

To: All Members, Warehouse Companies and London Agents

Ref: 13/326 : A312 : W125

Date: 7 November 2013

Subject: **RESULT OF CONSULTATION ON CHANGES TO LME POLICY REGARDING THE APPROVAL OF WAREHOUSES IN RELATION TO DELIVERY OUT RATES**

## Summary

1 Notice 13/208 : A201 : W076 (the “Initial Notice”) initiated a three-month market consultation (the “Consultation”) in respect of the Linked Load-In / Load-Out Proposal (the “Proposal”). Over the course of the Consultation, the London Metal Exchange (the “LME”, or the “Exchange”) has held meetings with every market participant who has so requested, resulting in a deep and productive engagement across the global metals industry. Additionally, 33 market participants (of which several were industry groups, representing a larger number of underlying members) chose to submit written responses to the Consultation.

2 The LME Executive and Board have given the greatest possible focus to both written and oral responses received, and engaged in significant discussion on this topic. As such, the LME is confident that every relevant action has now been taken to understand, analyse and formulate policy in respect of this topic.

3 Accordingly, the LME has confidence in laying out a detailed, practical and balanced package of measures which, in the opinion of the Exchange, will address the issues identified in the Consultation, and deliver an optimised and best-in-class physical storage network which will continue to support the LME’s role as the global venue for non-ferrous base metals price discovery.

4 This Notice lays out the LME’s key conclusions and decisions arising from the Consultation. In addition, the Exchange has decided to publish a full report of the Consultation. In making the decision to release this substantial analytical work to the market, the LME hopes to illustrate the breadth and depth of the Consultation, and to demonstrate that all views raised have been fully considered by the Exchange in reaching its conclusions and in making its decisions.

5 It is crucial to note that the Consultation has revealed a very significant polarisation of opinion in respect of this topic. The LME fully recognises the right of all market participants to hold their own view. However, in basing its decision on a detailed Consultation process, the Exchange is confident that it has reached an independent decision reflecting the best possible approach for the market. Furthermore, following the adoption of this package of measures (and subject to the



ongoing review measures set out in this Notice), the LME reminds market users that – as a regulated market – there must be a single set of rules by which all participants abide.

### **Assessment of the global metals market**

6 Following extensive work in the Consultation, the LME believes that the effect of queues is to create a discount between the free market price of metal, and the value of an LME warrant in a warehouse with queues. By extension, this causes the LME price to trade at a discount to the free metal price. This is then observed by the market as the free market price of metal trading at a premium to the reported LME price. Although there will always be a premium due to the “in-warehouse” nature of the LME contract (requiring, for example, the payment of an FoT load-out charge to convert an LME warrant into free metal), the effect of the queues is to increase this premium as a proportion of the “all-in” free metal price.

7 While the LME does not believe that the effect of queues is indicative of economic or market failure, the Consultation has clearly indicated that the existence of the increased premium that excessive queues cause creates significant difficulties for the metals community in respect of both discovery of the “all-in” price, and effective hedging of that price. Accordingly, it is appropriate to take action to address this issue.

### **Action: Reduce queues via implementation of the Linked Load-In Load-Out Proposal**

8 While the LME fully accepts that there may exist other routes to ameliorate the problem (which are separately considered in this Notice), and which routes the LME does not rule out taking if necessary and feasible, the fundamental role of the queues in increasing premiums and thus creating price discovery issues must surely mean that the most logical course of action is to address the existence of those queues. This will allow the LME to better deliver a market of last resort to physical metals users. This is the core intent of the Proposal, and the Exchange affirms this aim.

9 Furthermore, in the context of the Consultation, no alternative course of action to address queues has been proposed which, in the opinion of the Exchange, better balances the need to manage queues down within the practical and legal framework under which the LME operates, the logistical constraints of certain warehouse facilities, the equitable right of warehouse operators to recoup the significant investment made in LME facilities, and concerns from producers as to the effects of large quantities of stored metal being discharged into the market over a short period of time.

