

To: All warehouse companies

CC: All members

Ref: 14/319 : W149

Date: 7 November 2014

Subject: **CONSULTATION ON CHANGES TO THE WAREHOUSE AGREEMENT**

Summary

- 1 The LME seeks the views of warehouse companies in relation to proposed amendments to the Warehouse Agreement.

Background

- 2 The LME is today by separate notice announcing a market-wide consultation in respect of its warehousing policy and physical delivery network.
- 3 On 1 July 2013, the LME announced (in Notice 13/208 : A201 : W076) a consultation in respect of queues at LME listed 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.
- 4 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 modification¹ 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”). Implementation of the 2013 LILO Rule was delayed by litigation, but a slightly revised version of the LILO Rule will now come into force on 1 February 2015.
- 5 In both the Decision Notice and in the 2013 Consultation Report, the LME committed to commission an independent review of the Warehouse Agreement by external counsel. This work has now been undertaken. The changes the LME is now proposing are explained in this consultation notice and are set out in full in the Appendices (Appendix 1 is a ‘track-changes’ mark-up of the Warehouse Agreement,

¹ An altered queue threshold.



and Appendix 2 is a clean version of the Warehouse Agreement with the changes included).

Responses to the Consultation

- 6 Formal responses to the Consultation should be submitted in writing to consultation@lme.com by no later than 9 February 2015. No consideration will be given to submissions made after the due date.
- 7 Following due consideration, the LME may implement either:
 - a. the changes to the Warehouse Agreement set out in the Appendices;
 - b. a modified version of the Warehouse Agreement; or
 - c. no changes to the Warehouse Agreement.
- 8 This notice shall constitute a consultation with warehouse companies as required by the LME's regulatory requirements and as contemplated by Clause 9.11.4 of the Warehouse Agreement. Following the completion of the consultation, warehouse companies shall be given 90 days' notice of the changes in accordance with Clause 9.11.4 of the Warehouse Agreement.
- 9 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.
- 10 The LME acknowledges that warehouse companies may incur some additional administrative costs in relation to implementing the proposed additional requirements set out in the revised Warehouse Agreement (for example, but without limitation, in relation to the requirement to conduct a stock count). The LME is of the view that any potential cost or inconvenience to warehouse companies will be outweighed by the benefits both to the warehouse companies themselves and to the market. The LME is interested in the views of respondents to the consultation in this regard.

Proposed Changes to the Warehouse Agreement

- 11 Set out below is a summary list of the proposed changes to the Warehouse Agreement:
 - a. Clauses 1.5.2, 2.4.1, 6.3.3, 7.3.3, 7.5.1, 9.3.6 and Definitions – introduction of a new defined term "Relevant Law and Regulation". The previous term "applicable law" is being amended and clarified so as to bring clearly within its scope compliance with market abuse prohibitions. The LME proposes the



inclusion of a new defined term of "Relevant Law and Regulation" meaning "the laws, rules and regulations of any statutory, governmental or regulatory authority in any country relevant to the operations of the Warehouse including without limitation the principles, rules and standards of the Financial Conduct Authority as in force from time to time". This would clarify both the compliance obligations of warehouses and how the LME may take action when required to do so by law and regulation, including where a warehouse may have breached the FCA's market abuse regime, which is discussed in more detail below.

- b. Clause 2.1.2 – the requirement that metal delivered for placing on warrant must conform to the relevant weights for those metals as outlined in the Special Contract Rules for Metals is clarified.
- c. Clause 3.3.1 – this clarifies, for the avoidance of doubt, that a warehouse must notify the Exchange about lost, stolen, destroyed or damaged metal to which a warrant relates. Warehouses are also asked to inform the Exchange as soon as they are aware of a circumstance which could indicate amongst other things a stolen, destroyed or damaged warrant or underlying metal. Warehouses will need to promptly investigate and keep the Exchange updated at all times.
- d. Clause 3.3.4 – for the avoidance of doubt, this clause states explicitly that warehouse companies must keep the Exchange updated at all times and also take such steps as are necessary to protect the owner of the metal in question and assist with the orderly operation of the market. This clause is clarificatory and does not increase the obligations of warehouse companies – the principles of conduct already contain general obligations, for example, on a warehouse company to deal with the Exchange in an open and cooperative manner and to organise and control its affairs in a responsible manner.
- e. Clause 4.2 and Definitions – amendment of “delivery” to “load-out”. This amendment is clarificatory. “Load out” is the term used in the Policy on the Approval and Operation of Warehouses. Other minor purely clarificatory changes are made to this clause.
- f. Clause 5.1.4 – a narrower requirement is proposed so that a warehouse need only fix and publish (and justify at the request of the Exchange) "maximum" rent and FOT rates. This proposal is clarificatory in nature.
- g. Clause 6.3.3 and Definitions – the beginning of the clause is reworded so that it is expressed more clearly. A defined term of “Queues” is introduced as



"circumstances where load-out requests cannot be serviced immediately by a Warehouse, measured by the number of calendar days a metal owner cancelling a warrant today must wait for a scheduled delivery slot".

