LONDON METAL EXCHANGE

To: All members, warehouse companies and their London agents

Ref: 14/121 : A117 : W056

Date: 7 April 2014

Subject: **FURTHER UPDATES ON WAREHOUSE AND PHYSICAL NETWORK REFORMS**

Summary

1 The LME is pleased to update the market on progress in reforms to its warehouse policies and physical network, including its intention to launch a physically-settled regional aluminium premium contract.

2 Following consultation with the market (the "Consultation"), Notice 13/326 : A312 : W125 laid out a 12-item package of measures, each of which is designed to further enhance the LME's physical delivery network, optimise contract price convergence, and continue to deliver best-in-class price discovery and hedging solutions for all market users.

3 This Notice updates on each of the 12 measures. Although enactment of the Linked Load-In Load-Out Rule (the "Rule") remains on-hold following the judgment of the High Court on 27 March 2014, the items below represent key deliverables in the LME's ongoing process of market enhancement.

4 The LME reiterates its strong commitment to ensuring that its global contract structure offers the optimal price discovery and hedging mechanism for industry and investors, recognising in this context the global nature of the metals markets which it serves. The LME is confident that the measures set out below will help ensure that its worldwide model best serves the needs of the underlying metals markets, with important enhancements to assist players with regional exposure to hedge more effectively, while still taking advantage of the world's most liquid metals trading venue.

A. Enactment of the Rule

5 As set out in Notice 14/106: A103: W103, the LME is disappointed by the decision of the High Court, the result of which is that the Rule could not be implemented as planned on 1 April 2014.

6 However, the LME's commitment to address queues, and their consequent impact on efficient price discovery, remains unchanged. The LME is taking legal advice to establish the quickest effective route by which action can be taken to reduce queue lengths at Affected Warehouses.

THE LONDON METAL EXCHANGE | 56 Leadenhall Street, London EC3A 2DX LME.COM
Tel +44 (0)20 7264 5555 | Fax +44 (0)20 7680 0505 | Email info@lme.com

7 The LME would note that, even prior to the introduction of the Rule, the behaviour of Affected Warehouses has altered. In particular, of the five warehouses with queues at the beginning of the Consultation on 1 July 2013:

- Impala Antwerp, Pacorini Johor and Pacorini New Orleans have all demonstrated net load-out, with the result that queues in all three locations have fallen. As of 31 March 2014, the queue at Impala Antwerp had fallen to 53 days, Pacorini New Orleans to 42 days, and the queue at Pacorini Johor had been eliminated completely. The LME believes that this represents a positive outcome, both in terms of preventing larger queues accumulating at these warehouses, and also in aiding price convergence for the metals delivered primarily at these warehouses (in particular, copper)
- The warehouses with the two longest queues have exhibited either net load-out (Metro Detroit, net load-out of 32,485 tonnes) or broadly balanced load-in and load-out (Pacorini Vlissingen, net load-in of 151 tonnes) since the start of the Consultation. As such, the key driver in respect of queues at these warehouses has been the cancellation behaviour of warrantholders, rather than the load-in behaviour of the warehouses – given that a number of warrantholders have cancelled warrants in order to gain access to metal, queues at these locations have risen. As of 31 March 2014, queues at Metro Detroit were 625 days (compared to 575 days as at 30 June 2013), and queues at Pacorini Vlissingen were 610 days (compared to 518 days as at 30 June 2013)

8 The LME has indicated to the market that the Rule may still be implemented (potentially with revised timing periods), either as the result of an appeal or a fresh market consultation. In either event, were the LME to later implement the Rule (or a modified version thereof), the LME's present intention, subject to any comments received in future representations, is that the Preliminary Calculation Period would commence (as set out in the current formulation of the Rule) on 1 July 2013, and run until the eventual introduction of the Rule. During this period, the LME's present intention is that Affected Warehouses which demonstrate a net load-in of stock would incur greater load-out requirements during the Preliminary Discharge Period (as defined under the reformulated Rule).

9 Based on latest stock data, it would appear that Affected Warehouses are maintaining a broadly neutral balance of load-in and load-out. The LME welcomes this behaviour as consistent with the aim of the LME to ensure that stocks at Affected Warehouses do not grow, given the potential for this to give rise to greater future queues.

B. Enhanced LME investigation and action powers against artificial queues

10 The LME's clear position is that warehouses must not intentionally create or cause, or attempt to create or cause, a queue (including by, but not limited to, the payment of inducements). With its new powers under Clause 9.3.4 of the Warehousing Agreement (which came into effect on 1 April 2014) the LME is

confident that its Special Committee is equipped to take action against the creation or maintenance of any future such artificially created queue.

