LONDON METAL EXCHANGE

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

Ref: 14/318 : A310 : W148

Date: 7 November 2014

Subject: **CONSULTATION ON PROPOSED AMENDMENTS TO THE POLICIES AND PROCEDURES RELATING TO THE LME'S PHYSICAL DELIVERY NETWORK**

Summary

1 The LME is today announcing a market-wide consultation (the "Consultation") in respect of amendments to its policies and procedures relating to its physical delivery network.

2 Primarily, this will address the need to ensure that the LME's physical network fully services the requirements of the global metals market.

The Consultation process

3 The Consultation is open to all interested market participants, and also regulatory and governmental bodies.

4 Formal responses to the Consultation should be submitted in writing. Any market participant wishing to submit a response to the Consultation, or to arrange for further discussions seeking clarification in relation to the Consultation, is asked to contact Georgina Hallett at consultation@lme.com or +44 (0)20 7423 5780.

5 Although the LME will consider responses submitted in any format, it would be most helpful if respondents can reply to the numbered Consultation Questions set out throughout this Consultation Notice.

6 During the period of the Consultation (see below), the LME will, subject to reasonable logistical constraints, be available for meetings to discuss the subject matter of the Consultation.

7 Responses made after the closing date of the Consultation (see below) will not necessarily be taken into consideration. The LME may need to share responses received with regulatory authorities or its legal or other professional advisers, or as required by law. Apart from this, all responses received will be treated in confidence.

Warehouse Consultation

8 In parallel with this Consultation, the LME is also undertaking a consultation with Warehouses on proposed changes to the Warehouse Agreement (the "Warehouse Agreement Consultation").

Historical background

9 On 1 July 2013, the LME announced (in Notice 13/208 : A201 : W076) a consultation in respect of queues at LME-licensed warehouses (the "2013 Consultation"). In particular, the 2013 Consultation proposed the introduction of a linked load-in / load-out rule. The 2013 Consultation ran from 1 July 2013 to 30 September 2013 and saw strong market engagement.

10 On 7 November 2013, the LME announced in Notice 13/326 : A312 : W125 (the "Decision Notice") the outcome of the 2013 Consultation, including the adoption of the Linked Load-In / Load-Out Rule as proposed, with one modification[1] and certain clarificatory drafting changes (the "2013 LILO Rule"), together with a set of other measures. The LME also published a comprehensive report on the 2013 Consultation (the "2013 Consultation Report").

11 In the 2013 Consultation Report and Decision Notice, the LME undertook to implement a Warehouse reform package with twelve core elements. Of these twelve core elements, six have already been implemented: (a) separate steel load-out rate, (b) per-warehouse queue length report, (c) commitments of traders report, (d) creation of the Physical Market Committee, (e) specific powers for the LME to address behaviour that creates or maintains queues (clause 9.3.4 of the Warehouse Agreement), and (f) information barrier policy review. Notice 14 / 276 : A268 : W136 updated the market on progress in respect of the LME's reforms of its physical delivery network, including the status of the LME's appeal to the Court of Appeal against the decision of the English High Court of Justice in relation to the Judicial Review brought by United Company Rusal plc ("Rusal") (the "Appeal"), and the impact of the Appeal on the implementation of the LME's planned programme of warehousing reform, as well as providing further detail on proposed warehousing rules to support LME premium futures contracts.

12 A summary of the remaining elements of the Warehouse reform package, together with information on how the LME is addressing each element, is set out below:

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[1] An altered queue threshold.

a. **Implementation of the LILO Rule.** Following the recent judgment of the Court of Appeal, the LME intends to implement the LILO Rule with effect from 1 February 2015.

b. **Warehousing logistical review**. This is covered by this Consultation (see below).

c. **Warehousing Agreement review**. This is covered by the separate Warehouse Agreement Consultation.

d. **Premium futures contracts**. This is covered by this Consultation (see below).

e. **Re-assessing the possibility of capping or banning rents in queues** (see below).

f. **Re-assessing the possibility of capping the level of daily rents and FOTs** (see below).

