

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

Ref: 14/276 : A268 : W136

Date: 11 September 2014

Subject: **UPDATE ON LME WAREHOUSING REFORM: JUDICIAL REVIEW, MARKET STATUS AND PREMIUM CONTRACTS**

Summary

- 1 This notice updates the market on progress in respect of the LME's reforms of its physical delivery network. This includes the status of the LME's appeal to the Court of Appeal against the decision of the English High Court of Justice in relation to the Judicial Review brought by United Company Rusal plc (the "LME Appeal"), and the impact of the LME Appeal on the implementation of the LME's planned programme of warehousing reform, and further detail on proposed warehousing rules to support LME premium futures contracts.

Background

- 2 On 1 July 2013, the LME announced (in Notice 13/208 : A201 : W076) a consultation in respect of queues at LME-licensed warehouses (the "2013 Consultation"). In particular, the 2013 Consultation proposed the introduction of a linked load-in / load-out rule. The 2013 Consultation ran from 1 July 2013 to 30 September 2013 and saw strong market engagement.
- 3 On 7 November 2013, the LME announced in Notice 13/326 : A312 : W125 (the "Decision Notice") the outcome of the 2013 Consultation, including the adoption of the Linked Load-In / Load-Out Rule as proposed, with one modification¹ and certain clarificatory drafting changes (the "2013 LILO Rule"), together with a set of other measures (together the "Warehouse Reform Package"). The LME also published a comprehensive report on the 2013 Consultation (the "2013 Consultation Report").
- 4 On 27 March 2014, the English High Court of Justice announced its decision to uphold certain aspects of a Judicial Review brought by United Company Rusal plc and quashed the adoption of the 2013 LILO Rule. Accordingly (as set out in Notice

¹ An altered queue threshold.



14/106 : A103 : 046 Announcement on Outcome of Judicial Review), the 2013 LILO Rule has not been introduced.

- 5 On 29 and 30 July 2014, the LME's Appeal was heard in the Court of Appeal in London. To date, the Court of Appeal has not handed down its decision on the LME Appeal (the "Appeal Decision"). The LME fully respects the time required for the Court of Appeal to come to a complete view on this matter, and awaits the Appeal Decision at the appropriate juncture.
- 6 The LME is mindful that the Appeal Decision, regardless of its outcome, may contain important guidance as to the conduct of future consultations. Accordingly, the LME believes it appropriate to wait for the Appeal Decision before proceeding with the next steps in its warehousing reform package. Nevertheless, the LME is also mindful that it may be helpful for the market for the LME to provide an update on the status of the 12 core elements of the Warehouse Reform Package.
- 7 In particular, of the 12 core elements of the Warehouse Reform Package, the following 6 items have already been delivered:
 - **Separate steel load-out rate.** This was implemented on 1 April 2014. The steel billet contract will form the backbone of the LME's ferrous product suite expansion, which is currently the subject of discussions with the steel industry to deliver an optimised product offering.
 - **Warehouse queues-length report.** This was published for the first time on 12 May 2014. The LME believes that the report has served to provide enhanced clarity and transparency to the metals market.
 - **Commitments of Traders report.** This was published for the first time on 5 August 2014, and the LME believes that it provides a helpful assessment of positions of participants in its market.
 - **Creation of the Physical Market Committee.** The Physical Market Committee has now held two meetings, and the LME believes that the Committee is playing an important role in bringing the views and concerns of the physical market to the Exchange.
 - **Specific powers for the LME to address behaviour that creates or maintains queues.** This was implemented on 1 April 2014 via new Clause



9.3.4 of the Warehousing Agreement. The LME's intention is that this should act as a deterrent to the accumulation of queues in the future.

- **Ongoing commitment to a best-practice information barrier policy**, which resulted in proposals to update the LME's information barrier requirements. The consultation period for this review has now closed, and the resultant changes will come into effect on 1 January 2015 (see Notice 14/202 : A195 : W098).

