

LME consultation on warehouse reform

July 2019



SETTING THE GLOBAL STANDARD



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1. EXECUTIVE SUMMARY

On 29 March 2019, the London Metal Exchange (“LME”) 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 is now launching a formal, market-wide consultation (“Warehouse Reform Consultation” or “Consultation”) on those items in the discussion paper which it believes represent positive progress for the LME warehouse network. Further, the LME is also consulting on a number of other proposals which were not included in the discussion paper, but on which the LME believes further action is appropriate. The LME believes that these broadly fall into three main categories, and as such, this Consultation paper comprises the following sections:

- (i) Logistical optimisation
- (ii) Transparency and compliance
- (iii) Rebalanced rules and a pathway to simplification

The paper outlines the core features of the LME’s warehouse reform proposals, as well as information on how to contact the LME in respect of the Consultation, and how to submit a formal response.

This Consultation only focuses on those items from the discussion paper on warehouse reform which the LME is proposing to progress at this point in time. A full discussion of the items not contained in this Consultation, and the rationale for why the LME is not currently considering them for implementation, is included in a separate report (“the discussion paper feedback analysis”) released via Notice 19/237 (“2019 LME consultation on warehouse reform”).

2. THE CONSULTATION PROCESS

2.1. Responding to the Consultation

The LME welcomes feedback to this Warehouse Reform Consultation from all market participants and other interested parties, including regulatory and governmental bodies.

The Consultation will be open until 12 September 2019. During the period of the Consultation, the LME will, subject to reasonable logistical constraints, be available for meetings to discuss the subject matter of the Consultation. Any market participant seeking clarification in relation to such is asked to contact Hugo Brodie at consultation@lme.com or +44 20 7113 8766.

Formal responses to the Consultation should be submitted in writing and sent to the LME at consultation@lme.com (or to the LME's postal address).

2.2. Elements of the Consultation

The LME seeks the views of the interested parties set out above on:

- (i) Amendments to the LME Policy on the Approval and Operation of Warehouses (the "AOW Policy");
- (ii) Amendments to the LME Policy on the Approval of Locations as Delivery Points (the "LDP Policy");
- (iii) Amendments to the LME Warehouse Agreement (the "Warehouse Agreement"); and
- (iv) Amendments to the LME Complaints Procedure (the "Complaints Procedure").

The LME's proposed revisions to these documents are set out in the appendices; each document is attached in both a redline version which shows the proposed changes, and a clean version incorporating those changes.

This paper, together with its Appendices A-H, constitutes this Consultation.

For the avoidance of doubt, this Consultation paper is intended to provide the background and rationale to the LME proposals, but respondents to the Consultation should pay particular attention to the language of the proposed rule changes.

The LME welcomes feedback on all of these elements. For clarity, each sub-section below is organised by "Consultation Proposal" ("CP"). Although the LME will accept responses submitted in any format, for ease of analysis it would appreciate respondents referring to the relevant CP number when responding.

An index of the location of each CP number in the relevant documents is provided in Section 9 below.

2.3. Defined terms

Terms defined in the Rules and Regulations of the LME (the "Rulebook") shall have the same meaning in this Consultation paper, unless stated otherwise.

2.4. The consultation process, timing and steps following consultation

Responses made after the closing date of the Consultation will not be taken into consideration. The LME will take account of all responses received by the closing date. The LME may need to share responses received with regulatory authorities, members of its group, and its legal or other

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professional advisers, or as required by law. Anonymised responses (verbatim or paraphrased) may be included in the Notice(s) stating the outcome of this Consultation. Apart from this, all responses received will be treated in confidence.

Following due consideration, the LME may implement:

- (i) in respect of each Consultation Proposal, a modified version of the Consultation Proposal, an alternative to the Consultation Proposal, or
- (ii) no measure in respect of the Consultation Proposal;
- (iii) any other measure(s); or
- (iv) no measures.

Following the Consultation, the LME will advise the market, via one or more Notices.

2.5. 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). This rate has not increased since 2002, and the LME's decision-making process, and its conduct of the Consultation, is in no way 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. It is also important to the LME's value as an ongoing business. These two factors far outweigh any financial return which could accrue as a result of the stock levy on rents in any economic circumstance (or any linked economic effects, such as greater trading volumes arising from higher stocks).

3. BACKGROUND AND RATIONALE

3.1. Discussion paper process

As outlined in Section 1, in March 2019 the LME released the discussion paper on 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.

The LME would like to thank the 46 market participants who provided written feedback to the discussion paper, as well as those who provided their thoughts through meetings and calls. The Exchange very much appreciates the time and effort taken by all those who contributed.

The LME has taken all the feedback into careful consideration, and has today published a report on this feedback in its discussion paper feedback analysis. Alongside the feedback analysis, the report outlines the LME's thinking in respect of the issues raised by respondents regarding the proposals, explains which proposals it is progressing to consultation and those which it is not, and provides a rationale for both. For those proposals not progressing to consultation, the LME explains any relevant next steps where appropriate.

In reviewing the feedback from the discussion paper, the LME has remained conscious of the fact that its physical network operates for the benefit of a broad spectrum of industry stakeholders. In order to continue to provide that service, the LME (and its warehouse operators) must ensure that all physical market participants along the value chain are able to access the network effectively, and receive a service that is efficient, transparent and regulatory compliant.

That said, the corollary of providing such a service to such a broad stakeholder and user group is the difficulty in forming a significant consensus of opinion on the right steps forward, or indeed, on the core purpose of the LME physical network itself. Certainly, as the feedback to the discussion paper feedback analysis indicates, there are very few areas where the market is fully in consensus. Further, the LME also accepts that alongside the divergence of market opinion, the needs of the market, the requirements of regulators, and myriad other considerations will evolve, and therefore the physical network needs to evolve with them.