13 Rusal have now sought leave to appeal the Judicial Review proceedings to the Supreme Court. Given the relevance of (e) and (f) above to the ongoing proceedings brought by Rusal, the LME cannot address these items further at this time.

Elements of the Consultation

14 This Consultation puts forward the following proposals (the "Proposals"):

a. As detailed above, the LME committed to commission an independent report into broader aspects of the LME's physical network and logistical arrangements (the "Logistical Review"). This work has now been undertaken by Oliver Wyman, and is attached as Appendix A (the "Logistical Review Report"). The LME has largely accepted the suggestions made in the Logistical Review Report, and is proposing a set of changes to its Policy on the Approval and Operation of Warehouses (Appendix B) and Policy on the Approval of Locations as Delivery Points (Appendix C) in order to give effect to these suggestions (the "Logistical Review Report Proposal"). The changes to the Policy on the Approval and Operation of Warehouses and the Policy on the Approval of Locations as Delivery Points also incorporate certain administrative or other amendments which the LME believes would be helpful for the market.

b. The LME also committed to launch a set of regional premium contracts, which require modifications to the LME's warehousing policies in order to function effectively (the "Premium Contract Rule Proposal").

c. The LME is, additionally, taking the opportunity to propose a further change not covered in the 2013 Consultation, but which it believes will assist the success of its existing aluminium alloy and NASAAC contracts (the "Aluminium Alloys Rule Proposal").

Timing and steps following the Consultation

15 Following due consideration, the LME may implement either:

a. in respect of each of the Proposals, that Proposal, a modified version of that Proposal, an alternative to that Proposal, or no measure in respect of that Proposal;

b. any other measure(s); or

c. no measures.

16 In the event that the LME decides to adopt any new rules following the Consultation, the LME presently intends to adhere to the following timetable:

a. the Consultation will run between 7 November 2014 and 9 February 2015;[2]

b. the LME will aim to publish its conclusions by mid-March 2015;

c. the three-month notice period required under the Warehouse Agreement will run between mid-March and mid-June 2015; and

d. any new rules adopted as a result of the Consultation will come into effect around mid-June 2015.

The LME's financial interest

17 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

2 This will also encompass the consultation with Warehouses under the Warehouse Agreement.

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, and hence these two factors far outweigh any financial return which could accrue as a result of the stock levy on rents in any economic circumstance.

THE LOGISTICAL REVIEW REPORT PROPOSAL

18 Oliver Wyman has produced the Logistical Review Report, which is attached as Appendix A. The Logistical Review Report provides a full assessment of the various issues which the Logistical Review was tasked to cover, and the reader's attention is hence drawn to that document for a full exploration of the various issues and proposals.

19 The LME has largely accepted the suggestions made in the Logistical Review Report [3], and is hence proposing to make the rule changes set out in the Policy on the Approval and Operation of Warehouses (Appendix B) and the Policy on the Approval of Locations as Delivery Points (Appendix C), which give rise to the various changes advocated by Oliver Wyman. Note that the blackline of the Policy on the Approval and Operation of Warehouses shows the changes as against the version currently in force. As announced by separate Notice, the changes relating to LILO will take effect on 1 February 2015.

20 The LME welcomes the recommendations relating to best practice for warehouse companies set out in section 4.1 of the Logistical Review Report. Going forward, as part of its routine audits of Warehouses, the LME intends to review how Warehouses are implementing these recommendations as set out in section 4.1 of the Logistical Review Report at Appendix A to ensure the efficiency of their operations, consistent with meeting their obligations to LME warrant holders.