10 As such, the LME confirms that it will proceed to implement the rule laid out in the Proposal, subject to certain modifications as set out below (such rule, together with the modifications, the “Rule”).



### *Queue threshold*

11 Significant attention from respondents in the Consultation has focused on the queue threshold above which a Warehouse becomes an Affected Warehouse, and hence subject to the Rule.

12 The original decision to set the threshold at 100 days was driven by the Exchange's assessment that metals users do not generally make use of LME warrants as a direct element of their metals sourcing strategy, preferring instead (even in the absence of queues) to employ the services of merchants to deliver metal of a given brand and shape to a particular location. As such, the 100 calendar day threshold was chosen not because the LME believes that this represented an appropriate waiting time for physical metals users, but rather because the LME viewed the queues as drivers of premiums, and believed that queues capped at 100 days would appropriately mitigate the impact on premiums.

13 The Consultation has confirmed the view that physical users are unlikely to make significant direct use of LME warrants as a direct avenue of metal sourcing, even in a non-queue environment. However, many respondents have suggested that the LME's role as a market of last resort should require warrants to be accessible within the sourcing horizon of a physical metals user. This would further have the effect of rendering the LME price more comparable to the free metal price charged by a merchant, as one of the key elements of the merchant premium (ready access to metals, in contrast to queued LME warrants) would fall away. The Exchange therefore agrees that a lower queue threshold would have desirable consequences for users.

14 The logistical argument against a lower (or even zero day) queue threshold is that any warehouse (even one prioritising quality of logistical service) has the potential to accumulate a queue if multiple warrant holders cancel simultaneously (which may be driven by an exogenous economic event). It is not felt desirable to subject warehouses with "operational" queues to a set of requirements which are designed to address "structural" queues, particularly given the need to incentivise continued investment in the LME warehouse network (see paragraph 28 below).

15 As such, the appropriate approach is to reduce the queue threshold to the point where a material risk of catching purely "operational" queues under the Rule would not arise. As a result of the views expressed in the Consultation, the Exchange considers the appropriate threshold to be 50 calendar days – and, at this level, the Exchange is confident that the contribution of queues to premiums will be appropriately mitigated.

16 The Exchange will continue to keep this figure under active review. In particular, if the metal user community demonstrates a desire to make direct use of LME warrants for metal sourcing, this would be viewed by the Exchange as a persuasive argument for a future reduction in the queue threshold. Furthermore, as explained further in paragraph (37) below, the LME will reserve a general power to take specific action against Warehouses which it considers to have intentionally created queues, even if such



queues remain below the threshold.

### *Decay factor*

17 Consultation respondents have additionally focused on the 0.5x decay factor in the calculation of the Cumulative Incremental Load-Out Requirement. In very simple terms, this requires that the Rule must be in operation for two Business Days to remove one calendar day of accumulated queues.

18 Again, the formulation of policy in this respect will require the LME to arrive at a compromise between the demands of metals users (who, in general, wish to see a higher decay factor, given that this will both increase the flow of metal out of the warehouse, and cause queues to shrink more quickly) and warehouses (for whom an increased decay factor could give rise to greater obligations, which may act to make the Rule less practically workable for warehouses with logistical constraints as a result of historical decisions as to their construction).

19 However, in the view of the Exchange, the first-order effect (increasing queue decay) is less significant than the second-order effect (decreasing the willingness of warehouses to pay a significant incentive for metal). Even if queues will take several years to fall below the threshold (which is the likely scenario for certain of the Affected Warehouses), those Warehouses will be incentivised by the Rule to restrict load-in further compounding queue lengths for fear of giving rise to significant load-out obligations – and this phenomenon has already been reported (presumably on the basis that warehouses expect implementation of the Rule) during the course of the Consultation. As such, the willingness of warehouses to pay high incentives to any metal owner would be expected to be mitigated in the short-term, in advance of the queue itself coming under control.