It is in this context that the LME's discussion paper on warehouse reform set out a number of possible reforms. These were designed to both ensure the ongoing attractiveness and effectiveness of the LME warehouse network, and also ensure that the network adapts to meet these evolving needs. Following extensive market feedback and engagement on these proposals, this Consultation provides more detail on those which the LME believes will have a material positive impact on its network as a whole.

3.2. Underpinnings of the LME warehousing model

A key element of the discussion paper, with which respondents were encouraged to interact, related to the underlying case for the LME's warehousing network. Following the analysis of such feedback, combined with the Exchange's own analysis, this section sets out the LME's current assessment of this topic.

It remains the position of the LME that the core function of the warehousing network is to facilitate physical delivery of contracts on the Exchange – and, in this regard, the required levels of stock in the warehouse are relatively low. In particular, the LME notes that – even though market

commentary has focused on low stock levels in recent months, particularly in relation to certain metals – it has always been possible to effect delivery on the LME. Indeed, the nature of the LME’s market means that low warranted stock levels may result in backwardations, the effect of which is to attract metal onto warrant. In this sense, and in respect of the narrow function of the delivery function of the warehousing network, the warehousing model continues to operate effectively.

However, the LME also recognises that its warehousing network fulfils a broader set of functions than simply the facilitation of delivery against contracts. It is generally accepted amongst market participants that it is desirable for the LME warehousing network to maintain a stock level greater than that required simply for the purposes of delivery. Such higher levels of stock are broadly viewed as having three positive market effects:

- **Provision of a “buffer” against spread tightness**, meaning that it is not necessary for markets to flex into backwardation simply due to a technical shortage of warrants (although backwardations would still be expected when the underlying physical market – i.e. LME warrant and off-warrant metal – demonstrated supply tightness)
- **Market-wide transparency**, providing a more holistic view of stocks of LME metals, as opposed to the more limited assessment currently available from the subset of stocks held on LME warrant
- **A vibrant LME warehousing network**, respecting the role of LME-listed warehouse operators as partners in the LME’s ecosystem, and service providers facilitating effective settlement across the LME’s physically delivered contract suite

It should, however, be noted that these three drivers suffer from a “tragedy of the commons” risk. The provision of a spread tightness buffer, market-wide transparency and a vibrant warehousing network represents a shared resource which is beneficial for all market participants. However, no single market participant is sufficiently incentivised to contribute to this shared resource. Particularly given the greater cost of LME warranting, the rational economic step for market participants may be to store their own metal off-warrant (hence achieving a lower cost and consequent individual economic benefit), while simultaneously calling for all other metal owners to use LME warranting. In the case of transparency, this problem is even more pronounced – the optimal trading strategy will often be to “hide” one’s own metal stocks from the market, while using the knowledge of others’ metal levels and locations to trade.

While acknowledging that it may never be possible to fully overcome these challenges, the LME does therefore accept that it should be an aim of its warehousing policy to incentivise a level of stock beyond the core requirement of physical delivery. However, there then arises a second question, namely how this should be achieved. There would seem, in general, to be three methods to achieve this:

- (i) **Increasing the difficulty of stock withdrawal (an approach which is generally unacceptable to the broader market)**. Given the individual economic incentives set out above, a metal owner taking possession of LME warrants may have a strong incentive to cancel the warrants and relocate the metal to private store, thus reducing LME stock levels. Periods when LME stocks have been highest have often been those when the withdrawal of metal was most difficult – in particular, during the period when queues were prevalent. However, there exists general market agreement that the lengthy structural queues which emerged following the global financial crisis of 2008-09 resulted in significant operational and reputational damage to the LME, and this is therefore not an approach which the LME will contemplate

- (ii) **Enhancing the logistical attractiveness of the network.** A number of market participants believe that the core weakness of the LME network is its (in their view) lower logistical attractiveness, compared to off-warrant storage. Particular factors quoted are the relatively high rent and FoT charges compared to off-warrant storage, but also the potential for the emergence of load-out queues. Those espousing this argument suggest that, were these issues to be addressed, the propensity to warrant metal would be increased, and the propensity to remove metal from warrant would be decreased, with the overall result that warranted stocks would increase.

At the heart of this argument is a realisation that the warehousing network has evolved significantly over recent years, and the historical need for LME warranting (driven often by the requirements of financing banks and insurers) have been diminished by the rise of so-called “shadow LME warehousing”, being an off-warrant metal storage service offered by warehouses, combining the benefits of private store (in particular, significantly lower charges compared to LME warranting, and no requirement to report stocks) with the advantages of LME warranting (in particular, a commitment that metal can be placed on-warrant within a certain time period if needed for Exchange delivery). For the LME to continue to be able to attract stock, according to this argument, it needs to ensure that it remains best practice in respect of logistical efficacy

- (iii) **Increasing the financial incentive to place metal on-warrant.** An opposing view is that a large amount of metal is only placed on warrant because an incentive is paid by the warehouse operators to the metal owner. The incentive must be paid from the profits made by the warehouse operator during the lifetime of the metal. Consequently, funding a sufficiently competitive incentive requires higher rates of rent and FoT to be chargeable by the warehouse. It also requires a less restrictive set of rules in respect of queues (since a warehouse’s financial assessment of the profitability of the storage of an LME warrant will be decremented by any potential obligations resulting from the formation of a queue, such as the need to provide expedited load-out under LIFO, or discounted rent under QBRC). Accordingly, those espousing this argument would suggest that the LME’s ruleset be liberalised (including allowing the charging of higher levels of rent and FoT), allowing higher incentives and consequently greater flows of metal onto warrant

If (i) is ruled-out, then the question resolves effectively to a debate between views (ii) and (iii). To a significant extent, these approaches are not compatible – approach (ii), for example, would necessitate a significant reduction in the maximum charge levels which warehouses could levy, while approach (iii) would look to maintain (or even increase) current maximum charge levels. This is not to say that only one theory is correct – it may well be the case that the LME’s network current exhibits a sub-optimal balance between logistical and financial drivers, and a definitive move in either direction would result in an increase in stocks. But, it is clearly not feasible for the LME to reform in both directions at once – if reform is to be effected, then one direction must be chosen.