8 The LME believes that the remaining items are most appropriately addressed after the publication of the Appeal Decision:

- **Implementation of the LIFO Rule.** This forms the key element of the Appeal Decision, and hence cannot be progressed pending the Appeal Decision being handed down.
- **Re-assessing the possibility of capping or banning rents in queues.** The LME has committed to re-assessing the possibility of capping or banning rents in queues, subject to the constraints of applicable competition law. Given the discussion of related issues in the Appeal, the LME believes it appropriate to await the Appeal Decision prior to engaging with the market on this topic.
- **Re-assessing the possibility of capping the level of daily rents and FoTs.** The LME has also committed to re-assessing the possibility of capping the level of daily rents and FoTs. The LME will also defer communication with the market on this topic until the handing down of the Appeal Decision.
- **Warehousing logistical review (the "Logistical Review").** The Logistical Review has been undertaken by global consultancy firm Oliver Wyman, and has now been completed. The LME is grateful to all those who took part in the market discussions, and believes that the recommendations advanced in the Logistical Review will materially enhance the efficient operation of the LME's physical network.

The changes recommended by Oliver Wyman will involve amendments to the Policy on Approval of Warehouses and the Policy for the Approval of Good Delivery Locations. Such changes will require consultation with the market prior to any implementation. Accordingly, and in accordance with the principles set out above, the LME proposes to wait for the Appeal Decision before publishing the Logistical Review and initiating a consultation on the



proposed changes. The LME notes that the Logistical Review was originally scheduled to be published by the end of August 2014; because of the LME Appeal, this timeline cannot be met.

Warehousing Agreement legal review (the “Legal Review”). Following a review in conjunction with external counsel, the LME intends to propose certain changes to the Warehousing Agreement. These changes will require consultation with warehouse companies. As with the Logistical Review, the LME believes it appropriate to wait for the Appeal Decision prior to the launch of the consultation.

- **Premium futures contracts.** Following extensive market engagement, the LME has now fully-specified its proposed premium contracts, which the LME intends to launch in the second quarter of 2015.

In order to support the LME’s premium contracts, it will be necessary to ensure that warrants delivered against premium contracts are protected from any potential future emergence of queues. It is proposed that this will be achieved by a warehouse opt-in mechanism, whereby LME warehouse operators will agree to create premium warrants.

This will require the publication of new rules (the “Premium Contract Rules”), which will be the subject of consultation with the market which will take place following the handing down of the Appeal Decision. However, the LME believes it will be helpful for the market to set out at this stage the principles, as currently envisaged, behind the Premium Contract Rules, which are set out later in this Notice.

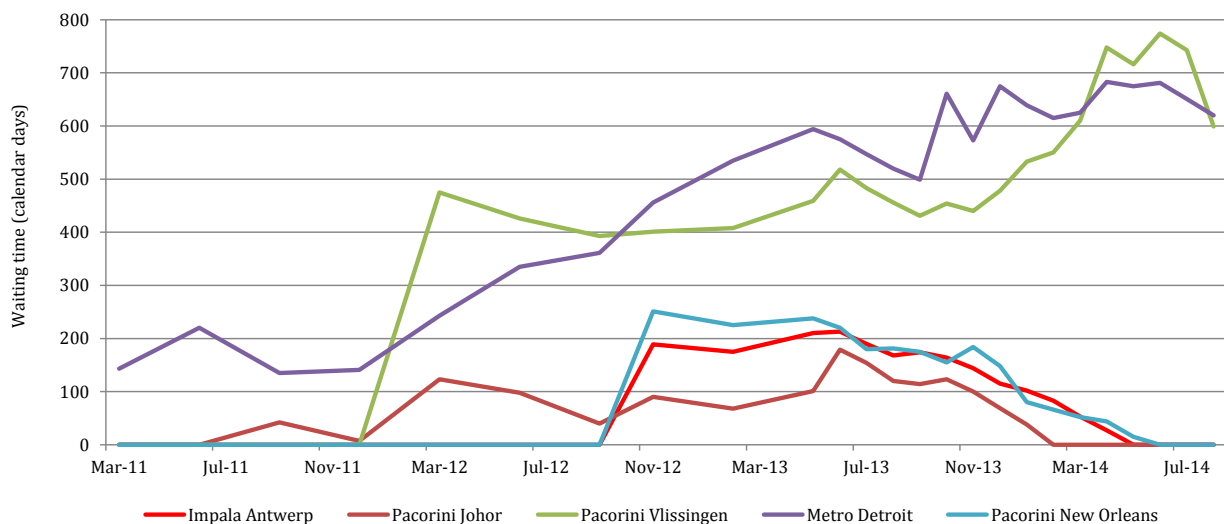
UPDATE ON QUEUES AND WAREHOUSE BEHAVIOUR