20 On this basis, the LME does not propose to modify the decay factor in light of the Consultation. However, the Exchange understands that this is a key policy lever, and therefore intends to keep it under review and to make further necessary corrections on either a systemic basis, as set out in paragraph (25) below, or per Warehouse, as set out in paragraph (37) below.

### *Rents and FoTs (“Charges”)*

21 The possibility of increased Charges as a result of the Rule was highlighted in the Initial Notice. Furthermore, a number of Consultation respondents have commented that (even in advance of any potential future increase), warehouse Charges are already too high.

22 Following considerable analytical work, the LME does not believe that the warehouse market is uncompetitive. However, as has been known for some time, there does exist a model of warehousing use (under which a metal owner warrants metal and then immediately sells that warrant) whereby competition between warehouses is



conducted not on the basis of low Charges (which will be substantially paid by the buyer of the warrant, who does not control the choice of warehouse), but on the basis of high incentives (which are paid to the initial metal depositor, who does control the choice of warehouse). Ultimately, as explained in paragraph (6) above, the value transfer between seller and buyer is priced-in to the level at which the warrant trades between the parties (and hence the LME price). As such, whilst this does not represent a market failure, it does give rise to potential significant difficulties in price discovery and hedging as explained in paragraph (7) above.

23 The ability of warehouses to pay incentives, and hence the motivation to levy high Charges, is significantly (although by no means totally) linked to the existence of queues. As such, the long-term impact of the Rule in reducing queues will, the LME believes, eventually put downward pressure on Charges. If warehouses were to seek to increase their Charges by way of response, the risk of a distortive impact on price discovery and hedging would very likely remain.

24 There is currently considerable user, regulatory and political scrutiny of the LME warehousing system. Any attempt by warehouses to increase their fees in the short term is likely to be viewed in an extremely negative light by key market stakeholders.

25 Furthermore, the LME views the issue of high Charges as interlinked with the issue of queues, given that the worst-case “embedded revenue” for a Warehouse is found by multiplying per-warrant queue length by the rent, and adding the FoT charge. In particular, the Exchange’s decision not to increase the decay factor, as explained in paragraph (20) above, has been made on the basis of fee structures as currently conceived. To the extent that submitted 2014 rents demonstrate an increase, the LME will consider the extent to which an appropriate and proportionate policy response would be an increase in the decay factor so as to protect against the distortive effect such increases may have on price discovery and hedging.

26 Many consultation respondents expressed concern with existing high Charges and requested that the LME take action to regulate the LME warehousing system by capping Charges. This is an ongoing issue and the LME recognises that there is considerable public interest in tackling it. Accordingly, the Exchange has in train a legal review of the parameters for action in this regard.

#### *Other unintended consequences*

27 As laid out in the Initial Notice, a core concern for the market is the potential lack of willingness of a Warehouse to accept large quantities of metal for warranting given the potential for that Warehouse to incur obligations under the Rule. The Consultation has revealed that, in the economic short-term, operators of non-Affected Warehouses are ready and willing to make up any shortfall in warranting capacity resulting from the impact of the Rule on Affected Warehouses. However, short position holders on the LME are reminded that it remains their responsibility to ensure that warranting capacity exists for metal they intend to deliver in settlement, and such shorts may need to ship



metal to non-Affected Warehouses in order to ensure load-in.

28 In a cross-cycle economic context, the Exchange accepts that the existence of the Rule may disincentivise investment in new LME warehouse capacity in a time of net load-in (such as seen during the last economic crisis). While the Exchange is confident that economics will still act to create new capacity, the market should be aware that the costs of warranting may increase in such a scenario.

29 The Exchange fully accepts that a probable effect of the Rule will be to reduce the quantities of metal within the LME system. However, the LME believes that the natural demand drivers for LME warehousing (including the need for deliverable warrants and the verifiable service standard provided by LME-licensed warehouses) will remain – and, furthermore, that addressing the issues of queues and Charges should further enhance the attractiveness of the LME warehouse offering.