21 The LME also proposes to make certain other changes to the Policy on the Approval and Operation of Warehouses. These include:

a. Separate daily additional load-out quantities for tin and nickel (where previously the load-out requirement referred to a combined tonnage for both

[3] With the exception that the LME has not accepted the suggestion in section 3.2 of the Logistical Review Report that it "create a probation period of two years to monitor whether operations of a new Warehouse are carried out according to the LME standard", during which period the LME would have the right to suspend or delist the warehouse company on three months' notice; as the LME already has adequate powers to terminate set out in section 9.4 of the Warehouse Agreement including the ability to terminate and delist a Warehouse by the service of six months' prior notice.

such metals). In order to ensure appropriate load-out rates for both tin and nickel, the LME considers that there should be a separate obligation in relation to each of these metals. The additional load-out obligations for tin and nickel take a similar approach to that proposed for Aluminium Alloys (see below).

b. Clarification that a "dominant metal" will always be the first metal scheduled to be delivered out on any given day. This is to ensure that it is clear that there can only ever be one "dominant metal" on a daily basis, regardless of whether more than one metal exceeds the scheduled delivery-out threshold on that day.

c. Clarification that charges above the Free on Truck charge ("FOT") for the return of metal can only be applied by Warehouses in certain limited circumstances. This is to reflect the fact that additional charges will typically only be appropriate when returning metal to certain Delivery Points, in order to reflect the increased logistical and transport costs incurred by Warehouses in such Delivery Points.

22 Market feedback is requested in relation to these rule changes.

Consultation Question 1: Do you have any comments on the changes to the Policy on the Approval of Locations as Delivery Points or the Policy on the Approval and Operation of Warehouses?

THE ALUMINIUM ALLOYS RULE PROPOSAL

23 Since the 2013 Consultation, the LME has invested significant time in assessing the performance of both the aluminium alloy and the NASAAC contracts (collectively "Aluminium Alloys"). It is the view of the LME that, as relatively low-volume contracts with accordingly lower volumes of warranted stock, Aluminium Alloys suffer particularly from the existence of queues composed of primary aluminium.

Construction of the Aluminium Alloys Rule

24 The additional load-out requirements in relation to the Aluminium Alloys Rule are set out in the Policy on the Approval and Operation of Warehouses in Appendix B, and are summarised below.

25 Any Warehouse licensed to warrant Aluminium Alloys will be subject to an additional load-out requirement of 500 tonnes per day for its Authorised Warehouses in a particular Delivery Point (being the "Aluminium Alloys Minimum Daily Load-Out") of Aluminium Alloys. This will operate as with the current nickel and tin requirement, i.e. if the normal course scheduling of metal in the queue (including the non-dominant metal load-out requirements, but not including any additional requirements

under the LILO Rule) does not result in 500 tonnes of Aluminium Alloys being loaded-out, then additional load-outs must be made (in the order of Aluminium Alloys warrant cancellation) such that total Aluminium Alloys load-out is at least 500 tonnes.

Benefits of the Aluminium Alloys Rule

26 The core benefit of the Aluminium Alloys Rule, in the view of the LME, is the reduction in the discount to the all-in price at which the Aluminium Alloys trade – which, based on feedback from the market, is a core barrier to broader uptake of the contracts by key market participants.

Unintended consequences of the Aluminium Alloys Rule

27 The primary potential negative consequence of the Aluminium Alloys Rule is that Warehouses may choose to increase their rates in respect of Aluminium Alloys, to reflect any greater costs which may be associated with providing separate load-out rates. However, the LME considers that the benefit of the Aluminium Alloys Rule outweighs any negative consequence.

Key parameters of the Aluminium Alloys Rule

28 The key parameter in respect of the Aluminium Alloys Rule is the Aluminium Alloys Minimum Daily Load-Out. The LME has calibrated this figure based on current Aluminium Alloys stocks, and believes that a load-out of 500 tonnes per day would restore price convergence to the contract.

Consultation Question 2: Do you have any comments on the Aluminium Alloys Rule Proposal?