- 9 As set out more fully in the 2013 Consultation Report, queues at LME warehouses arose as a result of the large quantities of metal being placed on-warrant during the financial crisis, and the consequent cancellation of this metal, so causing long waiting times for load-out.
- 10 It is important to note that, notwithstanding the High Court Judgment, the behaviour of LME warehouse operators has changed since the start of the 2013 Consultation on 1 July 2013. The LME believes that this is because warehouse operators expect that, at some point, the 2013 LILO Rule (or a version thereof) will be introduced, and that the most efficient behaviour for operators to observe during the Preliminary Calculation Period associated with any future introduction of such a rule is to balance



load-in and load-out. In this regard, it should be noted that, following the High Court Judgment, the LME indicated that were the 2013 LILO Rule (or a version thereof) to eventually be introduced following either an appeal or a fresh consultation, the intention of the LME would be to retain the 1 July 2013 start date for the Preliminary Calculation Period, and hence it may be expected that warehouses would operate their business on this basis.

- 11 The result of such behaviour has manifested itself differently in respect of the five warehouses with queues over 50 days (being the queue threshold proposed in the 2013 LILO Rule) from 1 July 2013, the start date of the 2013 Consultation, as shown on the following graph² (data as of end of August 2014):



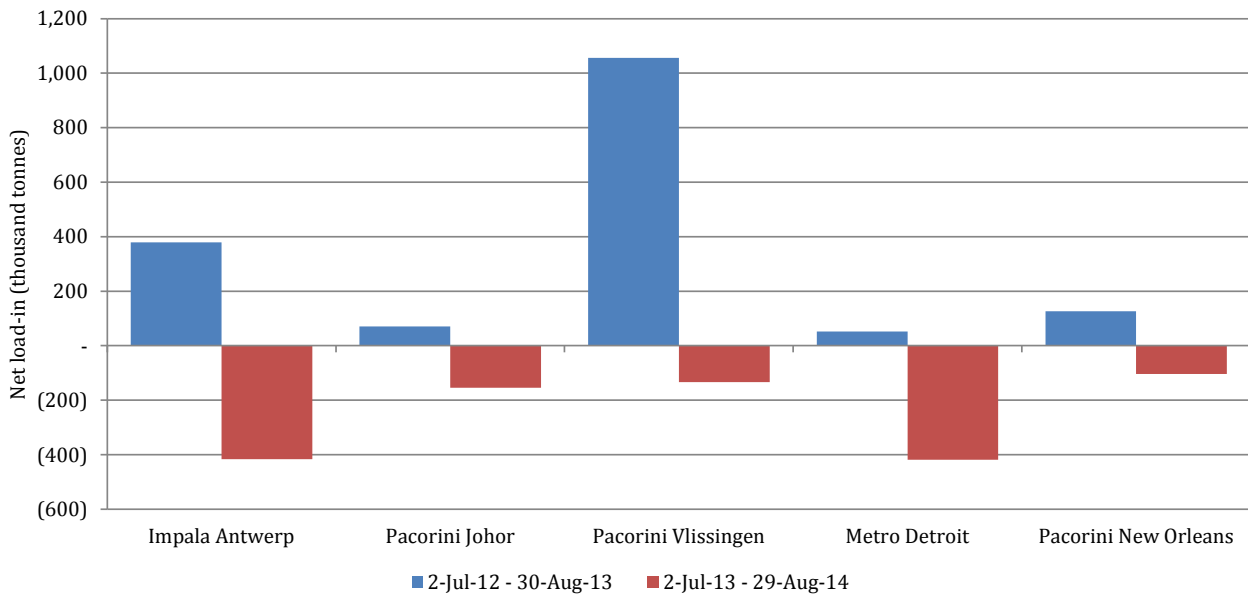
- 12 In summary, the warehouses with the three shortest queues (Impala Antwerp, Pacorini Johor and Pacorini New Orleans) have seen those queues disappear entirely. On the other hand, the warehouses with the two longest queues (Metro Detroit and Pacorini Vlissingen) have fluctuated month-on-month, but over time have continued to increase.

