



# Consultation on warehouse reform: Feedback analysis

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# 1 EXECUTIVE SUMMARY

On 29 March 2019, the London Metal Exchange (“LME” or the “Exchange”) released a discussion paper (the “discussion paper”), outlining a number of proposals put forward by both the LME Warehousing Committee, and the LME itself, in respect of possible reforms to its global physical network. These reforms were designed to ensure that the LME network represents best practice for physical market infrastructure storage and logistics. On the basis of the feedback received to the discussion paper, and the LME’s own analysis, the LME launched a market-wide Consultation (“Warehouse Reform Consultation” or “Consultation”) on those items in the discussion paper which it believed represented positive progress for the LME warehouse network. Further, the LME also consulted on a number of other proposals which were not included in the discussion paper, but on which the LME believed further action was appropriate.

The Consultation feedback period closed on 12 September 2019 and 13 responses were received. Following careful consideration of the responses, the LME has decided to implement all of the Consultation Proposals, as they were set out in the Consultation. This report provides the LME’s summary of the feedback received in respect of the Consultation, the LME’s analysis of that feedback, and an outline of next steps where relevant.

The Consultation Proposals will be implemented and take effect on 1 February 2020, with the exception of CP15 (in relation to the Complaints Procedure), which will be implemented and take effect on 15 November 2019.



## **2 RESPONSE OVERVIEW**

### **2.1 Consultation respondents**

In total, the LME received 13 responses to the Consultation. Not all respondents submitted feedback on each proposal of the Consultation.

The LME would like to thank these respondents for taking the time to reply and for all the comments and feedback provided. The Exchange appreciates that, in many cases, considerable time and effort has been invested by respondents in formulating their responses.

### **2.2 Consultation responses**

The Consultation was divided into three sections:

- (i) Strategic proposals put forward by the LME Warehousing Committee
- (ii) Operational proposals put forward by the LME Warehousing Committee
- (iii) Other proposals put forward by the LME

Within this structure, the LME outlined the various reform proposals and asked a number of Consultation proposals (“CP”) for the market to address specifically (although for the avoidance of doubt, the LME accepted responses structured in all forms). The feedback to these questions is addressed in turn in Section 3 below, along with the LME’s analysis and comment.

The LME has considered all responses in full. The fact that any particular point raised in any particular response is not expressly included in this document does not indicate that the LME has not considered it.

### **2.3 Capitalised terms**

Terms defined in the Rules and Regulations of the LME (“Rulebook”) shall have the same meaning in this report, unless stated otherwise.

### **2.4 The LME's financial interest**

As the market is aware, pursuant to the LME stock levy, the LME receives 1.1% of the rent charged by LME-licensed warehouses on LME-warranted metal (including metal waiting in queues, subject to the same terms as Queue-Based Rent Capping). This rate has not increased since 2002, and the LME’s decision-making process, and its conduct of the Consultation, is not influenced by the existence of the stock levy. The LME’s focus on ensuring that prices can be effectively discovered on the LME is essential in order for the LME to ensure that the market functions in an orderly manner in accordance with its regulatory obligations; this is also important to the LME’s value as an ongoing business.



## 3 ANALYSIS OF CONSULTATION RESPONSES

### 3.1 Evergreen rent deals [CP1]

Within the logistical optimisation section of the Consultation, the new and potential restrictions proposed to evergreen rent deals generated a number of responses. When describing evergreen rent deals the Consultation also referred to them as “lifetime rent deals” and “post-sale economic arrangements.” Additionally, the Consultation defined them as any agreement between a warehouse company and a metal owner which confers on that metal owner the right to some formulaic share of economics (calculated as revenues or some other measure) received by the warehouse company in respect of metal underlying an LME Warrant, for a period of time subsequent to the sale of the metal by that metal owner as agreed between those two parties, or until that metal is loaded-out of the warehouse by a subsequent owner.

In the Consultation the LME proposed to place a restriction, potentially from February 2020, whereby only the metal owner that places the metal on warrant may enter into a revenue sharing deal with a warehouse (although this rule would not apply to deals entered into before February 2020). Furthermore, the LME reserved the right to extend the restriction to require an evergreen rent deal to terminate upon cancellation of the warrant, or when a metal owner writes to the warehouse company to express their wish to terminate. Finally, the Consultation made clear the existing position that a warehouse may not disclose the identity of any subsequent metal owner to someone with whom they have a post-sale economic arrangement.