In making this assessment, the LME has adopted a risk-based assessment of the situation. It stands to reason that reform in either direction (ii) or direction (iii) will make those who support that direction more likely to use LME warranting (but only providing that the degree of reform was sufficient to overcome their current reticence to hold metal on-warrant), while those who support the opposite direction may be less likely to use LME warranting. In this regard:

- **Pursuing route (ii)** – i.e. prioritising the logistical aspects of the network – would clearly reduce the degree of warranting undertaken by metal owners seeking an incentive payment, given that

the requisite rules (particularly around reductions in maximum rent and FoT levels) would also reduce the financial incentives which could be paid by warehouses to those warranting metal. At the same time, it is unclear to the LME whether sufficiently meaningful logistical reforms could be made even to offset this loss. For example, the Exchange understands that rent levels in the off-warrant market are significantly lower than those typically charged for warranted metal. It seems unlikely that the LME could effect (or warehouses would accept) a reduction in LME maximum rent and FoT levels down to the levels of the off-warrant market (if only because the costs of LME storage are higher for warehouses, given LME stock levy and reporting requirements) – meaning that, although the quantum by which LME warehousing is more expensive would reduce, there would still be a differential. And, given the success of the “shadow LME storage” model of replicating the benefits of LME warranting, it is unclear that metal owners would be prepared to pay even a reduced upcharge to avail themselves of on-Exchange storage.

This problem becomes even more acute when considering the topic of stock reporting. Because some metal owners actively eschew transparency in respect of their own stocks, it is possible that – even if LME charges were reduced to the same levels as those of the off-warrant market – metal owners would still choose to use private storage in order to avoid disclosing the existence of their stocks. Although it may be possible to reduce this effect by providing greater transparency over non-warranted stocks (as articulated further below), it seems probable that a material element of metals storage business may never be capable of being attracted to warranted storage.

As such, although the LME does not claim that route (ii) is unviable, the risk associated with a flawed implementation of route (ii) would appear to outweigh the potential benefits. This is not to say, however, that logistical improvements are impossible – the Exchange has identified a number of areas (for example, in respect of the structuring of “evergreen” incentives) where it believes that logistical improvement is indeed possible, and which are hence included in this Consultation

- **Pursuing route (iii)** – i.e. providing scope for a greater financial incentive for the warranting of metal, does seem, to the LME, to be more obviously capable of increasing on-warrant stocks, given the direct economic link between higher incentives and metal owners’ propensity to warrant.

In this scenario, the risk is primarily around the consequences of rule relaxation. The most restrictive rule, according to the warehouses which have made representations to the Exchange, is QBRC. However, QBRC is also important in mitigating the consequences of operational queues for consumers in terms of reducing the rent which they can be charged in the queue. Accordingly, any rule changes should be proportionate, and introduced in such a manner that their effect can be gauged, any negative consequences identified, and reform ceased if such consequences are material.

An equally significant consideration is the risk that the ability of warehouses to pay increased incentives could disrupt the balance of the physical market, if such incentives increased above the physical market premium, and hence warehouses came into competition with consumers for the sourcing of metal. Again, the Exchange believes it will be important to ensure that the parameters of any rule change are calibrated so as to avoid such an outcome

Accordingly, the general approach of the LME proposed in this Consultation is to combine the most effective elements of route (ii), i.e. logistical reform where this will be of market-wide benefit, and route (iii), i.e. the recasting and rebalancing of rules, where this can incentivise more metal on-warrant without exerting negative market consequences.

A final observation in respect of the philosophy of the LME network is in respect of simplicity. The LME has always accepted that the model of its warehouse network is complex, and the addition of the LILO and QBRC rules to address the issue of queues further added to the intellectual overhead. It is therefore unsurprising that many market participants have called for simplification of the rules.

However, this valid desire for simplicity must be tempered by a realisation that the current rules, while complex, have broadly addressed the issue of structural queues, and have protected the market over the past few years. The LME does not believe (and no stakeholder has identified) a route by which the current set of protections can be maintained in a simpler set of rules – that is to say, simplification would necessarily result in a change to the protections enjoyed by the market.

Furthermore, it should be noted that many parties calling for simplification also intend that such simplification would achieve specific policy changes. The Exchange believes that it would be inadvisable and intellectually dishonest for such changes to be effected under the guise of simplification. Rather, the aims of policy change and rule simplification should be disaggregated, with the current ruleset modified to achieve desired policy aims within a well-understood framework, and a final simplification step then effected once the impact of such policy changes had been fully understood.

3.3. Structure of the Consultation package

On the basis of the above analysis, the LME has determined which proposals to advance to this Consultation.

Not all of these proposals have emerged through the discussion paper process. Alongside some of the strategic ideas which have been progressed from the discussion paper, this Consultation also includes logistical proposals on technical issues relating to the LME's requirements for its listed-warehouses, as discussed with the LME Warehousing Committee. It also contains proposals designed to enhance the LME's powers to protect its network – and users of such – from concerns around sanctions and warehouse insolvencies. Further, the LME is also proposing changes to its Complaints Procedure.