THE PREMIUM CONTRACT RULE PROPOSAL

29 In Notice 14/121 : A117 : W056, the LME announced its intention to launch a set of regional premium hedging contracts, initially in respect just of aluminium, but potentially in relation to other metals as well. These contracts will be settled via existing LME warrants – however, the contracts will have more restrictive rules as to which warrants (such eligible warrants being “Premium Warrants”) can be used in settlement. Notice 14/276 : A268 : W136 provided further information on the proposed construction of the premium contracts.

30 In particular, it is currently envisaged that only Warehouses without queues in a particular Delivery Point will be eligible for the delivery of warrants against LME premium contracts in that Delivery Point. However, a core concern for the LME in respect of premium contracts is the emergence of queues at Warehouses in that Delivery Point which previously did not have queues.

31 For example, consider that a long holder of an LME premium contract takes delivery of a Premium Warrant at a Warehouse not affected by queues. If, immediately following the delivery of this warrant, other metal owners in the associated Warehouse were to cancel large quantities of metal, then it is possible (under the existing rules) that a queue could build up at that Warehouse in the particular Delivery Point, which would then affect the ability of the recipient of the Premium Warrant to readily access the underlying metal. While the LME believes that its new powers (contained, in particular, in Clause 9.3.4 of the Warehouse Agreement) will materially restrict the creation of any new queues, it remains possible for such queues to arise, particularly over a short timeframe driven by material warrant cancellations.

32 Accordingly, it is the view of the LME that those receiving premium contracts require greater protection, otherwise the contract (which was requested by a broad set of market participants during the 2013 Consultation) will not function effectively.

33 Specifications for the LME premium contracts will be set out in the LME rulebook (contained within a new section to be entitled the "Premium Contract Regulations"). Because the precise specifications cannot be set out until this Consultation has concluded, a summary of the proposed specifications is provided in Appendix D.

Construction of the Premium Contract Rule

34 The Premium Contract Rule is set out in the Policy on the Approval and Operation of Warehouses in Appendix B, and is summarised and explained below.

35 Within the LMEsword system, it is proposed currently that functionality will be added whereby London agents, acting on the instructions of a Warehouse, can endorse warrants as Premium Warrants in respect of a given premium region and given metals (such regions and metals being defined in the Premium Contract Regulations). Warrants not so endorsed will be referred to as "Standard Warrants".

36 In order for a Warehouse to endorse a warrant as a Premium Warrant, it is proposed that the following conditions must be satisfied:

(i) The Warehouse must be located in one of the premium regions, as set out in the Premium Contract Regulations. So, for instance, a Warehouse located in Chicago would be able to endorse US Premium Warrants, whereas a Warehouse located in Rotterdam would be able to endorse Western European Premium Warrants.

Warehouses not located in any premium region (e.g. a Warehouse in Liverpool) are not able to endorse any form of Premium Warrant;

(ii) The Warehouse must have opted-in to the premium warrant regime, by completing the appropriate agreement with the LME. The LME will publish a list of all Warehouses which have opted-in to the premium warrant regime. Once opted-in, a Warehouse in a particular Delivery Point may only opt-out if its stock of Premium Warrants is zero; and

(iii) At the time of endorsement of the Premium Warrant, the Warehouse in the particular Delivery Point must not have a queue in respect of any LME metal. Furthermore, if a metal owner, having cancelled a warrant, completed the necessary formalities and requested prompt load-out by truck, is told by the Warehouse that load-out cannot be completed within two London business days, the Warehouse will have an immediate duty to inform the LME, which will then (within one London business day) announce to the market that the Warehouse will cease to be able to endorse new Premium Warrants three London business days following such announcement. This three day period is designed to ensure that metal owners in the process of creating Premium Warrants for use in contract delivery are able to complete such process before the Warehouse is prohibited from endorsing Premium Warrants.

However, and notwithstanding the three day adjustment period, metal owners should note that, given the above, the emergence of a queue at a Warehouse may impact their ability to create Premium Warrants at the Warehouse in that Delivery Point. Accordingly, those holding short positions in respect of LME premium contracts are urged to ensure that they have created the requisite Premium Warrants in good time prior to delivery.