A number of respondents affirmed that they were supportive of the Consultation’s evergreen rent deal proposals. Of those that provided more detailed responses, the opinions tended to fall into three categories. The first category included those who were supportive of the proposed restrictions, and those that went further in respect of implementation timeline, calling for the LME to immediately implement the requirement for evergreen rent deals to terminate at cancellation or on written request of the metal owner. The second category of responses also tended to be supportive, yet requested the LME enhance the currently proposed restrictions to evergreen rent deals, and the final category believed rules regarding evergreen rent deals to be outside of the LME’s remit.

For those in the first category, one respondent argued that immediate implementation of the requirement that evergreen rent deals end at cancellation would be particularly useful as they felt a warehouse company’s hands were tied when they entered into an evergreen rent deal. This is because, they asserted, they would not be able to accommodate any new warrant holder looking for a deal, as the metal would already be subject to a pre-existing evergreen rent deal. This, they argued, hindered new stock coming on warrant. Another respondent commented that not having deals end at cancellation created friction – under the current rules, it is possible that metal would have to be cancelled, loaded out and physically moved to a different warehouse (often in the same location) for the new owner to achieve lower storage costs.

Respondents in category two, in a similar vein, argued for additions or amendments to the proposed deal restrictions proposed in the Consultation. Building on the proposed implementation of clause 9.3.8, some respondents requested a further restriction that would prohibit evergreen rent deals for metal that was previously on Exchange to be moved to another LME warehouse within the same location. These respondents argued that without this rule, metal owners would continue to be incentivised to move metal to a new LME warehouse to receive an evergreen rent deal if they could not achieve one in the existing warehouse. Additionally, one respondent was concerned that the current system of rent shares remained open to sensitive information being passed between



warehouses and metal owners and encouraged further action to prevent this. Furthermore, one respondent argued that the definition of post-sale economic incentives should be widened to include all Free on Truck (“FoT”) and rent discounts, rather than just evergreen or lifetime rent deals.

Only one respondent fell into the third category, and asserted a warehouse company's right to contractual freedom in respect of evergreen rent deals. This respondent stated that the identity of parties with whom the warehouse company decided to share its income is not a matter with which LME should concern itself. Limiting rent deals, this respondent believed, would be beyond the LME's remit and best left to the metal owner and warehouse company.

In answer to those respondents who called for immediate implementation of evergreen rent deals at cancellation (as outlined above) the LME points out that it is reserving the right to introduce such rules via Notice (to be communicated to the market with a minimum of 30 days' notice). This allows for the LME to review the market response to initial changes and act appropriately. In respect of the second group of respondents, the LME does not believe that a prohibition of evergreen rent deals for metal that was previously on Exchange being moved to another LME warehouse within the same location, represents the solution. Metal owners have the right to move their metal as they prefer, and further, this proposal would give rise to significant challenges of tracking the flow of metal between warehouses. In respect of the third group of respondents, the LME considers that it is within its remit to ensure evergreen rent deals are appropriate as part of the LME's key objective of running a fair and efficient market.

In regards to the confidentiality concerns raised by the third category respondent, as highlighted in the Consultation, the LME's confidentiality requirements on its warehouse companies mean that warehouses may not provide confidential information to parties with whom they have a post-sale economic arrangement. In particular, warehouse companies may not disclose the identity of any subsequent metal owner to someone with whom they have a post-sale economic arrangement. Therefore, the LME believes there are sufficient rules in place to prevent prohibited sharing of data. The LME does not believe that limitations on evergreen rent deals are an overreach of the LME's remit. Instead, the LME contends that well-structured rules around evergreen rent deals will ensure core delivery functions of the LME warehouse network are operating effectively.

### **3.2 Headline rents and FoT rates [CP2]**

Headline rents and FoT rates are set by the warehouse companies annually at (or below) rates mandated by the LME. Since 1 May 2016, rents and FoTs have been under a charge freeze, currently scheduled to end for the charge year 2022-23. In the logistical optimisation section of the Consultation, the LME proposed to extend this freeze for a further five years (scheduled to end 2027-28) as, although not likely to materially reduce the current delta between headline rent rates and off-warrant and bilaterally negotiated rent rates, it would ensure that this delta did not increase during the freeze period.

