable proportion of its market and the wider community, including the investment community, expects market infrastructure providers such as the LME to ensure that the products and services they offer meet expected standards for responsibility and sustainability, and that this is essential to maintaining a "licence to operate". There is an argument that the absence of LME action in respect of Russia's actions in Ukraine undermines the LME's responsible sourcing programme, especially given the focus on issues pertaining to human rights and conflict financing; and

- **Commercial considerations.** Under this heading, market participants have highlighted that the fundamental role of the LME is to provide pricing of metals. These prices are underpinned by the Exchange's physical delivery mechanism, which drives convergence with the price of generally acceptable metal in the market, i.e. the price a consumer pays bilaterally to a producer. In the event that the majority of consumers opt to "self-sanction" and choose not to accept Russian metal, the expectation is that there will be a significant influx of this metal into the LME warehouse network, dominating delivery against the underlying LME contract. As such, in time, the LME price would no longer reflect the "real world" price of LME-grade metal, but the price of Russian metal, likely to be trading at a discount. This has a concomitant impact on producers whose contracts state pricing based on the "LME price", and will subsequently be selling at the discounted rate. It will likely also cause disruption in the premium market, as consumers are forced to pay a premium to secure non-Russian metal.

23. As set out in paragraph 13, the LME tracks closely the impact of the Russia-Ukraine conflict on stocks in its listed warehouses, and in particular, the levels and flow of Russian metal through the system.

24. This information has not formed part of the LME's standard reporting – however, given the topic under discussion in this paper, the LME does believe that it would be appropriate to make available relevant data when considering their response to this paper.

25. To this end, Figure (i) charts the percentage of Russian copper, nickel, primary aluminium, aluminium alloy and NASAAC in LME-listed warehouses globally, since March 2022. Where other LME metals are not included, this is because no Russian stocks of these metals have been on warrant at LME-listed warehouses during this time.

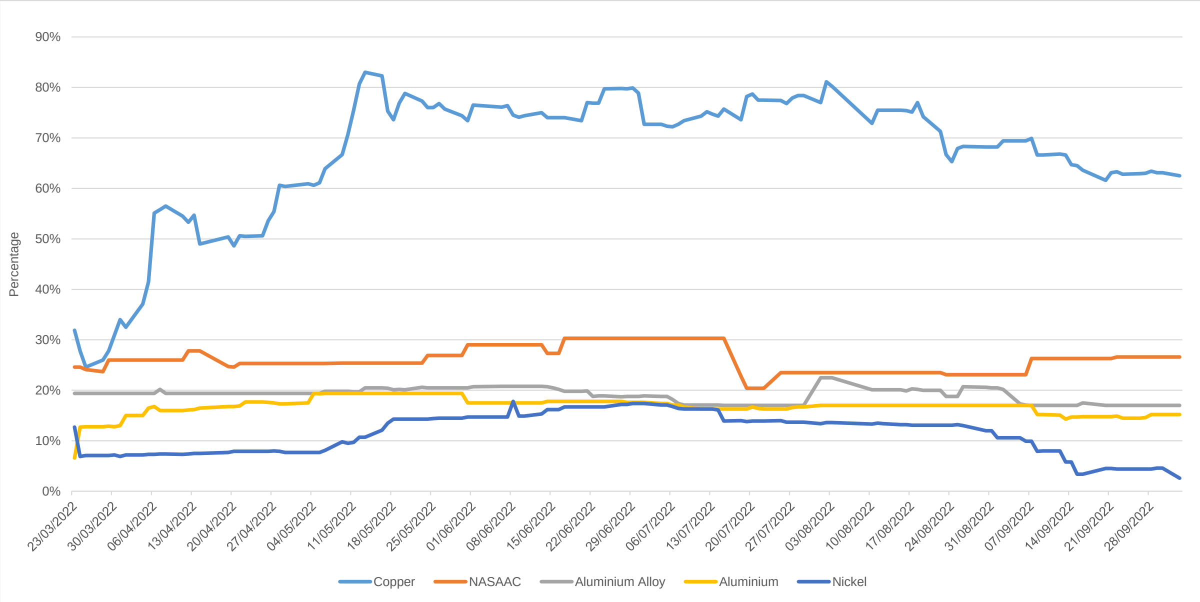

Figure (i): Percentage of live tonnage of Russian brands by metal

26. As Figure (i) demonstrates, for most LME metals, the percentage of Russian compared to other jurisdiction metal has remained both stable, and relatively low. For copper, however, the percentage of Russian compared to non-Russian-metal has been high, peaking at over 80% in both May and August 2022.