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

Warehouses which have cleared their queues in the relevant Delivery Point will be entitled to resume the issuance of Premium Warrants following the publication of the next monthly per-Warehouse queues report confirming that no queues remain.

The ability to endorse Premium Warrants applies at the level of all of the Authorised Warehouses (the sheds of a particular Warehouse) of a Warehouse in a particular LME-approved Delivery Point – the new definition of "DP Warehouse" in the Policy on the Approval and Operation of Warehouses will capture this meaning. Accordingly, if a Warehouse has a queue in one Delivery Point, this will not prevent that Warehouse endorsing Premium Warrants at its facility in a different Delivery Point, provided that the second facility does not have a queue.

A new definition of "DP Warehouse", meaning all the Authorised Warehouses of a particular Warehouse within a Delivery Point, has been introduced to the Policy on the Approval and Operation of Warehouses so as to clarify the application of the policy, and, in particular, the Premium Contract Rule and the LILO Rule. The new definition is consistent with the meaning of the term "Warehouse" as it applies in the current version of the LILO Rule.

(iv) A Premium Warrant can only be endorsed if the metal owner so requests, and the Warehouse agrees to do so. There are two routes by which a Premium Warrant may be created:

- In connection with fresh metal loaded-in to the Warehouse, a warrant is issued in respect of that metal, and is immediately endorsed as a Premium Warrant. Warehouses may set a different rent and FOT rate in respect of Premium Warrants – such rates will be reported to the LME by Warehouses and published annually in the same way as for Standard Warrant rent and FOT rates. As with current metal load-in, no Warehouse is obligated to accept metal for warranting, and metal owners must ensure that Premium Warrant creation capacity is available at their intended Warehouse – in particular, it is expected that Warehouses will not wish to warrant more premium metal than they could logistically load-out pursuant to the greater requirements attaching to such metal. However, the LME would expect Warehouses which have opted-in to the premium warrant regime not to unreasonably refuse the load-in of metal and the creation of Premium Warrants; or

- An existing Standard Warrant is converted to a Premium Warrant. Warehouses opting-in to the premium warrant regime may indicate whether or not they are prepared to undertake such conversion, and to identify if they wish to charge a conversion fee (the amount of which will be reported to the LME and published annually by the Warehouse) which will be levied in this event. Warehouses may also set a maximum quota (expressed as a tonnage) in respect of the maximum amount of Standard Warrants which they will be prepared to convert to Premium Warrants. This may be important for Warehouses with large stocks of Standard Warrants, and which would not be able to take on the additional requirements were the entire stock to be converted to Premium Warrants. However, within their stated quota, Warehouses will be expected to convert Standard Warrants into Premium Warrants on a non-discriminatory and first-come-first-served basis. Once a Standard Warrant has been converted into a Premium Warrant, then the Warehouse's published Premium Warrant rents and FOTs will apply.

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

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

and

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

38 For the avoidance of doubt, nothing in respect of load-out obligations for Premium Warrants will change the treatment required for Standard Warrants – load-out obligations for Premium Warrants are in addition to those already applying to Standard Warrants. The currently published load-out rates (modified as appropriate for other rules adopted as a result of this Consultation) will continue to apply to Standard Warrants, and the basis on which minimum load-out rates for Standard Warrants are calculated will take into account total stored tonnage in the Warehouse, both Standard Warrants and Premium Warrants.

Benefits of the Premium Contract Rule Proposal

39 The core benefit of the Premium Contract Rule is that greater certainty can be given to the buyers of warrants through premium contracts that the warrants they receive in settlement will, indeed, be readily-accessible. In the absence of such action, there would exist various abusive scenarios in respect of the LME's premium contracts – for example, a metal owner holding a large number of uncancelled warrants in a Warehouse without a queue could deliver one of those warrants against a premium contract, while simultaneously cancelling all of the remaining warrants and creating a queue. This would materially reduce the value of the warrant delivered in settlement (as it would subsequently sit in a queue), and the original seller could then offer to buy it back for a discount. By then re-warranting the cancelled warrants which it still owned, the original seller would then restore the value of the delivered warrant back to a premium level.