Several responses indicated that they were supportive of a rent and FoT freeze without going into further detail or explanation. More substantial responses to the Consultation can be ordered into three themes, namely; those in favour of raising rents, those who wished the LME would add provisions that would allow for amending the freeze under certain conditions, and, finally, those who wished for a large reduction in headline rents.



One respondent argued that raising headline rents and FoTs increased the financial incentive to put metal on-warrant and would lead to higher LME stocks. This, they argued, was the best way for the LME to proceed. The second group of respondents was supportive, or accepted the freeze; however, they also asked the LME to consider potential revisions in a particular region should “unusual circumstances” (one respondent cited the example of a currency collapse) in that region occur. Another respondent suggested that once a year it should be possible to challenge the charge cap for both FoTs and headline rents. As a final point in this group, one respondent requested that an extension of the freeze should be delayed for an “adequate amount of time”, such that the impact of the current geopolitical environment could be fully analysed before progressing.

The third group of responses requested that the charge cap for both FoTs and headline rents be significantly reduced, rather than be subject to another freeze, therefore achieving caps that would be more in line with off-warrant or bilaterally agreed storage rates. This group asserted that lowering rents would serve to narrow the incentive for metal owners to hold metal off-warrant, and therefore this rent lowering would be the “silver bullet” to what they saw as ongoing market distortions, including lower stocks. They argued that without what they deemed as high rents, metal owners would not be forced to withdraw their metal from the LME warehouse network to save on rent costs. Further to this point, a few respondents commented that with rents more aligned to off-warrant storage rates, warehouse companies would no longer be incentivised to build warehouse queues. Finally, one respondent cited models used by another exchange as an example of how rents could be lowered effectively, leading to higher stocks on warrant.

The LME does not consider it appropriate to raise headline rents or FoTs at this time, as it would only serve to increase the distortion between on- and off-warrant rates. To the respondent who asserted that once a year any warehouse should be able to challenge the charge cap, the LME notes clause 5.3.6 of the Warehouse Agreement, which already allows a warehouse to challenge the rates within fourteen calendar days of the publication of the relevant charge cap. It is the LME’s view that the current process gives sufficient leeway for appropriate action, and allowing for a more frequent amending of the cap would contribute to a more confusing, and ultimately less orderly, market. In answer to those who believe headline rents should be significantly reduced, the LME retains the belief that current rates support a sizeable proportion of incentives on offer for placing metal on warrant, and that in their absence, the motivation for warranting metal would be significantly reduced. The LME believes that the reduction required to make these costs comparable to off-warrant, or even bilaterally negotiated costs is too great to be realistically achievable. Further, even if such rent reductions were achieved, this would not increase the motivation for storing metal on-warrant as they would still be subject to LME load-out rules, transparency requirements, as well as LME requirements more broadly.

### **3.3 Definition of “load-out” [CP3]**

Respondents to the Consultation were supportive of this proposal.

### **3.4 Clarification of FoT charges denomination [CP4]**

In the Consultation the LME proposed to maintain the publication of FoT rates in local currencies, but clarify that it is possible to pay in US dollars or any other currency, subject to the agreement of both parties. The majority of responses received to this proposal were supportive of the proposed clarification, with the exception of one respondent who was in favour of FoT rates being in US dollars which, they argued, was consistent with current rent rates.



The LME maintains its view that market participants should continue to be free to pay in any currency, provided that both parties agreed to the currency in question, and to the conversion rate from the original local currency.

### **3.5 Door wording amendment [CP5]**

Respondents to the Consultation were supportive of this proposal.

### **3.6 Stock reporting clarification [CP6]**

Respondents to the Consultation were supportive of this proposal.

### **3.7 Probation period for new LME Delivery Points [CP7]**

In the Consultation, the LME proposed to introduce a rule which prescribes that in the event that no warehouse applications are received after a six month period for a new delivery location, the invitation to list would be rescinded and the applicant location would be required to submit a new application should they wish to re-qualify.

The majority of responses received were supportive of the proposal. However, one respondent requested that the LME consider a longer timeframe than six months, as market circumstances may dictate that more time is required for listing. Current trade barriers, they argued, may also give rise to new locations being used or not in the short term and a probation period of 12–18 months may be more suitable.