Together, the LME believes that these proposals, which have developed through conversations with the LME market (including the LME Warehousing Committee, the LME's own analysis, and formal feedback to the discussion paper), reflect a package of measures which would enhance the LME physical network across three core areas:

- (i) **Logistical optimisation** – insofar as they do not threaten the ability of the warehouse network to attract metal onto warrant, a set of logistical changes which are intended to make the LME network easier to use for the metals industry, and metals consumers in particular. This includes restrictions on so-called “evergreen rent deals”, an extension of the current freeze on maximum levels of rent and FoT, operational proposals progressed from the discussion paper, as well as logistical proposals on technical issues relating to the LME's requirements for its listed-warehouses, as discussed with the LME Warehousing Committee

- (ii) **Transparency and compliance** – the LME believes that its warehouse network, and indeed its broader market, must reflect best-practice in respect of transparency and compliance, for the benefit of the entire metals industry. It is, therefore, advancing proposals to increase the transparency of global metals stocks, to provide more information around the status of cancelled stocks in warehouses, to enhance the Exchange’s powers to protect users from warehouse insolvencies, to address issues relating to financial crime, and to provide an enhanced complaints procedure

- (iii) **Rebalanced rules and a pathway to simplification** – a recognition that the LME’s rules to address queues – and in particular, QBRC and LILO – have now been in place for several years, and should be reassessed to ensure that they provide a fair balance between the protection of consumers, and facilitation of LME warranting (for the benefit of the market as a whole, as well as the business models of LME-listed warehouses). Any changes must respect the needs of the physical market, and importantly not make LME warehouses a competing bidder for metal. Such changes should also be made progressively, with the impact fully assessed. Additionally, the endpoint of such evolution should be a significantly simplified set of rules

As such, this paper is divided into three sections to reflect these categories. The LME has reflected all the proposed changes in the relevant policies and other documents, and these are attached in the appendix in both redline and clean versions to provide clarity to the market as to how these measures would operate – and be governed – in practice.

4. LOGISTICAL OPTIMISATION

The discussion paper on warehouse reform put forward a number of logistical and operational proposals, designed to facilitate the use of the LME physical network for both warehouse operators and users of the network. Those which the LME believes would add material value, and as such, with which the LME is progressing to consultation, are outlined below. In addition to these proposals, the LME is also consulting on a number of technical issues which have emerged from the LME's discussions with its listed warehouse companies in the LME Warehousing Committee, and on which the LME is now seeking feedback from a broader range of market stakeholders.

4.1. Evergreen rent deals [CP1]

Of these logistical proposals, the issue which has prompted the broadest range of opinions is the debate surround the use of evergreen rent deals, also known as lifetime rent deals or (in line with the LME's proposal) "post-sale economic incentive arrangements". The terms of this debate were outlined in the discussion paper so will not be re-examined here. However, following a review of all the feedback received on this topic, and the LME's own analysis, the LME is proposing to place certain restrictions around the use of such deals.

For the purposes of the LME rules, and as more fully set out in clause 9.3.8 of the LME Warehouse Agreement attached to this report at Appendices E and F, a post-sale economic arrangement refers to 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 as agreed between those two parties, or until that metal is loaded-out of the warehouse by a subsequent owner.

While the current formulation of the LME Warehouse Agreement does not restrict the duration of such arrangements, the LME is now proposing that from 1 February 2020¹, a warehouse may only enter into such an agreement with the party placing metal onto LME warrant. By definition, therefore, this will prohibit such arrangement being made with a metal owner who has purchased metal in an already-warranted state. For the avoidance of doubt, this includes a party taking receipt of warrants in settlement of an LME contract. In the view of the LME, this will continue to allow the incentivisation of metal owners bringing fresh stock to the LME network, while protecting the system from the incidence of parties purchasing LME warrants purely in order to extract a post-sale economic incentive arrangement.

However, in recognition of the fact that many post-sale economic arrangements are already in existence, the LME is proposing that this new rule will not apply to such deals entered into before 1 February 2020.

As outlined above, a post-sale economic arrangement may last until the metal is loaded-out of a warehouse, or until some earlier point agreed by the parties. However, the LME is also reserving the right (to be communicated to the market by Notice, with a minimum of 30 days' notice) to require that all such deals made after a future specified date, be terminable upon one of two events (with the relevant event specified in the Notice):

- (i) Cancellation of the warrant by a subsequent metal owner

¹ NB: All dates relating to implementation are indicative only. The LME reserves the right to amend these as necessary and appropriate

- (ii) Notification by a subsequent metal owner that it wishes the warehouse company in question to terminate the post-sale economic arrangement

Pursuant to the LME's confidentiality requirements on its warehouse companies, 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.

For the avoidance of doubt, this proposal is not intended to prevent a subsequent metal owner from negotiating to obtain a level of rent and / or FoT below the published rent rates in respect of that metal, provided that such discounts apply only during the period that they continue to own those warrants. To the extent that metal subject to such negotiations is also subject to a post-sale economic arrangement with an earlier owner, the warehouse company may confer with the counterparty to the post-sale economic arrangement (subject to the confidentiality provisions above) to determine whether that counterparty would be willing to modify the terms of the rent deal in order to facilitate the new metal owner's request for discounted charges.

The proposal also makes it clear that warehouses must not agree any post-sale economic arrangement in respect of any warrants or metal that: (i) contemplates, or has the effect, that a later metal owner is prevented from withdrawing the metal from the warehouse, or from making alternative arrangements for the storage of the metal; or (ii) has a distortive, manipulative or disorderly effect on the market. The LME has a power to direct a warehouse to terminate a post-sale economic arrangement that it considers to have such effect.

4.2. Headline rents and Free on Truck ("FoT") rates [CP2]

LME headline rents and FoT rates are set by warehouse companies annually, at or below the maximum rates as mandated by the LME. In 2016, the LME announced (in Notice 16/320 : A314 : W098 "Decision notice on amendments to the LME Warehouse Agreement in respect of charge-capping") that, alongside setting caps on those rates ("Charge-Capping"), it would also impose a five year freeze on those caps.

The current headline rent freeze is scheduled to end for the 2022-23 charge year. The LME is now proposing to extend this freeze for a further five years, to end for the 2027-28 charge year, as set out in clause 5.3.3 of the LME Warehouse Agreement attached to this report at Appendices E and F. While the LME accepts that this will not materially reduce the current delta between LME headline rates and both off-warrant and bilaterally negotiated LME storage rates, it will, however, ensure that this delta does not widen further (and may reduce, given the impact of inflation), at least for the duration of the extended freeze period.