- h. Clauses 6.3.3.1 and 6.3.3.3 – pursuant to Clause 6.3.3, warehouses are prohibited from revealing their stock of metal under warrant to any person except in certain circumstances. The LME is proposing clarifying that exceptions to this prohibition should only apply broadly where the disclosure is reasonable and necessary to enable the recipient to perform the proper functions of his employment, profession or duties. This amendment would make the disclosure exceptions consistent with the Market Abuse Directive.
- i. Clause 6.3.3 (and also Clauses 7.3.3 and 9.3.6) – the LME proposes simplifying the exclusions to the general principle of confidentiality, to allow the LME to disclose information provided under these clauses to regulatory authorities.
- j. Clause 6.3.3.5 and Definitions – introduction of a defined term “Group”.
- k. Clause 7.2.1 – it is proposed this Clause is amended by the addition of a provision allowing the LME to require enhancements to the security measures maintained by a warehouse. In certain circumstances it may be necessary for the LME to require a warehouse to put in place additional security measures on a case by case basis, where, for example but without limitation, the risk of theft is particularly high (e.g. where a warehouse is storing high value material in an area of high theft risk).
- l. Clause 7.3.1 – correction of a typographical error.
- m. Clause 7.3.2 – grammatical change.
- n. Clause 7.3.3 – clarificatory change. The Warehouse Agreement allows the Exchange to require warehouses to provide information to the LME concerning metal held both on warrant and off-warrant. The proposed amendment clarifies this for the avoidance of any doubt.
- o. Clause 7.3.4 – correction of a typographical error.
- p. Clause 7.4 – the review of the Warehouse Agreement presents a useful opportunity to include a requirement for warehouses to, at least annually, appoint an independent third party auditor to carry out a 100% stock count of the metal which the warehouse holds on warrant and the LME proposes that this inclusion is made. The LME currently undertakes a 10% stock count as



part of its own audit programme. This would not be necessary in the event of a third party auditor stock count, which would allow the LME to focus its resources on random checks on warrants. The LME acknowledges that this provision will introduce an additional obligation on warehouse companies which will have cost implications. However, the LME is of the view that warehouse companies may in many circumstances already be appointing third parties to carry out stock counts, and the potential costs are outweighed by the benefits to warehouse companies themselves and to the market by introducing an additional level of assurance that all warrants are backed by physical metal (the importance of which has been demonstrated by the recent issues surrounding off-warrant warehouse receipts in Qingdao). It is proposed that the Exchange must agree the identity of the independent third party auditor so as to ensure that it is appropriately qualified. The requirement to conduct a stock count would apply from 2015, and warehouse companies must submit to the LME the first independent third party stock count report by not later than 1 March 2016.

- q. Clause 8 – clarifies, for the avoidance of any doubt, that the LME may investigate any breach of the Warehouse Agreement and take disciplinary action.
- r. Clause 9.2 – the changes proposed are minor grammatical amendments.
- s. Clause 9.3 – the changes proposed for this Clause are some of the most material changes proposed in this consultation notice, and are discussed in detail below (see heading “Clause 9.3 – Proper Functioning of the Market”).
- t. Clause 9.9 – the LME proposes changing the current title "Governing law and submission to the jurisdiction arbitration" to: "Governing law and agreement to arbitrate". The LME proposes amending the wording in Clause 9.9.3 to make it easier to invoke arbitration internationally. The LME is proposing that the Clause would be replaced with the following: "If the Warehouse is not incorporated in England and Wales, it hereby appoints its London Agent as its agent for service of process for the purposes of any proceedings commenced in the English Court seeking interim relief in support of an existing or prospective LCIA arbitration or enforcing any award granted by a tribunal in any such LCIA arbitration."
- u. Clause 9.10 and Definitions – given that the LME is now part of a larger corporate group it is considered appropriate for the exclusion of liability to reflect this. It is proposed, therefore, that a new definition of “LME Group” shall be added to the Definitions section of the Warehouse Agreement.