After consideration, the LME is of the view that a six month probation period should be sufficient even when taking into account current geopolitical factors. Further, the LME has also provided some flexibility to allow the extension of the probation period in the event that warehouse company has provided to the LME information regarding a proposed application to operate at such Delivery Point and the LME is satisfied that (i) such application will be provided within a reasonable period and (ii) it has sufficient information to determine that such application will be a substantive application submitted in good faith.

### **3.8 LME discretion on approving new Delivery Points [CP8]**

Respondents to the Consultation were supportive of this proposal.

### **3.9 Review period [CP9]**

Respondents to the Consultation were supportive of this proposal.

### **3.10 Specific ban on sharing queue information [CP10]**

Respondents to the Consultation were supportive of this proposal.

### **3.11 Eligible stock reporting [CP11]**

Within the transparency and compliance section, eligible stock reporting generated the most feedback amongst respondents to the Consultation, as well as the largest divergence of opinion. In some cases, respondents only replied to this proposal of the Consultation.





In CP11, the LME proposed to introduce a rule whereby off-warrant stock would need to be reported by warehouse operators if (i) their storage agreement with a metal owner specified that metal must be held in an LME-registered shed (including metal not eligible for warranting metal), (ii) their storage agreement specified that metal could be warranted on request of the owner (including metal that was not currently held in an LME Delivery Point), or finally, (iii) the metal owner voluntarily requested that the warehouse disclose the stock to the LME.

Reporting under the new rule (contained in clause 6.3.4 of the Warehouse Agreement) will commence on 10 March 2020 (in respect of the quantity of metal held by the Warehouse on the final day of the preceding calendar month of February 2020). Before that date, the LME intends to develop and publish, through the Warehouse Committee, further guidance on how to ensure compliance with the new reporting obligations (including a reporting template).

Feedback to CP11 can be broadly organised into three categories: those who agreed with the transparency the proposed eligible stock reporting would offer, but suggested further amendments; those who wished to understand how the reporting would operate in practice; and, finally, those who felt that such reporting would be impossible to implement effectively and questioned the LME's jurisdiction over such data.

In the first category, many respondents expressed general support for the principle of improving transparency; they felt that this was a critical issue facing the industry, and welcomed the LME's eligible stock reporting requirements. Respondents in this group voiced concerns that a lack of transparency pervaded the industrial metals market, with one respondent citing aluminium as an example. This is because, they asserted, off-warrant aluminium is not tracked consistently, and therefore price discovery is not working efficiently. They further suggested that those against such reporting were largely of that view due to the gains they felt could be achieved by storing metal off-warrant, and therefore unseen by the market. Other respondents in this group emphasised that although the Consultation's proposals for eligible stock reporting were a good first step, they felt that the requirements should go further to promote transparency. These respondents suggested that voluntary stock reporting would be a "non-starter" and market participants should be required to report stock. Additionally, it was suggested by one respondent that monthly reporting would not significantly improve the transparency the LME was looking to achieve, and instead weekly reporting should be considered.

The respondents in the second category were not necessarily against the eligible stock reporting requirements proposed in principle. However, they did assert that there were still many uncertainties around how the proposals would work in practice. One respondent emphasised that warehouse companies are often asked by metal owners to store metal that is not suitable for LME delivery (for example, because of metallurgical composition) and questioned the utility of reporting this data to the LME. It was asserted by another respondent that only metal that is of an LME brand should be reported. Clarification was also requested, by one respondent, as to how a location should be reported for metal that was stored in a non-LME delivery point. Finally, respondents in this group also wished to have further details as to how this data would be audited, with one respondent emphasising the need for LME auditors to review warehouse company and metal owner storage agreements. Respondents cautioned that, without effective auditing, those seeking to use such data would not be able to rely on it.