30 A number of respondents have indicated that, should a Warehouse experience difficulty in increasing load-out under the Rule, there will exist greater scope for conflict between warehouses and metal owners around logistics – and, in particular, the treatment of metal owners who fail to meet their load-out slots. If such issues become apparent in respect of a given Affected Warehouse, the LME will be empowered to issue location-specific logistical guidance clarifying the responsibilities of both warehouse operators and metal owners.

#### *Technical and logistical issues*

31 The issue of re-warranting (i.e. the decision by a metal user in a queue at a particular Warehouse to reverse the load-out request and return that metal to warrant in the same Warehouse) continues to cause significant confusion in the market. The LME reaffirms that Warehouses are not permitted to use re-warranting in order to reduce their total load-out – regardless of re-warranting behaviour, the total amount of physical metal leaving a Warehouse must comply with the minimum load-out requirements. As such, the effect of re-warranting is simply that owners sitting later in the queue than the re-warranted metal are invited to move their slots forward. Any attempt to re-warrant at a point close to the scheduled load-out date, such that the slot could not be practically offered to a player later in the queue, would be immediately visible to the LME in respect of metal load-out rates, and may be viewed as abusive conduct on the part of the Warehouse that would expose it to the possibility of disciplinary action pursuant to its Warehouse Agreement.

32 Accordingly, the intention of the Rule was that re-warranted metal would not be counted towards load-in (hence use of the term “new metal placed on-warrant”), otherwise there would arise an inequitable balance for the Warehouse. Consider the case where metal was loaded in, cancelled, re-warranted, cancelled again and then loaded-out. Were re-warranted metal to be counted towards load-in, then there would be two load-in entries (once when the metal was initially warranted, and once when it was re-warranted), against only one load-out entry (when the metal finally left the



Warehouse). Accordingly, the fact that re-warranted metal will not count towards load-in has been further clarified in the wording of the Rule.

33 A number of Affected Warehouses queried whether the calculation of the Cumulative Incremental Load-Out Requirement should be conducted on a daily basis. A daily methodology was initially chosen by the LME to address the issues of a Warehouse which may be an Affected Warehouse on one day, and a non-Affected Warehouse on another day. However, this does have the effect that greater load-out requirements attach to a Warehouse creating a large number of warrants on certain Business Days, compared to a Warehouse creating an equal number of warrants on each Business Day. As such, the LME is not averse to moving to an approach of averaging over the Calculation Period. However, to avoid potential manipulation, it will be necessary for the Rule to apply for the entirety of a Calculation Period if the Warehouse is an Affected Warehouse for any portion of that Calculation Period. Discussions during the Consultation suggested that warehouse operators are comfortable with this methodology, and an adjustment has hence been made to the wording of the Rule. For the avoidance of doubt, this would not change the expected queue decay profile under the scenarios modelled by the LME.

34 The issue of Rule complexity was additionally raised. In general, the Consultation suggested that such complexity is manageable. The LME will work closely with warehouse companies on queue scheduling and monitoring in respect of Affected Warehouses.

35 Separately, the Consultation identified a concern in respect of steel billet. The conversion of this contract from a global to a European basis has resulted in warranted steel in non-European Warehouses requiring to be either withdrawn by the warrant holder by 30 May 2014, or shipped (at the expense of the current Warehouse) to a European good delivery location. However, the withdrawal of metal (which often is desired by both the metal owner and the Warehouse) is made more difficult by the fact that the cancelled steel often sits in queues, and – because the warehouse operator must obey the ordering of the queue – it will not be possible for the steel to be loaded-out before the deadline. Accordingly, it is proposed that a separate load-out be required for steel at the minimum levels set out in the revised LME Policy Regarding the Approval of Warehouses. Given that steel is stored separately from non-ferrous metals, this also represents a logical approach from a logistical perspective.