Unintended consequences of the Premium Contract Rule Proposal

40 In general, the unintended consequences of the Premium Contract Rule Proposal are limited, given that opt-in is required from both Warehouses and metal owners.

As such, any market participant which does not agree with the Proposal is free not to participate in the Rule.

41 In particular, the Rule does not disadvantage holders of Standard Warrants, in comparison to their current situation, as no load-out rates for Standard Warrants can be reduced as a result of the Rule. Indeed, the Rule will likely lead to improved efficiencies for holders of Standard Warrants, given that a Premium Warrant cancelled prior to the cancellation of a Standard Warrant (which, in the absence of the Rule, would have resulted in the Premium Warrant being ahead of the Standard Warrant in the queue) will be loaded-out pursuant to a separate queue, hence accelerating the passage of the Standard Warrant in the existing queue.

42 As a boundary condition, it is possible that the load-out of a Standard Warrant may be delayed because a Premium Warrant cancelled after the Standard Warrant is loaded-out more expeditiously, resulting in the total Warehouse stock falling below one of the thresholds and hence leading to a lower required load-out rate for the Warehouse. This could slightly delay the load-out of the Standard Warrant compared to a scenario in which the Rule were not in force. However, the LME thinks this is very much an exceptional scenario, and does not believe that it represents a major concern in respect of the Rule.

43 Given the greater requirements attaching to Premium Warrants, it may be expected that Warehouses will set levels of rent and FOT in excess of those for Standard Warrants, which may further accentuate the concerns of the market in respect of perceived high levels of rent and FOT. However, it should be noted that the construction of the regional premium contract is fundamentally different to that of the core LME contract, in that the cash payment from buyer to seller at settlement is reduced by the rate of FOT associated with that transferred warrant. As such, the seller effectively funds the FOT, and a metal owner looking to create a Premium Warrant and deliver against an LME premium contract is hence incentivised to choose the most competitive level of FOT. Although the buyer will need to fund rent after the transfer of the warrant, the buyer has the option (in the event of considering that rent in the Warehouse is unreasonable) to load-out the metal (given that the FOT will have been paid, in effect, by the buyer).

44 Notwithstanding the above, the mechanism by which FOT is paid to the Warehouse remains the same, i.e. a cash payment from the cancelling metal owner to the Warehouse.

Key parameters of the Premium Contract Rule

45 The Minimum Premium Warrant Load-Out Requirement has been set to 1,000 tonnes per day on the basis of the LME's expectations as to the potential volume of Premium Warrants likely to be created.

46 The Premium Warrant Load-Out Percentage has been set to 3%. Accordingly, even if in the worst case all warrants were cancelled simultaneously, the longest queue which could be expected to exist at the Warehouse in respect of Premium Warrants would be 34 business days. This is broadly comparable to the 30 days threshold which is viewed by the LME as being an average sourcing horizon for a metal consumer requiring access to metal bought in the physical market.

Consultation Question 3: Do you have any comments on the Premium Contract Rule Proposal?

Consultation Question 4: Are there any other matters you wish the LME to consider in the context of any aspect of the Consultation?

Matthew Chamberlain
Head of Business Development

Cc: Board Directors
Warehousing Committee
Special Committee
Physical Markets Committee
User Committee
All metals committees

List of Appendices

APPENDIX A.	Oliver Wyman Logistical Review Report
APPENDIX B	Proposed LME Policy on the Approval and Operation of Warehouses – clean and blackline
APPENDIX C.	Proposed LME Policy on the Approval of Locations as Delivery Points – clean and blackline
APPENDIX D.	Summary draft Premium Contract specifications