The third category of respondents believed that the LME's eligible stock reporting proposal was both impossible to impose and the request to submit such data was an overreach by the LME that would lead to a change in market trading behaviour for the worse; further, that the LME does not have the



“right” to such data on the basis of its standards, because those standards are equally met by warehouses operating in non-LME locations. Respondents argued that on a practical level, warehouse companies could circumvent the rules by excluding the possibility of future warranting in their storage agreements and instead agree this verbally only, and that the inclusion in scope of metal not eligible for LME warranting was concerning, especially given that its ineligibility for warranting rendered it irrelevant to the LME. Additionally, it was argued by this group that warehouse companies would have to break their non-disclosure agreements (“NDAs”) with metal owners in order to comply with the eligible stock reporting requirements. One respondent also argued that changes would actually allow for greater potential data manipulation as, for example, 100k tonnes of eligible metal could appear “out of nowhere”, and just as easily disappear, depending on what a party wished to report. Moreover, this group also suggested that eligible stock reporting requirements would change trading behaviour as it would, as one respondent asserted, encourage metal owners to move affected metal away from LME storage and into non-LME affiliated warehouse locations, and reduce competition as traders would no longer be able to fulfil “just in time” deliveries in a more transparent market. Certain respondents took issue with the definition of “LME Facility Storage Agreement” including metal which would not be eligible to be put on warrant, but where the metal owner wishes the metal to be stored in an LME-registered facility. In general these respondents saw the LME’s proposed powers in this area as over-reach.

Finally, one respondent argued that off-warrant stock data should be considered as the property of warehouse customers (metal owners) and not the LME or even the warehouse company, and therefore any reporting of such material would be an overreach by both entities. Instead, this respondent suggested that an approach the LME could take that would be both within the LME’s jurisdiction and deal with the problem of large clips of metal appearing on warrant overnight, could be to impose eligible stock reporting prior to LME warranting as a requirement for warranting. In this scenario, metal would have to be reported as eligible at least seven days prior to warranting. Reporting would be done upon request of the metal owner and submitted to the LME by the warehouse operator as part of its daily stock report. In this scenario, the respondent asserted, the LME could generate data which is meaningful to the LME ecosystem without forcing licensed warehouse operators into a conflict of interest with their non-LME client base.

In respect of these comments, the LME would make the following observations:

- The off-warrant stock reporting proposal is, in the view of the LME, an appropriate and proportionate response to an area of increasing market concern. It is clear to the LME that, over recent years, a shift has occurred from on-warrant to off-warrant storage. While this is not in itself problematic (given that metal owners must have the right to choose their preferred storage approach), the consequent reduction in market transparency has caused specific concerns to users of the LME’s trading market. In particular, the fact that warranted stock may now represent only a small portion of warrantable metal has been cited as causing technical tightness in the futures market, which is not justified by the fundamental conditions of broader physical metal supply.

Furthermore, the LME believes that its proposal fully respects the commercial relationship between warehouses and metal owners. The LME is not attempting to exert any rights over metal held pursuant to a standard physical storage agreement (even where such metal is stored in an LME-registered shed). Indeed, the LME’s proposal in this regard is less restrictive than the “eligible stock reporting” requirements of peer exchanges, which require warehouse operators to report all metal in an exchange-registered shed, regardless of the metal owner’s intentions for such metal.



Instead, the LME's proposal only mandates reporting where the metal storage contract references the Exchange – either by stipulating storage in an LME-registered shed, or by guaranteeing LME warranting. The LME believes it entirely fair – if its name, brand and services are being invoked in a contract – that it places reasonable reporting requirements over the material covered by such contract, irrespective of whether warehouses meet those standards elsewhere. Reporting of LME-related activity is entirely standard for participants in the LME's trading market, and cannot be circumvented by citing non-disclosure agreements or similar devices. If metal owners wish to achieve confidentiality, they are still welcome to do so in physical storage agreements with warehouses – but specific references to LME storage and/or warranting cannot then be used. If the warehouses' contractual documentation currently restricts disclosure of certain information, then the warehouses may need to amend that documentation