4.3. Definition of "load-out" [CP3]

The LME is not proposing a change to its current definition of load-out, as currently contained in the General Definitions section of the AOW Policy, which indicates that all load-out from LME-registered sheds must meet the LME's load-out requirements.

However, the LME does recognise the concern expressed by a section of its market users that the existing wording of paragraph C.9 of the AOW Policy could give rise to an alternative interpretation; specially, that it could be read to indicate the LME load-out requirements only apply to the load-out through which a warehouse operator completes their daily minimum load-out requirement. As such, and in the interests of both transparency and clarity, the LME is proposing to clarify the relevant

paragraph in the AOW Policy, now contained at paragraph C.7 of that Policy (see Appendices A and B), to state that the LME requirements apply to all movements of metal out from LME-listed warehouses, including but not limited to load-outs through which a warehouse operator completes their daily minimum load-out requirement.

4.4. Clarification of FoT charges denomination [CP4]

Clause 5.2.3 of the LME Warehouse Agreement states that FoT rates should be quoted in the local currency denomination of the listed warehouse. While the LME is not proposing to amend this requirement, it does recognise that it is also common practice for a warehouse operator and metal owner to agree a charge in US dollars as an alternative. The LME does not believe that this represents an issue and is proposing to clarify that it is possible to pay FoT in US dollars or any other currency, subject to the agreement of both parties (including agreement on the applicable exchange rate), as set out in clause 5.2.4 of the LME Warehouse Agreement (see Appendices E and F).

Equally, it is worth noting that although the LME's current understanding is that the market preference is for the quotation to be in local currencies, it continues to be open to market views on this topic.

4.5. Door wording amendment [CP5]

The AOW Policy currently requires a minimum of two doors per Authorised Warehouse (that is, a shed operated by an LME-listed warehouse operator in a specific good delivery location), and a scaling door requirement based on space. The LME is proposing to amend this requirement to, in its discretion, allow a shed to be listed where it has fewer doors than the minimum space-based requirement for that warehouse. For example, the LME may choose to do so if it believes that this will not impair the efficiency of operations at that warehouse shed. If it does not exercise this discretion, the LME Physical Operations team will still require two doors (or a greater number based on the space-related formula) for the ongoing operators on that shed as LME-registered warehouse. This amendment is set out in paragraph C.1 of the AOW Policy.

4.6. Stock reporting clarification [CP6]

The LME is proposing to amend clause 6.3.1 (now 6.3.2) and to delete the former clause 6.3.2 of the LME Warehouse Agreement to clarify that stock report submissions from LME-listed warehouse companies to the LME can only be completed through LMEsword, as prescribed by the LMEsword Regulations and Operating Procedures. This is consistent with existing practice, so is a conforming change to ensure that the Warehouse Agreement is up-to-date.

4.7. Probation period for new LME Delivery Points [CP7]

The LME's LDP Policy sets out the LME's requirements for a location to become an LME Delivery Point (also known as a good delivery location). Broadly, upon completion of an application, the LME Physical Operations team will review the location to ensure that it meets the relevant requirements, and that application will also be reviewed by the LME's metals committees, Warehousing Committee and Executive Committee. Should the application be successful, the LME will issue a public notice confirming that warehouse companies may submit applications for warehouses to be listed within the location.

Until such time as a warehouse company has successfully applied to operate in the location, the location itself is effectively "inactive" (or a "zombie location") as no metal owner would be able to deliver metal for warranting. As such, the LME is proposing to introduce a rule which prescribes that in the event that no warehouse applications are received after a six month period, the invitation to list

will be rescinded and the applicant location will be required to submit a new application should they wish to re-qualify. At its own discretion the LME may extend this period if it is aware that an application is in process, or for other reasons at the LME's reasonable discretion. This requirement is set out in paragraph C.2 of the LME LDP Policy.

4.8. LME discretion on approving new Delivery Points [CP8]

As outlined in Section 4.7, the LME runs a rigorous process for the approval of new good delivery locations. However, the current provisions as delineated in the LDP Policy do not afford the LME any discretion over the approval of such locations. Rather, should a location meet all of the stated requirements, the LME is obliged to approve that location as a Delivery Point. The LME is proposing, therefore – and as set out in paragraph A.3 of the LDP Policy (see Appendices C and D) – to address this issue by granting itself the ability to refuse an application should it believe that the location in question has the potential to cause an adverse reputational impact to the LME, its group affiliates, and / or users of its physical network.

4.9. Review period [CP9]

The LME's LDP and AOW Policies both currently require the LME to review them on at least a biennial basis. The LME is proposing to change this to "from time to time" (see the LDP Policy paragraph E, and the AOW Policy paragraph H) on the basis that the LME may wish to review the Policies more or less often than biennially depending on the circumstances (e.g. to react to market feedback).

4.10. Specific ban on sharing queue information [CP10]

Recent cancellation activity has raised concerns in the market about the possibility of merchants and / or physical holders of metal working in concert with warehouse companies to use queues to maximise financial returns, possibly at the expense of other market participants. As such, the LME is proposing to clarify that this would constitute a breach of the LME Warehouse Agreement, by introducing wording at clause 6.3.3 of that Agreement, which explicitly prohibits the sharing of queue information except in some specific circumstances, also listed under clause 6.3.3.

5. TRANSPARENCY AND COMPLIANCE

In the interests of ensuring that the LME physical network (and its broader market) continues to reflect best-practice in respect of transparency and compliance, the LME believes that it must remain aware of the evolving requirements of its market, and equally, the evolving demands from market users and regulators, and be prepared to action change if necessary. To this end, this section sets out proposals to increase the transparency of global metals stocks, to enhance the Exchange's powers to protect users from warehouse insolvencies, and issues relating to financial crime and enhanced complaints procedures.