27. However, it is also notable that these levels of Russian stocks are not unprecedented. Figures (ii) – (iv) below chart the percentage of Russian stocks of copper, aluminium and nickel back to 2013, and demonstrate historical highs of 95% for copper in 3Q2021, 74% for aluminium in November 2014, and 65% for nickel in January 2013.

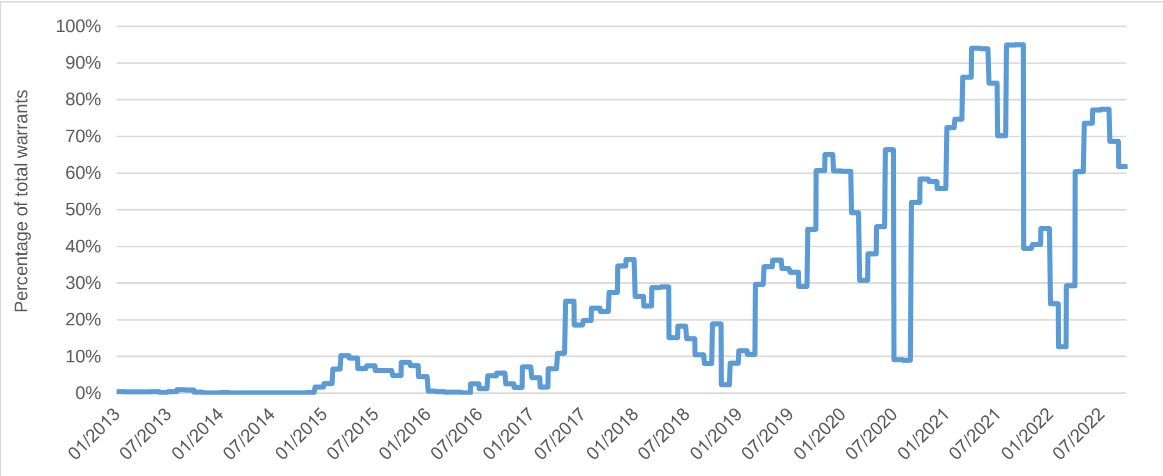

Figure (ii): Percentage of live tonnage of Russian copper

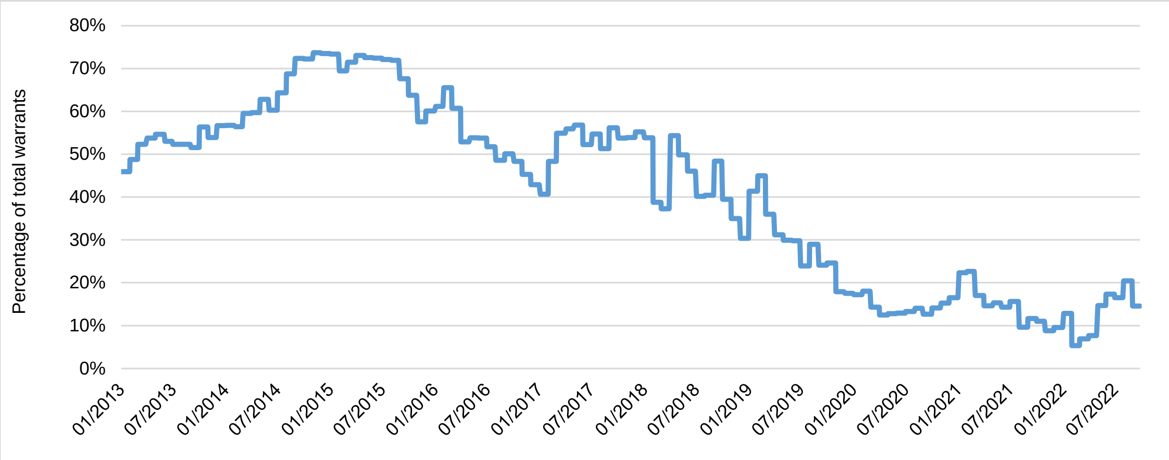

Figure (iii): Percentage of live tonnage of Russian aluminium