- The LME accepts that significant amounts of warrantable metal may not be subject to reporting under the mandated routes (if, for example, references to LME warrantability are removed from storage contracts). As such, the voluntary reporting route will be important – and this route may, at first, not be embraced by metal owners. However, the Exchange will work with the market to highlight the case for voluntary reporting, and, if required, will activate its further powers to incentivise voluntary reporting. The most likely route by which this would be achieved would be to increase the warranting fee for metal owners who could not demonstrate that they had voluntarily reported their stocks at the earliest possible opportunity following purchase. This would further disincentivise the behaviour, predicted by some respondents, that metal owners would store their metal in non-LME locations or in non-LME registered warehouses in order to avoid disclosure – such behaviour would still result in a higher warranting fee (because the metal owner would not be able to demonstrate that they had voluntarily reported their stocks as soon as the metal was acquired). It is acknowledged that this behavioural transition may take time, but the LME believes that such investment of time is justified by the value of enhanced market transparency
- More generally, the LME agrees that it will be necessary to assess the quality of the data generated from off-warrant stock reporting, and in particular to ensure that it will increase visibility for market participants, and not create undue opportunities for “gaming”. This is why the LME is proposing not to publish such data at the outset; rather, the LME will collate and assess the data, and will then determine whether its publication is warranted (or whether further changes should be made to the reporting regime, subject to applicable consultation or other requirements). In terms of frequency of reporting eligible stock, the LME appreciates that more frequent reporting would give way to greater transparency, but believes monthly reporting is an appropriate starting point – but this, like all elements of the reporting regime, will be kept under review by the Exchange
- In respect of data quality, the LME recognises that market participants may try to find “loopholes”, or simply to flout the reporting rules altogether. However, the Exchange benefits from the compliance culture of its key stakeholders (including members, merchants and warehouse operators), and believes that non-compliance will represent the exception. Furthermore, the LME is confident in its auditing rights of market participants, including its ability to cross-reference data from metal owners and warehouse operators. By way of example, the LME's introduction of the Financial OTC Booking Fee was subject to similar concerns in respect of avoidance and auditability; but, in respect of this fee, experience suggests that market participants do comply with the rules
- The LME will provide detailed reporting guidance (in the form of a reporting template) to warehouse operators. The details of the fields which can be requested by the LME are already covered in the proposed revised Warehouse Agreement (clause 6.3.4)



### **3.12 Daily stock reporting amendment [CP12]**

Responses to the Consultation were supportive of this proposal.

### **3.13 Sanctions [CP13]**

Responses to the Consultation were supportive of this proposal.

### **3.14 LME insolvency powers [CP14]**

In CP14 the LME proposed changes to clause 1.2 of the Warehouse Agreement, together with the introduction of new clauses 9.4 and 9.14 (see appendices E and F of the Consultation for further details). The changes include giving the LME powers to require cash, performance bonds or other assurances from warehouses in certain circumstances – such amounts could then be used, *inter alia*, to help resolve any difficulties with returning metal to its rightful owners in the event of a warehouse bankruptcy. Additionally, the Consultation made clear that the LME will expect warehouse companies to provide such accounts information and forward projections on a timely basis.

The majority of responses received were supportive of the proposal. However, one respondent commented that the proposal is an overreaction to one incident in 2018 and the steps laid out are unnecessary. One respondent challenged the proposed amendment of 1.2.1(ii) requiring a cash-flow forecast for a financial year, asserting that this is of no material benefit in determining capital adequacy.

The LME does not believe CP14 to be an overreaction and believes this proposal can contribute to protecting users from warehouse insolvencies. The LME disagrees with the respondent regarding 1.2.1(ii), believing that a cash-flow forecast can help the LME to determine whether the warehouse has financial difficulties.

### **3.15 Complaints Procedure [CP15]**

Within CP15, the LME proposed a number of changes to its Complaints Procedure, including, without limitation, amending the scope to help ensure that complaints are not dealt with by the LME where a more suitable forum for resolving a dispute between two parties exists, and allowing the LME to levy a registration fee for complaints against third parties (i.e. not against the LME) where appropriate, to reflect the costs that the LME incurs when investigating a complaint.

The majority of responses received were supportive of the proposal. However, one respondent requested further clarification in regards to what was meant by “a suitable forum”. The same respondent also questioned why the LME was proposing a fee as its view was that the current LME warehousing fees ought to cover this.

By the term “suitable forum” the LME is referring to a more appropriate service that settles disputes between commercial counterparties, as the LME complaints procedure is not intended to be a private dispute resolution service. The LME is proposing a fee as it has seen an uptick in the volume and complexity of complaints in recent years, which have cost the LME considerable time and expenditure (both in terms of the time cost of LME staff and third party advisors). The LME believes it is appropriate that the costs of this fall on the parties to the complaint, particularly the party at fault, which is why it has proposed to introduce a mechanism whereby it can recommend that some or all of a successful complainant's registration fee is refunded by the party complained about. The LME notes that paragraph 9 of the revised Complaints Procedure specifies that the registration fee is not



intended to be profit-making for the LME: it is merely intended to cover costs. In the event that the eventual costs exceed the registration fee, the LME will bear these costs.