- 13 A full explanation for this activity requires assessment of both the net load-in behaviour of the warehouses themselves, and the warrant cancellation behaviour of the owners of metal in those warehouses:

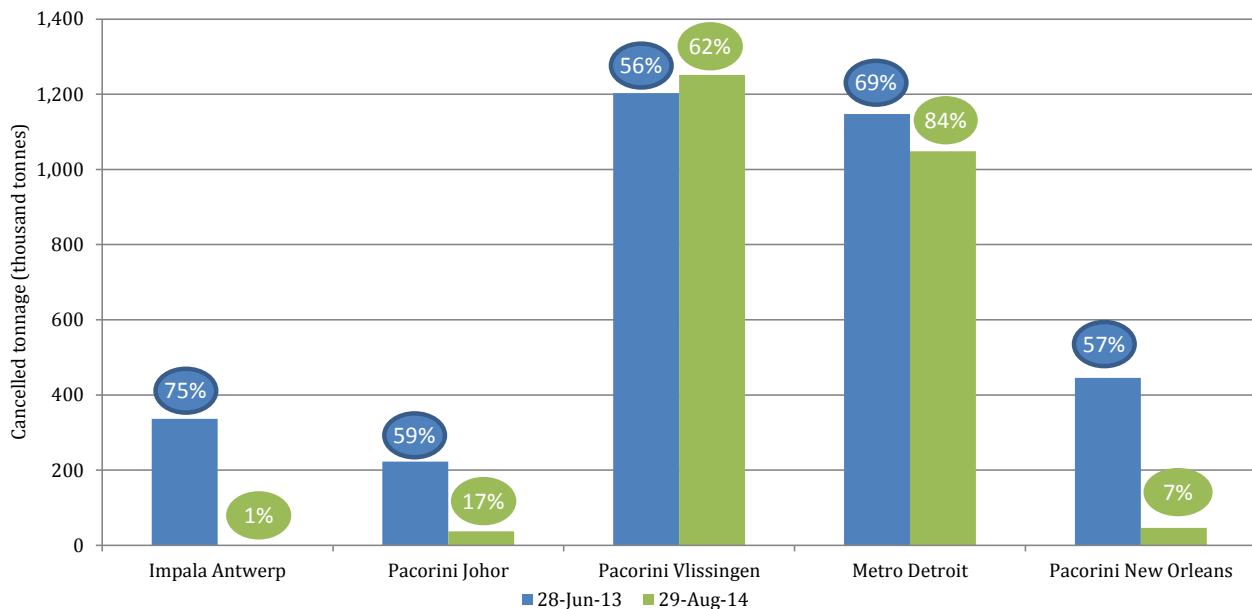
² Following changes to the LME Warehouse Agreement on 1 April 2014, the LME is now able to associate queues with the names of particular warehouse operators, which was not possible at the time of the 2013 Consultation Report



Net load-in for 5 affected LME warehouses:



Cancelled warrants as a percentage of total stock:



14 In the LME’s view, operators of potentially affected warehouses under the 2013 LIFO Rule (“Affected Warehouses”) are attempting to balance load-in and load-out, which is the most efficient mode of operation during the Preliminary Calculation Period to avoid enhanced load-out requirements during the Preliminary Discharge Period. The result is that the Affected Warehouses with the three shortest queues have had a significant fall in stocks, and hence queues.



- 15 However, in the two warehouses with larger queues, there remain such significant stocks of uncanceled warrants that, even in the absence of significant net load-in, the cancellation of these stocks by warrant holders will have the effect of increasing the length of the queue – and the cancellation data presented above clearly demonstrates the increased cancellation activity since 1 July 2013. While there is an upper limit to this phenomenon (namely, the point at which all warrants in the warehouse will have been cancelled, at which point the queue by definition would fall under the operation of the 2013 LIFO Rule), until such point is reached, the queues may grow.
- 16 In the view of the LME, the behaviour of potentially Affected Warehouses anticipating the potential introduction of the 2013 LIFO Rule (or a version thereof) demonstrates both the advantages and limitations of the LIFO Rule itself. On the one hand, the effect of the LIFO Rule is (either by affecting warehouse behaviour, or by imposing greater load-out requirements) to stem the growth of stock, and hence the maximum possible queue which could be accumulated by the cancellation of warrants in that warehouse. On the other hand, the LIFO Rule cannot control the behaviour of warrant holders, and it is hence possible that queues rise before they fall under the effect of the LIFO Rule (indeed, given the likelihood that warrant holders cancel metal in the light of their expectation of greater load-out rates, such an increase is not just possible, but indeed probable).
- 17 It should be noted that the observed behaviour of warehouses is that associated with the expected Preliminary Calculation Period, during which time the warehouse is incentivised to balance load-out and load-in, but is not compelled to load out more than it loads in (which would be the case under the First Discharge Period, and subsequent Discharge Periods, under the LIFO Rule). Metro has additionally announced that it will voluntarily comply with the 2013 LIFO Rule.
- 18 For the avoidance of doubt, the behaviour of warehouse operators is a matter for those operators – it is commented upon by the LME in this context, but should not be taken as suggesting that the LIFO Rule will necessarily be introduced.