#### **Action: Enhance LME powers to address queue formation**

36 It has been suggested by a number of respondents that, even under the Rule, a warehouse operator could still incentivise a large queue, or alternatively operate queues just below the threshold in multiple locations. More generally, it has been suggested that the LME should enforce the powers under the Warehousing Agreement to restrict “exceptional inducements”, and their role in the creation of queues.

37 Rather than attempt to legislate for particular behaviour, it is felt more appropriate



to provide a general power to the LME to investigate the formation of queues, including the right to compel Warehouses to disclose incentives paid to attract metal into the Warehouse, and the provenance of metal coming in to the Warehouse (which may help to identify the possible existence of “circular” metals flows between Warehouses). Having investigated thoroughly, the LME would be empowered to form a view as to whether an attempt has been made by the Warehouse to artificially create a queue by the use of incentives, and impose greater requirements on that Warehouse. Where justified to address such abusive behaviour, the Exchange would have the power to implement various measures, including imposing the Rule on any Warehouse with a queue even below the threshold number of days, and to increase the decay factor in respect of a Warehouse which would be subject to the Rule in any event.

38 Additionally, many respondents have advanced, as an alternative to the Rule, the concept of banning the charging of rents in queues. Such action would fundamentally re-engineer the economics of an implied contract between the metal owner and the Warehouse, and could additionally give rise to unintended consequences (such as an increase in warehouse FoT rates to compensate for lost queue revenues). Whilst the LME tends to the view that the Rule represents a more balanced market approach, nevertheless it considers it appropriate to have a legal review conducted to inform its understanding of the situation and its additional policy options.

#### **Action: Further deliver market transparency**

39 In relation to warehousing, transparency is provided by the various stock information issued by the LME on a per-location basis. In the Consultation, various respondents have requested more detailed information at a per-Warehouse level (which the LME is currently prohibited from disseminating due to confidentiality provisions in the Warehousing Agreement). The Exchange notes this, but is conscious that market participants may attempt to process detailed data on a real time basis and execute immediate trading or warrant cancellation decisions as a result. The LME does not believe it is desirable to create a “high frequency warrant market” of this nature.

40 Accordingly, the LME intends to provide, on a regular but delayed basis, per-Warehouse information, and will amend the Warehousing Agreement accordingly. The LME will work with market participants to define the precise format of such report.

41 More generally, the Consultation has highlighted a market demand for broader transparency – in particular, the publication of a “commitment of traders” report. Although the Exchange does not believe that such a report would have any effect on the issues of queues and premiums, it is separately felt appropriate for the LME to publish such data. The Executive has initiated dialogue with market participants on the desired format of such a report, and dissemination of the resultant report will be initiated once the necessary technical work has been undertaken.



### **Action: Investigate solutions to aid premium discovery and hedging**

42 A number of respondents expressed a desire for the LME to offer products to enable premium discovery, premium hedging, warrant transfers and synthetic warrant fungibility solutions. These approaches have been offered in some cases as an alternative to the Proposal, and in some cases as a complement.

43 The LME does not believe that even the successful introduction of such solutions would remove the core requirement to take action targeting queues, and as such these are not viewed as alternatives to the Rule. However, the LME will commit to a full investigation, working with market participants, as to the viability of such products.

44 However, it must be highlighted that the LME would only consider launching such products if it could be shown that such products would give rise to effective price discovery. In particular, the Consultation has revealed significant market concern in respect of potential cash-settled contracts based on survey-priced premiums, given the issues in diligencing such price benchmarks. Additionally, it is unclear from the Consultation whether such products would be supported by the broker community, given the attractive over-the-counter market currently operating in this space.

### **Action: Enhance communication, representation and review**

45 The LME is extremely grateful to all those who have participated in the Consultation, and feels that the quality of dialogue represents a strong basis for ongoing communication with the global metals markets. In particular, the Executive will commit to follow-up meetings with all Consultation participants, and other interested market users, to explain in detail the conclusions of the Consultation.