### **3.16 Applicable law for warrants [CP16]**

Responses to the Consultation were supportive of this proposal.

### **3.17 QBRC Rule parameters [CP17]**

CP17 put forward a proposal to amend the current rules for Queue-Based Rent Capping (“QBRC”) and was one of four CPs that generated a significant level of response. The proposal outlined that the phased element of rent reduction (currently 50% after 30 days, and no rent after 50 days) would be removed, and the overall QBRC threshold would be extended to 80 days. The proposal also stated that the introduction of the new parameters would be carried out on a phased basis, and should market behaviour indicate that the proposal was causing disruption, the LME would reserve the right to stop the phased implementation as well as disapply QBRC.

Respondents could be placed into three categories; those who were supportive; those who believed QBRC amendments should be trialled or only introduced under special circumstances; and respondents who were not supportive of any change.

Respondents in the second category argued to delay the proposal on the basis that changes should not be made until the market conditions made it necessary. One respondent gave the example of excess metal being in the market that could not be warranted due to warehouses refusing further load-in for warranting. This respondent believed implementing the proposed QBRC changes in current market conditions would distort competition dynamics between warehouse companies, giving warehouse companies with larger stocks in a single location a competitive advantage. Respondents who asked for a trial of changes before implementation also requested that the determination of what constituted a successful trial be made clear before it began.

A number of respondents were against any change to QBRC and believed any extension would send the message that the LME now supported excessive load out times, undoing trust built through the 2013-16 warehouse reform process. It was considered by respondents in this group that a QBRC extension would encourage new queues to emerge as warehouse companies altered their load-out behaviour to maximise “dwell time.” One respondent requested clarification from the LME on action the Exchange would take should new queues emerge. Similarly, one respondent maintained there was never a reason for there to be a queue and, consequently, rent should not be payable for any queue time. The chance to increase queue time, it was argued, meant that warehouse companies would be able to pay more to incentivise users to place metal on-warrant.

The LME recognises in a number of these responses a concern from the market that the LME warehouse network could again experience extensive queues and long delays in load-out. The LME is in full agreement with the market that such an outcome would be detrimental to the efficient operation, and indeed, reputation, of its warehouse network.

Equally, however, the LME believes that any such risks have to be balanced against the potential for positive impacts on its market, not least of which is the ability of its warehouse companies to act more commercially in offering storage terms to metal owners.

In assessing this trade-off, the LME believes it useful to consider two vectors of harm which could be caused by the relaxation of the QBRC threshold. The first such vector would be the impact on



warehouse incentives, and the potential for such incentives to “outbid” physical market premia, hence making warehouses a competing consumer of metal. However, it should be noted that the proposed revised 80 day QBRC cap has been chosen so that, in normal market circumstances, warehouses should not be able to offer incentives above usual physical market premia.

Clearly, this will need to be monitored closely. However, the LME believes that it has the relevant tools at its disposal, particularly given its warehouse incentive reporting regime. It is for this reason that the LME is proposing a phased increase in the QBRC threshold – it will, in the view of the LME, be relatively straightforward to assess the impact of the increasing threshold on incentives, and to compare these to physical market premia.

The second vector of harm is the formation of queues. In this regard, it is instructive to consider two scenarios by which queues may form, and the impact on such queues of changes to the QBRC parameters:

- The scenario where a queue forms against the wishes of the warehouse (an “operational queue”). With the exception of the abusive queue model outlined below, the preference of a warehouse is for metal to remain in the warehouse for as long as possible, as this maximises the rent which can be charged by that warehouse operator. Accordingly, the formation of a queue (which implies a significant cancellation activity) will be an unwelcome development, as metal will then leave the warehouse.