UPDATE ON PREMIUM CONTRACTS

- 19 Following the clear request from the market, the LME is in the process of developing a set of premium contracts. Following market discussions, the LME believes that these products will deliver strong price discovery and risk management capabilities to the market.
- 20 The LME feels it would be helpful for the market to set out the principles underlying the proposed Premium Contract Rules to improve market understanding. However, the precise rules will be the subject of a full consultation with the market in due course. Therefore this Notice should **not** be construed as a consultation in accordance with the LME's public law or regulatory obligations.
- 21 The LME proposes that its premium futures contract will be settled via existing LME warrants – however, the contracts will have more restrictive rules as to which warrants (such eligible warrants being “Premium Warrants”) can be used in settlement.
- 22 In particular, it is currently envisaged that only warehouses without queues will be eligible for the delivery of warrants against LME premium contracts. However, a core concern for the LME in respect of premium contracts is the emergence of queues at previously unqueued warehouses.
- 23 For example, consider that a long holder of an LME premium contract takes delivery of a Premium Warrant at a warehouse not affected by queues. If, immediately following the delivery of this warrant, other metal owners in the associated warehouse were to cancel large quantities of metal, then it is possible (under the existing rules) that a queue could build up at that warehouse, which would then affect the ability of the recipient of the Premium Warrant to readily access the underlying metal. While the LME believes that its new powers (in particular, Clause 9.3.4 of the Warehouse Agreement) will materially restrict the creation of any new queues, it remains possible for such queues to arise, particularly over a short timeframe driven by material warrant cancellations.
- 24 Accordingly, it is the view of the LME that those receiving premium contracts require greater protection, otherwise the proposed contract (which was requested by a broad set of market participants during the 2013 Consultation) will not function effectively.
- 25 The full specification of the LME premium contracts (the “Premium Contract Specifications”) will be set out in the LME rulebook. Draft specifications are available to interested parties from the LME upon request.



Construction of the Premium Contract Rule

- 26 Within the LMEsword system, it is currently proposed that functionality will be added whereby London agents, acting on the instructions of a warehouse, can endorse warrants as Premium Warrants in respect of a given premium region and given metals (such regions and metals being defined in the Premium Contract Specifications). Warrants not so endorsed will be referred to as “Standard Warrants”.
- 27 In order for a warehouse to endorse a warrant as a Premium Warrant, it is proposed that the following conditions must be satisfied:
- (i) The warehouse must be located in one of the premium regions, as set out in the Premium Contract Specifications. So, for instance, a warehouse located in Chicago would be able to endorse US Premium Warrants, whereas a warehouse located in Rotterdam would be able to endorse Western European Premium Warrants. Warehouses not located in a premium region (e.g. a warehouse in Liverpool) are not able to endorse any form of Premium Warrant.
 - (ii) The warehouse must have opted-in to the premium warrant regime, by completing the appropriate agreement with the LME. The LME will publish a list of all warehouses which have opted-in to the premium warrant regime. Once opted-in, a warehouse can only opt-out if its stock of Premium Warrants is zero.
 - (iii) At the time of endorsement of the Premium Warrant, the warehouse must not have a queue in respect of any LME metal. Furthermore, if a metal owner, having cancelled a warrant, completed the necessary formalities and requested prompt load-out by truck, is told by the warehouse that load-out cannot be completed within 2 London business days, the warehouse will have an immediate duty to inform the LME, which will then (within one London business day) announce to the market that the warehouse will cease to be able to endorse new Premium Warrants three London business days following such announcement. This three day period is designed to ensure that metal owners in the process of creating Premium Warrants for use in contract delivery are able to complete such process before the warehouse is prohibited from endorsing Premium Warrants.