5.1. Eligible stock reporting [CP11]

The possibility for greater transparency of stock reporting provoked some of the most divergent thinking in the discussion paper responses. Whilst a number of respondents were against the measure, arguing that metal owners have a right to maintain confidentiality over metal stored off-warrant, others argued that the rationale for this behaviour was driven not by a need for confidentiality, but rather by a preference to use this information for market gain.

While the LME understands both arguments, it believes that its priorities must remain market orderliness and efficient operations. To that end, the LME considers that the market benefits of increased transparency of such stock outweigh the potential negatives. Further, the LME is also aware – as outlined in the discussion paper – that much of the metal stored off warrant in “shadow LME storage” leverages the LME's standards and requirements for warehousing, without contributing to the market as a whole.

Equally, however, the LME is conscious that current versions of such rules both potentially disadvantage registered warehouses over non-registered warehouses, as well as leaving open a number of potential avoidance routes, so as to undermine the value of any subsequent reporting. For this reason, the LME will not progress with the “eligible stock” reporting model (whereby metal stored in an LME-registered shed must be reported as “eligible”, whether warranted or not), since this (i) may represent an over-reach into metal which may never enter the LME system, (ii) represents a competitive disadvantage for those warehouse operators who do register their sheds, and (iii) can be easily circumvented by storing metal just outside the warehouse.

Instead, the LME is proposing to introduce a regime which reflects the fact that many metal owners choose off-warrant storage, but with the comfort that metal can be warranted if ever required. In the view of the LME, such metal owners are benefitting from the option of LME warranting, and the trade-off for this option should be a willingness to contribute to off-warrant stock reporting.

For the purposes of the proposed rule, off-warrant stock will need to be reported to the LME by warehouse operators (but with no need to identify the underlying metal owner) where one or more of the following criteria apply:

- (i) The warehouse's storage agreement with the customer specifies that the metal must be held in an LME-registered shed (this requirement includes metal which would not be eligible for warranting, including metals not covered by an LME contract, but is required by the metal owner to be stored in an LME-registered shed); and / or
- (ii) The warehouse's storage agreement with the customer specifies that the metal can be LME-warranted on request by the metal owner i.e. the warehouse provides a guarantee of warrantability at some point in the future to the metal owner (this includes metal not currently stored in an LME Delivery Point); and / or

- (iii) The metal owner has voluntarily requested that the warehouse disclose the stock to the LME. The LME strongly encourages metal owners to opt-in to the voluntary disclosure system. However, the LME may in future consider changing the economic terms for metal owners to warrant metal, depending on whether the metal for warranting had been subject to off-warrant transparency at the earliest possible opportunity

Warehouse companies will be required to report monthly tonnage of such stock to the LME by metal and location. In turn, and having assessed the usefulness and representativeness of the data set, the LME may choose to publish data, on an anonymised basis and aggregated across all warehouse operators in one location. The full details of this requirement are including in clause 6.3 of the LME Warehouse Agreement attached to this report at Appendices E and F.

The LME believes that this proposal is both fair and proportionate, as it focuses on those tonnages where the LME is specifically named in a commercial contract, and/or where there appears to be an intention that LME services may be consumed (namely, the LME warranting of the metal). “True” off-warrant storage, where the metal owner never intends to warrant the metal, would not be captured. Furthermore, it does not disincentivise warehouses to become LME-listed, because metal held in “true” off-warrant storage would never need to be reported, regardless of whether the warehouse were LME-listed.

While the LME acknowledges that such a regime will take time to bed in and produce truly meaningful market-wide transparency, it believes that this is an appropriate and helpful first step towards this goal.

5.2. Daily stock reporting amendment [CP12]

The LME intends to change to its daily stock report to implement a new classification of metal held within each warehouse. Existing reporting includes a “live” (metal on-warrant) status, as well as a “cancelled” status. Cancelled metal, currently, can refer to metal that has been cancelled and is scheduled (or in the process of being scheduled) for load-out, as well as metal which has been cancelled, but where the metal owner has no immediate plans to take delivery. Under the new proposal, the “cancelled” classification would refer only to metal that was cancelled but not scheduled for load-out, while a new classification – “scheduled” – would refer to metal that had been cancelled and was scheduled (or in the process of being scheduled) for load-out. This would provide a clearer indication to the market about the real level of available stocks on warrant.

However, in order for this change to take effect, various LME systems – in particular, LMEsword – will require extensive upgrading and testing. As such, the LME is proposing to give itself the right to implement these changes by Notice in the future, at a point at which it is able to undertake the necessary system upgrades to facilitate the amended reporting. This is set out in clause 6.3.5 of the LME Warehouse Agreement attached at Appendices E and F.

5.3. Sanctions [CP13]

The LME is proposing to set out specifically the obligation on its listed warehouse operators to comply with sanctions, such as may arise from time to time in relevant jurisdictions for their operations, providing that such sanctions are not in conflict with the LME Warehouse Agreement or other policies or procedures. This requires a minor amendment to clause 7.5.1 of the LME Warehouse Agreement, attached at Appendices E and F.

5.4. LME insolvency powers [CP14]

The LME's warehousing model is intended, as far as possible, to insulate metal owners from the effects of a potential insolvency of a warehouse. In order to enhance these protections, the LME has 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). 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.

The proposal also requires warehouses to provide more visibility over their financial situation to the LME, although the LME is cognisant that such forward projections are liable to change at short notice depending on, amongst other factors, market conditions. As a result, while the LME will expect warehouses to provide such information on an accurate (at time of reporting) and timely basis, the LME would not propose to give itself the power to penalise warehouses should these projections change between reporting periods.

5.5. Complaints Procedure [CP15]

The LME is proposing to make a number of changes to its Complaints Procedure (see Appendices G and H), when a complaint is made to the LME against a third party (for example, a warehouse operator or member). The changes include amending the scope of the Complaints Procedure (for instance, 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 fee for complaints against third parties where appropriate, to reflect the costs that the LME incurs when investigating a complaint. The provisions have been drafted to ensure that complainants will have certainty as to the cost of the LME investigating a complaint, and to provide a mechanism whereby the LME can recommend that a successful complainant's costs are refunded by the party at fault.