Clearly, the warehouse’s lost revenue will be attenuated in such a scenario by the ability to charge rent in a queue – and, an increase to the QBRC thresholds will increase such rent (and, symmetrically, the cost to metal owners of withdrawing the metal will be increased). The LME fully acknowledges that, in the view of certain respondents, this is not an acceptable outcome

However, in the view of the LME, the key point is that the change to the QBRC parameters would not be expected to increase the propensity of an operational queue to form – this would continue to be driven by the cancellation activity referred to above. At worst, it could be argued that the relaxation of QBRC parameters would cause there to be more metal in the warehouse to contribute to the queue (because the warehouse could have offered higher incentives to attract metal). But, the frequency of queue formation should not be increased by the changes to QBRC

- The scenario where warehouses attempt to build a perpetual queue model (“structural queues”), by allowing the formation of a queue, and then incentivising the load-in of a greater quantity of metal than is loaded-out from the queue, propagating an entrenched queue model. Clearly, the harm caused by such a model would be materially increased by an increase in the QBRC parameters. However, the LME’s other powers, and other features of its warehouse rules, restrict the formation of structural queues, and the LME would not expect to see such models arising

In any event, the LME’s phased introduction of the QBRC parameter changes should again allow the impact of such changes to be measured – both in terms of the frequency of queues, and their status as operational or structural (as measured by the balance between load-in and load-out of metal at the queued warehouse).

Given these protections, the LME is proposing to progress with the changes to QBRC as proposed in the Consultation, but will utilise the phased changes to the parameters to actively monitor the success or otherwise of the implementation.



More broadly, the LME does believe it desirable to proceed eventually to a significantly simplified ruleset, based around a 1.5% daily proportionate load-out. As further set out in the Consultation, the LME believes it first necessary to demonstrate that an 80-day QBRC model can operate effectively. To the extent that the QBRC parameter change implementation is successful, the LME would look to consult on the simplification of its ruleset, which it believes would have material benefits for all market participants.

### **3.18 LILO clarifications [CP18]**

In CP18 the LME proposed to introduce new provisions to prevent metal owners from benefitting from their own cancellations, by allowing warehouses to request LME permission to disregard additional load-out requests submitted by metal owners who originally caused the warehouse operator to become LILO-affected. Additionally, the LME proposed amending the LILO rule so that, in respect of calculation periods commencing on or after 1 February 2020, the calculation of a warehouse's cumulative load-in and cumulative normal minimum load-out would only start on the day during the relevant calculation period on which the warehouse became an Affected Warehouse (defined as the Relevant Calculation Date). As such, the LILO requirement would only be calculated in respect of load-in that occurs after the warehouse becomes aware that it is an Affected Warehouse during the relevant calculation period. Thirdly, the LME in CP18 consulted on the introduction of a rule to specify that if a queue falls below 30 days at a particular location during a discharge period, the relevant warehouse company would no longer be required to schedule additional load-out slots pursuant to the LILO Rule during that Discharge Period.

The majority of responses received were supportive of the proposal. However, one respondent disagreed with the LILO clarifications asserted in CP18. This respondent argued that disapplying LILO at the discretion of the LME would create uncertainty and in their opinion the rule should either be clarified or remain as drafted in the existing rules.

The LME believes it has a clear framework of rules to provide appropriate certainty and notes that the discretion to disapply the LILO Rule already exists in the current version of the Policy (in Paragraph C8 of the LME Policy on the Approval and Operation of Warehouses ("AOW policy") currently in force). The LME considers it necessary to retain this discretion (now contained in Paragraph C6 of the proposed amended AOW policy) to dis-apply the LILO Rule, in exceptional circumstances and where a market participant requests it to do so, in order to prevent abuse and/or preserve the orderly functioning of the market, or if it is otherwise proportionate to do so. The LME's suggested changes clarify the use of this discretion and, as such, the LME considers such changes appropriate to provide market certainty while allowing it to exert appropriate oversight of the market.

### **3.19 AOW Policy housekeeping changes [CP19]**

In CP19 the LME proposed to update the Amendments to the AOW policy including clarifying the obligations on warehouses in respect of the minimum daily load-out tonnage and related obligations.

The majority of responses received were supportive of the proposal. However, one respondent believed that some of the text in Section C was now too vague, including the terms "without undue delay", "time-zone issues" and "completion of formalities."

The LME believes these terms are appropriately defined, and so does not intend to further modify those terms in Section C outlined by the respondent.



## 4 CONCLUSION

After due regard to the responses received to the Consultation, and in light of the observations made in this paper, the LME has decided to proceed to implement the warehouse reform in the unamended form in which it consulted the market. The LME is committed to ensure that its warehouse network represents best practice to support its market, and this objective was echoed by a number of respondents. Again, the LME would like to thank all its stakeholders and other market participants who have contributed towards the LME's 2019 warehouse reform, in particular its Warehousing Committee.