46 The Consultation has identified a common view from industry that the physical market is not well-represented in the LME's governance structures. Although this is demonstrably untrue for the various metals committees, and four of the 14 User Committee members are representatives of the physical industry, it is valid to note the absence, for example, of an aluminium fabricator on the User Committee.

47 As such, the LME will create a Physical Market Committee, with invited representatives from across the physical industry, including those individuals who have been most engaged in this Consultation. The Chairman of the Physical Market Committee will be represented on both the Warehousing Committee and the User Committee, and through the User Committee will have representation to the LME Board. The terms of reference of the Warehousing Committee will additionally be reviewed.

48 The LME will also continue with its policy of six-monthly review of its warehousing arrangements. In this context, the Exchange will consider specifically the operation of the Rule and its impact on queues. The Physical Market Committee will be expected to play a significant role in this ongoing review process, and views will additionally be solicited from all Consultation respondents.



### **Action: Fully review warehousing rules**

49 An observation made by several Consultation respondents has been the LME's rules in respect of good delivery locations, warehousing companies and sheds. In particular, the question has been raised as to whether certain requirements may be outdated, or new provisions may be required. Additionally, although the role of ExCom and the Board as the decision-making bodies is well-understood, several respondents also felt it appropriate to clarify the advisory roles of the various LME Committees in both approvals and rule-making.

50 Accordingly, the LME will commission a full review by external logistics consultants to consider these items, and to express an independent view on reasonable operational expectations and requirements for the loading-in, holding and loading-out of metals. The precise terms of reference for this review will be determined by the Executive, in consultation with relevant Committees.

51 During the course of this review, applications will continue to be accepted for new good delivery locations, warehousing companies and sheds. However, the Executive may choose to delay the approval of such applications, and any applications currently in-process, if it is believed that the results of the review may impact any specific approval decision.

52 As part of this process, the LME will work with external counsel to review the effectiveness of the Warehousing Agreement.

### **Action: Reaffirm existing best-practice information barrier policy**

53 The LME believes that its information barrier policy (set out in Notice 11/334 : A326 : W173) represents market best practice. In particular, the requirement for annual external audits gives the LME significant confidence that its rules are being applied by warehousing companies.

54 Furthermore, although Consultation respondents have cited ownership linkages between warehouses and trading companies as a source of potential concern, the LME has not identified any actual harm arising from vertical ownership structures, above the commercial arrangements which could validly exist between a trader and warehousing company with no ownership linkage

55 As part of its market engagement initiatives, the LME will commit to inform the market, on an annual basis, once it has received the required third-party audits in respect of information barriers at the warehouse operators, and identify any general issues arising therefrom. Additionally, with the assistance of external counsel, the LME will continue to monitor the sufficiency of the information barrier requirements.



## Implementation

56 The Rule will take effect as planned on 1 April 2014. The Preliminary Calculation Period, which commenced on 1 July 2013, will give rise to obligations in the Preliminary Discharge Period. The provisions in respect of steel, enhanced LME powers in respect of investigating queues and taking action in respect of deliberately-created queues, and the right of the LME to publish Warehouse-specific data, will also come into effect on 1 April 2014. Implementation will be via amendments to (i) the Terms and Conditions Applicable to all LME Listed Warehouse Companies, and (ii) the LME Policy Regarding the Approval of Warehouses. Revised versions of both documents are attached to this Notice.

57 Other provisions in this Notice require implementation work to be undertaken by the LME, and timing for each will be notified separately to the market.

58 The implementation of certain elements of this package of measures will require further discussion with warehouse companies. The LME has today issued Notice 13/327 : W126, which will formally initiate this discussion. It is expected that this will not delay the implementation of these measures on 1 April 2014

59 Full information on all aspects of the Consultation process (including the report of the Consultation) can be found at <http://www.lme.com/warehouseconsultation>

A handwritten signature in black ink, appearing to read 'M. Castro', with a long horizontal line extending to the right.

**Marcos Castro**  
**Company Secretary**

cc: Board directors  
User Committee  
Warehousing Committee  
All metals committees