The Complaints Procedure has also been amended so that it now covers complaints in relation to benchmarks administered by the LME under the European Benchmarks Regulation ("EBR"). EBR (which comes into force on 1 January 2020) requires the LME to provide a complaints handling policy including procedures for dealing with complaints about its benchmark calculation process.

For the avoidance of doubt, complaints against the LME will continue to be addressed in broadly the same way as at present, and will not be subject to a fee.

5.6. Applicable law for warrants [CP16]

The LME is proposing to amend the Warehouse Agreement at clause 2.3.2 (see Appendices E and F) to give the LME a general power to prescribe that warrants should be governed by the laws of a particular jurisdiction (e.g. English law). This general power would enable the LME to issue notices from time to time, specifying that the laws of a certain jurisdiction apply to warrants within a certain jurisdiction. This may be necessary to maintain the validity and efficacy of warrants under local law in those jurisdictions.

6. REBALANCED RULES AND A PATHWAY TO SIMPLIFICATION

As set out further above, the LME does consider it appropriate to consider a rebalancing of the parameters of its most significant warehousing rules – in particular, LILO and QBRC – given the length of time since their introduction. In so doing, the Exchange aims to enhance the ability of warehouses to attract metal on warrant, but without unduly harming the protections available to consumers, or creating a scenario in which warehouses compete for metal with the physical market. Furthermore, from a more a methodological perspective, the LME would only effect such change by means of a structured and staggered introduction, allowing the effects to be clearly understood and assessed.

However, more broadly, when considering the LME's ruleset – and, in particular, LILO and QBRC – it is worth noting that the discussions of the Warehousing Committee (which originally gave rise to the discussion paper) commenced with a desire for simplification. As set out earlier, the LME acknowledges the complexity of its rules, and hence concurs with this aim, provided that appropriate market protections can be maintained.

The underlying proposal for simplification is a move away from both QBRC and LILO, to a proportionate load-out approach, whereby a warehouse would have to load out, on any given business day, a specific percentage of its stock. This would mathematically have the effect of ensuring that, even in the worst queue-based scenario where every warrant had been cancelled, a metal owner's maximum wait time (even if at the back of the queue) would be capped.

The Exchange considered the concept of such a model during the 2013 warehouse reform process. However, at that time, the very large tonnages held by certain warehouses would have made such a rule logistically impractical. However, given the reduction in stocks over the intervening years, the LME does now agree that such an approach may be of value.

However, the core challenge in implementing such a model is (as with the parameters of the current QBRC rule in particular) in setting a percentage rate which provides adequate protection for users of the market, while ensuring that warehouses are able to bring metal onto warrant. Broadly, the worst-case wait which a metal owner may experience can be found by taking the reciprocal of the load-out percentage; for example, a 2% daily load-out (as is applied elsewhere in the exchange industry) would result in a 50 business day worst-case wait time, corresponding to a c.70 calendar day worst-case wait time. This contrasts with the current QBRC protections which come into effect after 30 days, and fully after 50 days. However, in making this comparison, it should be noted that QBRC does not compel timely load-out – rather, it simply provides rent protection in the event of queues. Timely load-out is effected in the current rule-set by LILO, but the precise wait time is a more complex analysis based on load-in; the simpler analysis permitted by a daily load-out rate is one of the clear benefits of such an approach.

However, the fact remains that, even at a 2% load-out, the worst-case wait time for metal users could be longer than the point at which relief would currently be available under QBRC – and, based on the indicative views of LME warehouse operators, it appeared that they would look for a lower daily load-out percentage (indicatively, 1.5%), which would further accentuate this effect. This, combined with some specific unresolved logistical questions around non-dominant metals and other edge effects, resulted in the LME not including such a simplification approach in the discussion paper. While the LME notes that warehouse operators were open to a preservation of metal owner protections via a mechanism whereby QBRC could be re-introduced by the LME if required, the Exchange considers

this to be an unworkable solution, given the need to provide clarity to the market in advance as to the circumstances in which such reintroduction would be effected (with no viable such model having been advanced).

Accordingly, the LME continues to believe that it would not be appropriate to progress any such rule change at the present time, given that the simplification would be accompanied by a material change as to the protections available to consumers. However, the LME would also note that, following the introduction of the changes proposed in the Consultation (and, in particular, to the QBRC Rule parameters), the degree of change represented by a percentage load-out approach would be materially reduced, and the Exchange would hence be minded to consider such a modification.

6.1. QBRC Rule parameters [CP17]

In view of the analysis set out in Section 3.2, and the LME's concerns about an immediate move to a simplified load-out related ruleset as outlined above, in the immediate term the LME is proposing to amend the current rules for QBRC to (i) remove the phased element of rent reduction (currently a 50% drop in rent obligations after 30 days), and (ii) extend the QBRC threshold to 80 days. This means that a metal owner, having completed all the necessary formalities to permit load-out, scheduled the load-out and waiting in a queue for their metal, would be obliged to pay for the first 80 days while in that queue.

The LME is conscious that a number of market participants remain sceptical about the possible negative impact of these changes, and the extension to 80 days in particular, and as such, is proposing to implement the change on the following phased basis:

- (i) Notification date: LME provides 90 days' notice of QBRC change implementation date
- (ii) Implementation date: QBRC rent obligations terminate at 50 days
- (iii) Implementation date + 3 months: QBRC rule rent obligations terminate at 60 days
- (iv) Implementation date + 6 months: QBRC rule rent obligations terminate at 70 days
- (v) Implementation date + 9 months: QBRC rule rent obligations terminate at 80 days

In this way, it would take a full year from the LME's notification to the market for the full impact of the proposal to take effect. Such an approach would allow both the LME and its market to assess the impact of the rule change as it progresses. Should market behaviour indicate that the proposal is causing disruption, the LME reserves the right to stop the phased implementation. Furthermore, the 80 day threshold has been chosen with the intention that this would not allow warehouse incentive payments to rise to a level where they compete with physical metals premia; again, the staged nature of the introduction above should facilitate observation of the effectiveness of this approach.