C. Investigation of premium hedging and related solutions

11 As set out above, the LME believes that its global contract structure is vital in addressing the price discovery and hedging needs of the global metals industry. In particular, market participants who buy metal in one geographical region, and sell in another, are best served by a global price, ensuring efficient hedging (including optimisation of hedge accounting and clearinghouse margin) between regions.

12 Physically-delivered contracts are, by the nature of their construction, settled at seller's option. In the case of a global contract, this means that contracts are generally settled by the delivery of the "cheapest to deliver" warrant available in the global system. As such, the LME price will always converge to the value of this "cheapest to deliver" warrant. A market user wishing to access any other warrant (for example, readily-available metal in North America) will need to pay an additional premium above the LME price.

13 At present, and particularly in respect of aluminium, the "cheapest to deliver" warrant will be in a warehouse with queues. This is because such a warrant will trade at a discount to the market price of free metal given the frictional cost of extracting the queued metal from the warehouse. For the avoidance of doubt, the LME remains committed to addressing the underlying causes of queues, and does not believe that a premium hedging contract is a substitute for such action. However, given the likely timescale for queues to diminish at LME warehouses (including the potential delays arising from legal proceedings as referenced above), a premium hedging contract may be of assistance to the market in respect of queue-based premiums until such time as queues have been managed down by LME rule-making.

14 However, even in the absence of queues, regional premiums may still be observed in the market. If, for instance, short-term demand for metal in North America were to intensify more quickly than in other regions, then North American metal would, other factors being equal, be worth more. In this case, settlement of LME warrants would be expected to move to other regions, with North American warrants commanding a premium to the observed LME price. As such, the LME also believes that an element of premiums is not related to the existence of queues, and that premium discovery and hedging tools have relevance even in an environment in which queues do not exist.

15 Accordingly, the LME has committed to investigate the possibility of a set of premium hedging contracts, which would provide the market with enhanced premium discovery and forward hedging capabilities.

16 The LME has been clear that the substantial effort required to launch such a contract can only be justified if there exists substantial market demand. As such, the LME has engaged with industry participants, including the User Committee and the Physical Market Committee, on the potential for such contracts.

17 Following positive feedback from key market participants, the LME is today announcing its intention to launch a new suite of products which will allow buyers to take physical delivery of readily-accessible metal warrants in specific regions of the world. The contract will initially be deployed for aluminium in three regions (North America, Western Europe and Asia), with the potential for other metals if market demand proves sufficient.

18 The product will sit alongside the LME's existing global aluminium contract. By trading both an existing LME aluminium contract and an associated LME aluminium premium contract, market participants will continue to enjoy access to the LME's liquid global market and reference prices, while also fully risk-managing their exposure to regional market dynamics.

19 Specifically, delivery of an LME premium contract will be effected by a "premium warrant". For example, in respect of North American aluminium, a "premium warrant" will be defined as an LME aluminium warrant in a North American LME-licensed warehouse not subject to queues. In this way, the very substantial tonnages of LME-warranted aluminium in non-queued warehouses, which currently are generally not delivered against the LME contract, can be brought into circulation.

20 The premium contract will be settled by the seller providing a "premium warrant", and the buyer providing a "cheapest to deliver" LME warrant plus cash (representing the regional premium). As such, a buyer who holds a long position on both an existing LME contract and an equivalent-dated LME premium contract will, in effect, be purchasing readily-available metal in a specific region, at a known all-in price (LME price plus regional premium). In this way, the LME will offer hedging for virtually the entire price exposure of an aluminium buyer or seller.

21 A full contract specification has now been defined, which will be shared with all interested market participants. Any parties wishing to engage in this process are asked to contact Oscar Wehtje in LME Business Development (oscar.wehtje@lme.com) for further details.

22 Following this more detailed market engagement, a formal announcement of contract specifications and launch date will be made to the market as soon as possible.

23 The LME expects its new contract to represent a valuable tool for physical metal users' hedging strategies, allowing the market to continue to benefit from a global aluminium liquidity pool, while facilitating effective regional price convergence.

D. Physical Market Committee

24 The LME has already announced the formation of the Physical Market Committee, which will provide a forum for all sectors of the physical industry to represent their views to the Exchange. The Physical Market Committee held its inaugural meeting on 3 April 2014, at which a number of topics (including warehousing) were discussed.

25 Further to the announcement that Professor Phillip Crowson has been appointed as the Chairman of the Physical Market Committee, today the LME is delighted to announce the full composition of the Physical Market Committee. The Committee members are:

- Suzanne Frost (Rexam)
- Robert Hanshaw (Coca-Cola)
- Rodrigo Hernandez (Codelco)
- Xiaoguang Jin (Minmetals)
- Christophe Koenig (Aurubis)
- David Lilley (Red Kite)
- Nick Madden (Novelis)
- Tarun Porwal (ArcelorMittal)
- Tim Reyes (Alcoa)
- Ian Scarlett (Luvata)
- Thorleif Schjelderup (Hydro Aluminium)
- Alexander Schmitt (Anglo American)
- Shaun Verner (BHP Billiton)
- Tim Weiner (MillerCoors)
- Rick Whitby (Mitsubishi)
- Joe Williamson (Southwire)

26 Short biographies of the new Committee can be found in Appendix A.

27 The Physical Market Committee has been composed to ensure balanced representations across metals and industry sectors, including all segments of the metals value chain. The LME thanks all of the above members for their commitment to the LME and the Physical Market Committee.