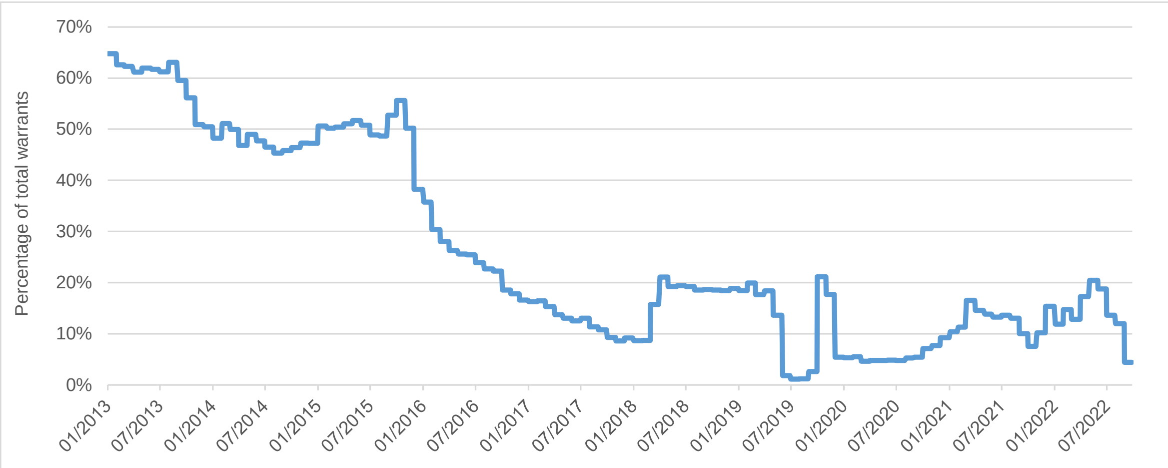

Figure (iv): Percentage of live tonnage of Russian nickel

28. Further, while stocks levels of copper have been high, they have also fluctuated; Russian metal continues to be loaded-out, as well as loaded-in, suggesting that – at present at least – market participants are still taking delivery of Russian metal. Evidence of this is provided in Figures (v)-(vii), which track the volume of Russian copper that has been delivered in, cancelled, and delivered out since mid-April 2022.