The LME is aware that a phased implementation of these changes could potentially create an incentive for metal owners to behave in a way calculated to maximise QBRC potential around the time of changes to the QBRC threshold. The applicable threshold would be determined by reference to the date of completion of the formalities necessary to permit load-out of metal in respect of a given request for load-out (as per the definition of Cancellation – see paragraph G.4 and Section I of the AOW Policy). The LME would monitor cancellation behaviour carefully during the phased implementation of the proposed changes to QBRC and reserves its right to disapply QBRC if the LME, acting reasonably in its sole discretion, considers it appropriate to do so, in accordance with paragraph G.7 of the AOW Policy.

Finally, the LME is also proposing to apply the QBRC Rule anti-abuse provisions to all requests for load-out of metal, not solely those of 10,000 tonnes or more, to prevent market behaviour which

utilises the current 10,000 tonnes threshold in order to maximise the QBRC Rule to achieve outcomes for which it was not originally intended.

These proposals are set out in full in paragraph G of the AOW Policy attached at Appendices A and B, and for the avoidance of doubt, the other rules which currently govern the application of QBRC would continue to apply.

6.2. LILO clarifications [CP18]

The LILO-related proposals in this Consultation emerged from concerns around the operation of the LILO Rule and whether it offers the appropriate protections for market users – and in particular, warehouse operators – from other market participants who might look to leverage the rule to achieve outcomes for which it was not originally intended. As such, the LME is proposing three core changes to the LILO Rule itself.

Firstly, the LME is proposing 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. If the LME, in its sole discretion, grants such a request, the warehouse company would still be required to meet the additional load-out obliged by the application of the LILO Rule, but would be able to offer the associated additional load-out slots to other metal owners caught in the queue. This is set out in full in paragraph E.5 of the AOW Policy, attached at Appendices A and B.

Secondly, the LME is proposing an amendment to LILO to address the concern that a warehouse operator does not know at which point it will become an Affected Warehouse if they do not have a queue, and then are impacted by a large cancellation request during the course of a Calculation Period.

To address this, the LME is consulting on an amendment to the existing LILO Rule paragraph which provides 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. This is set out in full in paragraph E.4 of the AOW Policy, attached at Appendices A and B.

Thirdly, the LME is consulting 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. It must, however, continue to fulfil all scheduled load-out slots, as outlined in paragraph E.5 of the AOW Policy, attached at Appendices A and B.

6.3. AOW Policy housekeeping changes [CP19]

In addition to the reforms outlined above, the LME is also proposing to undertake a number of housekeeping updates to the AOW Policy, including:

- (i) Clarifying the obligations on warehouses in respect of the minimum daily load-out tonnage and related obligations (i.e. the Additional Daily Metal requirement and daily minimum load-out quantities for specified metals) in Section C;

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- (ii) Removing references to steel and roasted molybdenum concentrate (“RMC”);
- (iii) Making references to delivery and load-out consistent, by making them all load-out;
- (iv) Clarifying the grounds on which the LME will exercise its discretion under C6 to disapply the LILO Rule;
- (v) Clarifying obligations on warehouses in relation to processing requests for load-out of metal, including the requirement that warehouses must schedule load-out to commence no later than the same time on the second business day after the completion of Formalities (as defined in the Policy);
- (vi) Clarifying the meaning of Queue, in particular in relation to when a Queue arises and how it is measured;
- (vii) Updating the worked examples in sections relating to the LILO Rule and QBRC; and
- (viii) Ensuring all defined terms are cross referred in the General Definitions section of the Policy.

7. CONCLUSION

The LME is committed to ensure that its warehouse network represents best practice in operational efficiency and as a market of last resort, and believes that the proposals defined above represent a fair and practical route forward to ensure that its physical network continues to evolve to meet emerging challenges. The LME would like to thank all its stakeholders and other market participants who have contributed towards the LME's process in defining its proposals thus far, in particular its Warehousing Committee, and looks forward to receiving further views in respect of this Consultation.

8. APPENDICES

- Appendix A: LME Policy on the Approval and Operation of Warehouses – redline
- Appendix B: LME Policy on the Approval and Operation of Warehouses – clean
- Appendix C: LME Policy on the Approval of Locations as Delivery Points – redline
- Appendix D: LME Policy on the Approval of Locations as Delivery Points – clean
- Appendix E: LME Warehouse Agreement – redline
- Appendix F: LME Warehouse Agreement – clean
- Appendix G: LME Complaints Procedure – redline
- Appendix H: LME Complaints Procedure – clean

9. INDEX OF CONSULTATION PROPOSALS

Consultation Proposal	Location
CP1	LME Warehouse Agreement, clause 9.3.8
CP2	LME Warehouse Agreement, clause 5.3.3
CP3	AOW Policy, paragraph C.7
CP4	LME Warehouse Agreement, clause 5.2.4
CP5	AOW Policy, paragraph C.1
CP6	LME Warehouse Agreement, clause 6.3.2
CP7	LDP Policy, paragraph C.2
CP8	LDP Policy, paragraph A.3
CP9	AOW Policy, paragraph H; LDP Policy, paragraph E
CP10	LME Warehouse Agreement, clause 6.3.3
CP11	LME Warehouse Agreement, clause 6.3
CP12	LME Warehouse Agreement, clause 6.3.5
CP13	LME Warehouse Agreement, clause 7.5.1
CP14	LME Warehouse Agreement, clauses 1.2, 9.4 and 9.14
CP15	Complaints Procedure
CP16	LME Warehouse Agreement, clause 2.3.2
CP17	AOW Policy, paragraph G
CP18	AOW Policy, paragraph E
CP19	AOW Policy, paragraphs C, E, G, I