28 Related to the development of the Physical Market Committee, the LME has also modified the structure of the Warehousing Committee. For the avoidance of doubt, the Warehousing Committee does not exercise any executive powers in respect of approving or delisting good delivery locations, warehouse companies or warehouse sheds, and is an advisory body which channels the views of warehouse operators to the Executive and Board of the LME. The views of the market (as users of warehousing services), previously represented by independent members of the Warehousing Committee, are now voiced through the Physical Market Committee.

29 Accordingly, the LME believes it appropriate to ensure that all LME-licensed warehouse operators have the opportunity to be represented on the

Warehousing Committee. The following individuals have been nominated by their companies:

- Adam Bell (SH Bell Company)
- Charles Bucknall (Impala Terminals Group)
- Hans Cleton (Independent Commodities Logistics BV)
- Alec Gunn (Erus Metals Ltd)
- John Harvey (Henry Diaper & Co Ltd)
- Graham Hawkins (Henry Bath & Son Ltd)
- Willem Jan de Geus (Metaal Transport BV)
- Chris Jonker (C. Steinweg-Handelsveem BV)
- Fritz Lippens (Metal Terminals International BV)
- Simon Maddocks (CWT Commodities (Metals) Pte Ltd)
- Alex Nizan (Worldwide Warehouse Solutions UK Ltd)
- Guillermo O'Shea (Halley Metals Iberica SA)
- Sue Smith (Keystore Ltd)
- Bart Van Gils (Zuidnatie NV)
- Christian Vollers (Vollers Hamburg GmbH)
- Peter Waskzis (Pacorini Metals Vlissingen BV)
- Chris Wibbelman (Metro International Trade Services LLC)
- Colin Wilson (Edgemere Metal USA LLC)

30 Fabian Somerville-Cotton (Independent Chairman) and Phillip Crowson (Chairman of the Physical Market Committee) also sit on the Warehousing Committee.

31 The newly constituted Committee held its first meeting on 26 March 2014.

E. Logistical Review

32 As announced in Notice 14/039 : A037 : W024, global management consultancy Oliver Wyman has been appointed by the LME to provide the LME with a logistical review (the "Logistical Review") of the LME warehousing network.

33 The Logistical Review has seen considerable interest from market participants. In Notice 14/068 : A065 : W033 the LME invited all interest market participants to participate in the Logistical Review and offered locations, dates and times for one-to-one appointments with Oliver Wyman. To-date, 19 meetings have been held.

34 A public report of Oliver Wyman's logistical review report is due for delivery by the end of August 2014. In parallel with the report, the LME will announce any

changes which it proposes to implement, and the mechanism (market consultation or otherwise) by which such changes might be brought into effect. Any changes recommended by Oliver Wyman but not accepted by the LME, if any, will be clearly visible by the LME by reference to the independent Oliver Wyman report.

F. Warehousing Agreement Legal Review

35 As announced in Notice 14/039 : A037 : W024, in parallel with the Logistical Review, the LME has commissioned a legal review (the "Legal Review") of the Warehousing Agreement. This will be conducted by Addleshaw Goddard LLP, and will focus on (i) ensuring that the Warehousing Agreement remains fit for purpose, and (ii) implementing any proposed changes arising from the Logistical Review.

36 Any proposed changes arising from the Legal Review will be announced to the market in parallel with the publication of the Logistical Review.

G. Steel

37 The separate load-out rate for steel was implemented on 1 April 2014 as scheduled. The LME steel contract has seen further positive reaction in respect of price convergence, as steel is no longer subject to load-out queues of other metals.

38 This price enhancement, combined with the regionalisation of the steel billet contract to Europe, now positions the LME to explore the next steps in the development of its ferrous offering, which may include enhanced marketing of the existing billet contract, as well as the launch of new physically- or financially-settled contracts. Any parties wishing to engage in this process are asked to contact Robert Fig in LME Business Development (robert.fig@lme.com) for further details of the options currently under consideration.

H. Warehouse data transparency

39 As of 1 April 2014, the LME has the power under the Warehousing Agreement to publish stock information on a per-warehouse level.

40 The LME believes that such information will be of assistance to metal owners in understanding the quantity of stocks, and the length of queues, at particular warehouses. However, as set out in the Consultation Report, the LME does not wish to create a "high-frequency" warrant trading market, and hence believes that the published data should be directly relevant to the physical market. Additionally, it is considered preferable to publish data on a delayed basis, although with sufficient timeliness to ensure that the information remains relevant to physical users.