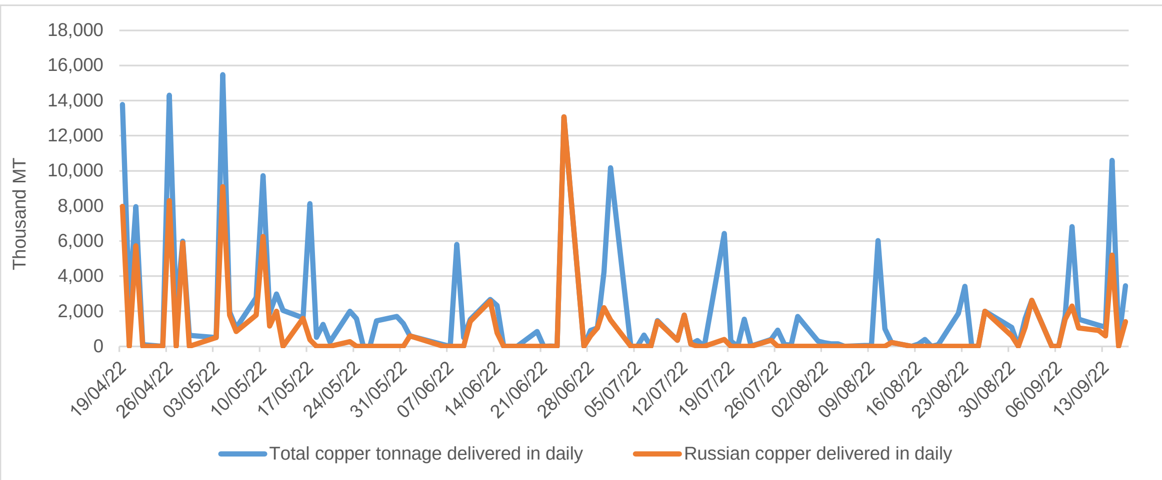

Figure (v): Delivered in – total copper vs Russian copper

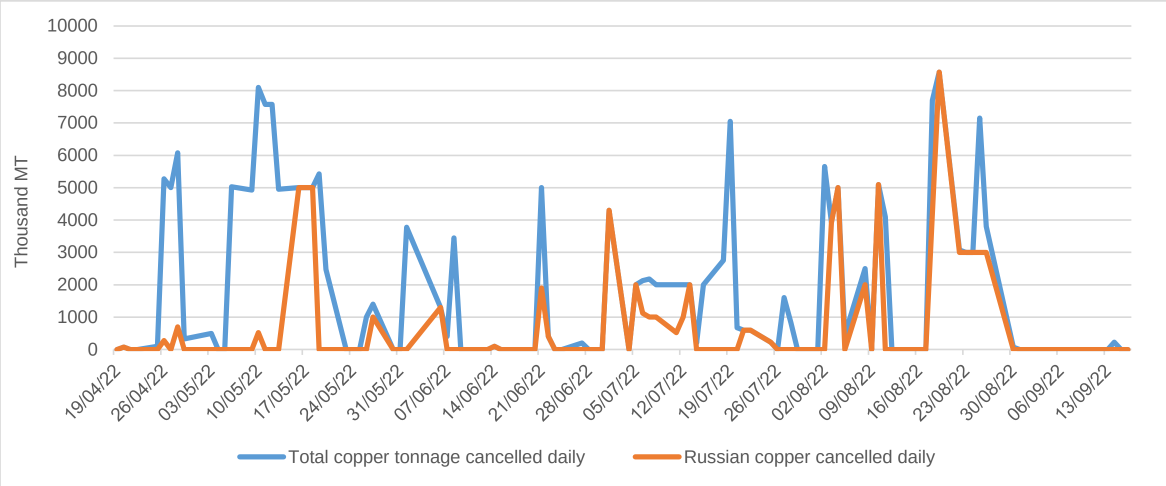

Figure (vi): Cancelled – total copper vs Russian copper

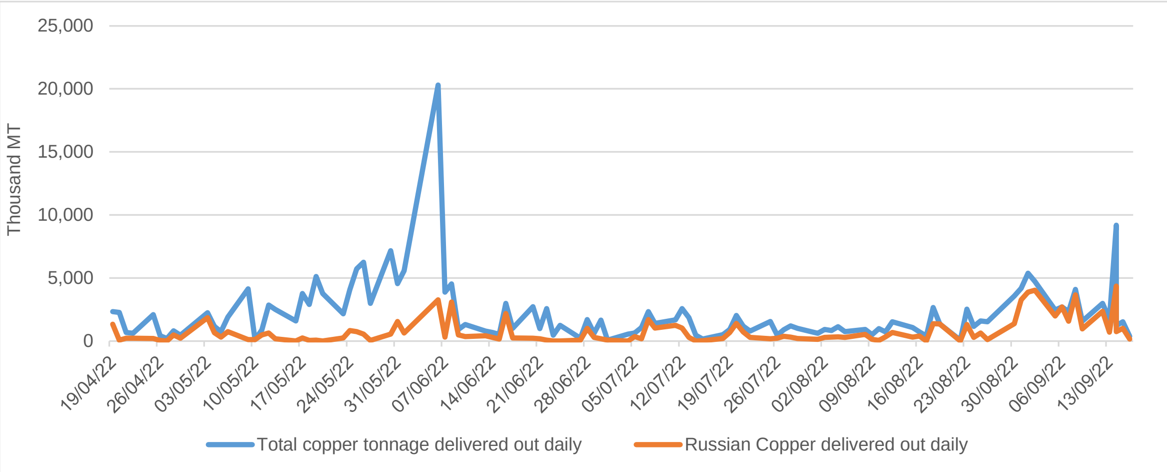

Figure (vii): Delivered out – total copper vs Russian copper

29. As indicated by the data above, the LME does not believe that Russian stocks currently represent a material issue in the physical market. Even for copper, the figures demonstrate that metal continues to move through the system, making it possible to conclude that – at present at least – the LME warehouse network has not been inundated with Russian metal.