However, and notwithstanding the three day adjustment period, metal owners should note that, given the above, the emergence of a queue at a warehouse may impact their ability to create Premium Warrants at that warehouse. Accordingly, those



holding short positions in respect of LME premium contracts are urged to ensure that they have created the requisite Premium Warrants in good time prior to delivery.

For the avoidance of doubt, the emergence of queues at a warehouse will not change the status of Premium Warrants previously issued by that warehouse - such warrants will remain as Premium Warrants.

Warehouses which have cleared their queues will be entitled to resume the issuance of Premium Warrants following the publication of the next monthly queues report confirming that no queues remain.

The ability to endorse Premium Warrants applies at the level of all of the authorised warehouses (the sheds of a particular warehouse operator) of a warehouse in a particular LME-approved delivery point (a "Delivery Point"). Accordingly, if a warehouse operator has a queue in one Delivery Point, this will not prevent that warehouse operator endorsing Premium Warrants at its facility in a different Delivery Point, provided that the second facility does not have a queue.

(iv) The metal owner must request that a Premium Warrant be endorsed, and the warehouse must agree to do so. There are two routes by which a Premium Warrant may be created:

- In connection with fresh metal loaded-in to the warehouse, a warrant is issued in respect of that metal, and is immediately endorsed as a Premium Warrant. Warehouses may set a different rent and FoT rate in respect of Premium Warrants – such rates will be reported to the LME by warehouses and published annually in the same way as for Standard Warrant rent and FoT rates. As with current metal load-in, no warehouse is obligated to accept metal for warranting, and metal owners must ensure that Premium Warrant creation capacity is available at their intended warehouse – in particular, it is expected that warehouses will not wish to warrant more premium metal than they could logistically load out pursuant to the greater requirements attaching to such metal. However, the LME would expect warehouses which have opted-in to the premium warrant regime not to unreasonably refuse the load-in of metal and the creation of Premium Warrants.
- An existing Standard Warrant is converted to a Premium Warrant. Warehouses opting-in to the premium warrant regime may indicate whether or not they are prepared to undertake such conversion, and to identify if they wish to charge a conversion fee (the amount of which will be reported to the LME and published annually by the warehouse company) which will be levied in this event. Warehouses may also set a maximum quota (expressed as a tonnage) in respect



of the maximum amount of Standard Warrants which they will be prepared to convert to Premium Warrants. This may be important for warehouses with large stocks of Standard Warrants, and which would not be able to take on the additional requirements were the entire stock to be converted to Premium Warrants. However, within their stated quota, warehouses will be expected to convert Standard Warrants into Premium Warrants on a non-discriminatory and first-come-first-served basis. Once a Standard Warrant has been converted into a Premium Warrant, then the warehouse's published Premium Warrant rents and FoTs will apply

- 28 Once a Warrant has been endorsed as a Premium Warrant, treatment of that Premium Warrant will be as for a Standard Warrant for as long as the warehouse does not have a queue. However, to the extent that a queue arises, then the warehouse will have an obligation to load out metal relating to cancelled Premium Warrants in a separate queue. It is currently proposed that the minimum daily load-out rate for such metal will be the higher of:

1,000 tonnes per day (the "Minimum Premium Warrant Load-Out Requirement")

and

3% of the total stock relating to Premium Warrants (live and cancelled) three business days following the announcement of a queue in that warehouse (the "Premium Warrant Load-Out Percentage")

- 29 For the avoidance of doubt, nothing in respect of load-out obligations for Premium Warrants will change the treatment required for Standard Warrants – load-out obligations for Premium Warrants are in addition to those already applying to Standard Warrants. The currently published load-out rates will continue to apply to Standard Warrants, and the basis on which minimum load-out rates for Standard Warrants are calculated will take into account total stored tonnage in the warehouse, both Standard Warrants and Premium Warrants.

NEXT STEPS AND TIMELINE

- 30 Following the handing-down of the Appeal Decision, the LME will re-engage with the market and articulate the next steps in the warehousing reform programme. The precise nature of such next steps will, of course, be dependent on the contents of the Appeal Decision.



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Cc: Board directors
User Committee
Physical Market Committee
Warehousing Committee
All metals committees