41 The LME has defined a reporting format, and discussed this with all of its metal committees, Warehousing Committee, User Committee and Trading Committee. The format has now been agreed and will include the following categories of information for each warehouse: waiting times in days for each metal; opening stock; delivered in; delivered out; and closing stock broken down into live and

cancelled tonnage. This report format has now been finalised, and a template is set out at Appendix B.

42 Delayed, per-Warehouse stock information will be published on the 10th day of each month or the first business day thereafter. Thus, the first report will be disseminated on 12 May 2014 for warehouse activity in April 2014.

43 Queue lengths are currently reported to the LME by warehouse operators. The LME is intending to produce a standardised template for the calculation and reporting of queues, to provide a consistent set of assumptions on which queue lengths are based.

I. Commitments of Traders report

44 The Consultation highlighted a more general market demand for broader transparency – in particular, the publication of a commitments of traders ("CoT") report.

45 The CoT report will classify the LME's market open interest by category of market participant, and be published on a daily basis. These categories will be consistent with the format utilised by the CFTC, namely:

- Producer / merchant / processor / user
- Swap dealer
- Managed money
- Other reportables
- Non-reportable positions

46 In the first instance, LME members will be asked to classify their clients into these categories, based on the classification of those clients in reporting to the CFTC or other exchanges – or, in the case of clients which do not currently hold positions on other exchanges with a similar CoT regime, on the basis of members' assessment of which category is most appropriate to the client in question.

47 The market is asked to note that the CoT report will be materially affected by the classification of certain large market users, whose activities arguably fall into multiple categories. Additionally, the practice by members of entering into OTC contracts with their clients, combined with the netting of member business placed on-exchange, will inevitably result in the published CoT data reflecting only a subset of the total activity conducted within the LME ecosystem.

48 The CoT report is on track for first delivery in Q2 2014. A Notice will be published in the near future to apprise members of the process for client categorisation.

J. Information barrier requirements

49 As outlined in the Consultation Results Notice, the LME believes that its information barrier policy represents best market practice. The requirement for annual audits gives the LME significant confidence that its rules are being

applied by warehouses, and the LME has not identified any actual harm arising from vertical ownership structures.

50 However, the LME is committed to ensuring that it continues to embrace market best practice. Accordingly, external counsel has now undertaken a review to assess the suitability and sufficiency of the information barrier requirements in achieving their stated aims.

51 This review has now been concluded. The conclusions reached by external counsel support the LME's view that the LME's information barrier requirements generally provide for a robust and effective compliance framework to protect Confidential Information held by Warehouse Companies, the possession of which by third parties (including Trading Companies) could otherwise give rise to conflicts of interest and, potentially, market abuse. The review has, however, helpfully recommended certain modifications to the existing requirements which the LME believes will further enhance certain aspects of the information barrier requirements.

52 The LME is currently undertaking a consultation with the market on these proposed changes. Further details can be found in Notice 14/110 : A107 : W049.

K. Assessing viability of limiting rent in queues

53 Because the subject of limiting rents in queues represents a key element of the High Court's judgment in respect of the Consultation, the path forwards in respect of this option will depend on the LME's response to the judgment.

L. Rents and FoTs

54 In the report of the Consultation, the LME noted market concerns as to high levels of rents and FoTs (collectively "charges") levied by warehouses. Accordingly, the LME proposed "three lines of defence" against increased charges.

55 The first line of defence is the LME's statement that a disproportionate increase in charges as a response to new rules would be unhelpful for the market.

56 On 30 December 2013 the LME published a schedule for rents and maximum FoT charges applicable to LME warehouse warrants for the period 1 April 2014 to 31 March 2015 via Notice 13/376: A360: W154. The rate of increases in both rents and FoTs has demonstrated a marked reduction for this rent year.

57 The second line of defence is the potential for the LME to increase the Rule's decay factor in response to a substantial increase in charges. To the extent that the Rule is implemented in future, as a result either of an appeal or a re-consultation, this option would remain open to the LME.

58 The third line of defence is the LME's stated aim of delivering a structural solution to address the market's concerns as to queue lengths. The metals market is facing challenges with respect to queue-related premiums due to a number of factors. The LME remains committed to finding solutions to these issues where appropriate.

59 Given that the third line of defence engages similar issues as in the consideration of capping rents in queues, the LME proposes to consider the two matters in parallel, with the path forwards depending on the LME’s response to the High Court judgment.

Matthew Chamberlain
Head of Business Development

cc: Board directors
User Committee
Warehousing Committee
All metals committees

Appendices:

A. Biographies of Physical Market Committee members
B. Format of per-warehouse data report