30. This data is consistent with what the LME is hearing from the market; specifically, that metal consumers are currently honouring 2022 supply contacts that allow for the supply of “LME deliverable metal” – a definition that includes Russian metal on the LME approved brands list.

31. However, as outlined above, the LME is aware of an increasingly stated concern regarding supply contracts for 2023; namely, that supply contract negotiations which have begun for 2023 are specifying that Russian metal will not be accepted for delivery. If this is the case, it is highly likely that this would lead to an influx of such metal into the LME warehouse system, potentially causing the type of price dislocation outlined above in paragraph 11.

Possible action

32. In considering its options, the LME is conscious of the balance of issues set out above. Further, it notes that these issues could be exacerbated by the fact that the metal market has been operating in a low stock environment for some time, adding further uncertainty. Acting pre-emptively could cause further market distortion during an already difficult time but, on the other hand, a failure to take action now could

mean that the LME's hands are tied in the future, when any move to address the situation could be undermined by the volume of Russian metal already on warrant.

33. Finding the appropriate balance for any action, taking into consideration the likely sensitivity of the timing of such action, remains paramount.

34. As such, the LME has so far identified the following potential courses of action. For the avoidance of doubt, this paper does not cover the powers by which any option would be implemented:

35. **Option A. Maintain the current position,** with no further action until such time (if at all) sanctions are imposed on metals by international governments, or stocks and pricing data suggest that warranted Russian metal is impacting pricing. This minimises the possibility of current pricing impacts and market disorderliness, but risks the LME acting too late, leading to future market impacts following an influx of Russian metal into the physical network. It also does not provide the market with any certainty as to possible future action.

36. **Option B. Introduce thresholds** for warranted Russian metal i.e. once Russian metals constitute a specified percent of stock on warrant for a particular metal, the LME would move to suspend further deliveries, at which point no further Russian metal could be warranted. While this route would provide more time for greater clarity to emerge, it also raises a number of issues, including:

    - How to specify the most appropriate threshold for each metal.
    - The issue of market uncertainty as to when the thresholds might be reached, and the suspension implemented, potentially leaving metal owners with no option to warrant with little or no notice.
    - Whether it would be necessary to define a process for adjusting the thresholds, should stock levels rise more generally, and if so, how that process should function and what levels of stocks would be required to prompt the adjustment.
    - Similarly, whether it would it be necessary to define a process to refine the thresholds down, should non-Russian stocks decline at the same time as Russian stocks increase.

    Given these complexities, the LME is not convinced that this would add material market benefit.

37. **Option C. Suspend the warranting of Russian metal** in LME warehouses globally. This risks causing market disruption in the short term, but would provide certainty for the market. The timing of such a suspension would need to be considered carefully across two metrics (i) the point at which the suspension is implemented and (ii) whether the suspension would apply to all Russian metal, or only that produced[3] after a particular date. In this instance, the LME is of the view that it would not be appropriate to apply the suspension to metal that is already on warrant.

    In general, the LME prefers to give the market notice of rule changes, such that market participants can undertake adequate preparation and planning. However, this is not always possible (such as during the introduction of sanctions by governments), or reasonable (if there exists the risk that an extended notice

[3] The LME is conscious that two approaches exist here – suspensions based on production date or export date. Broadly speaking, when restrictions are imposed through tariffs levied by international governments, these tend to be applied based on export date, as the tariffs are triggered by the geographical movement of the underlying commodity. In contrast, financial sanctions on metals have, in the past, been levied based on production date, being a point in the value chain before the economic benefit of the commodity has been realised. From the LME's perspective, a warranting suspension could be premised on either (or indeed, both) and achieve the same end; however, from a practical perspective, the documents available to the LME for the operation of such a suspension (typically, the Certificate of Analysis or "CoA") are more easily applicable to a production-based suspension, rather than export-based. That said, in the case of copper where the LME does not require a CoA for warranting, the LME would still have to rely on the information provided by the market participant warranting the metal

period would risk creating greater market disruption than action that was effective immediately). In this instance, the LME believes that the following options apply:

- **C1. Apply the suspension immediately, and for all Russian metal.** The suspension would apply with immediate effect following publication of the results of this discussion paper, with the suspension applying to all Russian metal, irrespective of the date it was produced. Applying the suspension to all Russian metal (excluding that which is already warranted) is the most straightforward approach from a practical perspective. It also further limits the amount of Russian metal likely to be on warrant which in turn, reduces the risk posed by the possibility of the imposition of sanctions at a later date which apply to all Russian metal, leaving the LME network system with high levels of stock which cannot be taken to consumption.
- **C2. Apply the suspension immediately, but only for Russian metal produced after a specified date.** The suspension would apply with immediate effect following publication of the results of this paper, but only to metal produced after a specified date.
- **C3. Apply the suspension following a short notice period, and for all Russian-origin metal.** It could be argued that there is a need for caution in specifying a significantly delayed start date, given the risk of significant levels of warranting of Russian metal during the notice period, creating the same problem the suspension was designed to mitigate. As such, the LME could propose a date between two weeks and a month following the publication of the results of this discussion paper. The suspension would apply to all Russian metal, regardless of the date it was produced.
- **C4. Apply the suspension following a short notice period**, **but only for Russian metal produced after a specified date**. As with option C3, the LME could propose a date between two weeks and a month following the publication of the results of this discussion paper. The suspension would only apply to metal produced after a specified date.
- **C5. Apply the suspension following a longer notice period, and for all Russian metal.** Given the evidence that Russian metal continues to be accepted for delivery in 2022, it could be appropriate to apply a suspension from 1 January 2023, the point at which it is expected that consumers stop accepting Russian metal. While this could lead to a degree of warranting before the end of 2022, it is also very possible that this would not be excessive, given the market demand for metal – largely in short supply – and the ongoing delivery out of metal from warehouses, evidenced by the data above. The suspension would apply to all Russian metal, regardless of the date it was produced.
- **C6. Apply the suspension following a longer notice period**, **but only for Russian metal produced after a specified date**. As with option C5, the LME could implement a suspension from 1 January 2023. The suspension would only apply to metal produced after a specified date.

  As a final point, options C2, C4, and C6 above would all require the LME to specify a production date; metal produced after this date would then not be eligible for warranting in LME warehouses. Given – as outlined in C5 above – the market continues to accept 2022 Russian metal at present, it could be that 1 January 2023 would be an appropriate date. However, the LME has also heard arguments that this date would more fittingly be from the date of Russia's invasion of Ukraine.

38. The LME fully recognises that any of the above options may bring about unintended consequences. Not taking action could result in market disorder, as more fully set out in paragraph 11. On the other hand, taking action would have impacts on market participants, as more fully set out in paragraph 5. The views of market participants on these (and other) potential unintended consequences are welcomed.

39. Furthermore, the taking of action could give rise to an immediate inflow of Russian metal to LME warehouses, given metal owners' desire to warrant metal in advance of any potential restrictions. Given that, as set out above, the LME's understanding is that Russian metal is broadly being accepted for consumption in 2022, the LME believes that the market impact of such an inflow in 2022 would be limited. However, the views of market participants on this matter – and all the topics outlined above – are welcomed.

Conclusion

40. The LME is keen to hear views on the topics in this discussion paper (in particular, from consumers in respect of their plans regarding accepting, or not, Russian metal moving forward) and also on the specific options laid out in the section on "possible action", comprising paragraphs 32-39. The LME would also welcome ideas not included in this paper.

41. This process is designed to provide the LME with the data it needs in order to define any further action in respect of Russian metal, and ensure that the LME can understand and incorporate as broad a range of perspectives as possible.

42. Market participants are asked to submit feedback to the LME CEO Office at discussionpaper@lme.com. The LME requests that such feedback is provided before 18:00 GMT on 28 October 2022.

43. As far as is possible, the LME will also endeavour to offer meetings with participants who would prefer to provide feedback in person rather than in writing. Please contact the LME CEO Office at discussionpaper@lme.com.

44. The LME will communicate any proposed changes and timeline to the market following the feedback period.

Matthew Chamberlain
Chief Executive Officer

cc: Board directors
All committees