- v. Clause 9.11.2 – it is proposed that any notices issued under Clause 9.11.1 shall be deemed incorporated into the Warehouse Agreement. Warehouses are already required to comply with notices.
- w. Clause 9.12 – the proposed alteration states that, in addition to a prohibition on a warehouse assigning the benefit of the Warehouse Agreement, it also may not declare a trust over such benefit, or enter into an analogous arrangement in any jurisdiction.
- x. Clause 9.13 and Definitions – the proposed alteration reflects the recent update to the rules on information barriers between warehouse companies and trading companies in the same group. It is proposed also that the definition of “Related Warehouse” shall also be clarified in the Definitions section.
- y. Definitions – introduction of a definition of “Public Official” as “an official, whether elected or appointed, who holds a legislative, administrative or judicial position of any kind of a country or territory inside or outside the UK”. The term “Public Official” is used in Clause 7.5.3 but was not previously defined. A minor amendment is made to the definition of Authorised Warehouse to clarify that it means "a warehouse storage facility operated by a Warehouse *in a particular Delivery Point*, which has been approved by the LME for the purposes of the Warehouse Agreement".
- z. Clause 11.2 – the LME proposes adding a Principle of Conduct expressly proscribing behaviour which would manipulate or distort the Exchange’s markets or create a disorderly market. This would include behaviour which would be likely to manipulate or distort the market with the effect of creating or maintaining a Queue.
- aa. Clauses 11.3 and 11.8 – the LME proposes certain changes to the Principles of Conduct to further clarify the high standards of integrity and fair dealing expected of warehouses.

Clause 9.3 – Proper Functioning of the Market

- 12 The LME is proposing amendments to Clause 9.3 in order to clarify, amongst other things, (a) the essential role which warehouses play in anchoring the LME price to the price of the underlying metal, (b) behaviour by warehouses which could prevent the orderly functioning of the market and which is therefore prohibited, (c) the LME’s right to request information, and (d) the LME’s powers in relation to behaviour which the LME considers may have, or has had, the effect of creating or maintaining a queue, or led to market manipulation or distortion, or otherwise created or



maintained a disorderly market. The LME is also proposing to introduce an obligation on warehouses to supply the LME periodically with information relating to inducements and charges.

- 13 The proposed amendments to Clause 9.3.1 clarify that warehouses must not prevent the orderly functioning of the LME market, including by doing anything which may directly or indirectly constrain the liquidity or elasticity of stocks of metal under warrant. This would include behaviour such as giving inducements, imposing unreasonable charges, or delaying the receipt or despatch of metal (save where necessary due to force majeure), where such behaviour may have a manipulative, distortive or disorderly effect on the market. The Clause also clarifies that the LME has an obligation to report such behaviour to the FCA where such behaviour may constitute Market Abuse. The LME is also proposing a definition of Market Abuse as "the types of behaviour proscribed by section 118 of the Financial Services and Markets Act 2000 or any successor law or regulation".
- 14 The proposed amendments to Clause 9.3.2 will oblige warehouses to supply the LME periodically with information relating to inducements and charges. This will help the LME in monitoring inducements and charges to ensure that they are not distortive and do not constrain the liquidity and elasticity of stocks under warrant in contravention of Clause 9.3.1. It is proposed that warehouse companies should initially supply information on inducements on a quarterly basis, in the form set out on the LME's website. The LME will work with the Warehouse Committee in order to determine (a) the appropriate form for submission of information on inducements and charges before it is placed on the website, and (b) the time period for such reporting to commence. Any future amendments to the form, or the timings, would also be discussed with the Warehouse Committee. All information supplied by warehouse companies pursuant to Clause 9.3.2 will remain confidential (see Clause 9.3.6).
- 15 There is also a proposed inclusion of a power in Clause 9.3.2 for the LME to request clarification on information concerning inducements. A specific right to investigate inducements and charges is reserved for the LME in Clause 9.3.4. The term "Inducement" would be defined as "without limitation, any fee, commission, discount, rebate, provision of transport services, or any other monetary or non-monetary benefit given to attract the load-in of metal or deter the load-out of metal". It is proposed that new Clause 9.3.3 shall oblige warehouses to provide the LME with information, including details of inducements and information about metal stored in the warehouse or another member of the warehouse's group. Any information requested pursuant to Clause 9.3.2 or 9.3.3 would be without prejudice to any right which the LME would have to require information pursuant to either Clause 7.3 (to the extent that the information is of a type set out in that clause) or the Disciplinary Procedures.



- 16 The changes proposed in relation to Clause 9.3.4 would clarify some circumstances where the LME has the right to investigate warehouses including in connection with:
- a. all Inducements and charges;
 - b. any behaviour it suspects may have, or has had, a manipulative, distortive, or disorderly effect on the market; and
 - c. a failure to meet any of the minimum loading-out standards and requirements from time to time laid down by the Exchange (save in an event of force majeure).

The LME may investigate the matter further pursuant to the Disciplinary Procedures.

- 17 Given that a breach of the proposed new Principle of Conduct in Clause 11.2, in relation to behaviour which manipulates or distorts the market or creates a disorderly market, would establish a right for the LME to take disciplinary action against a warehouse for such breach, much of clause 9.3 would arguably be otiose although it continues to be a useful clarification of the LME's desire to focus on irregular conduct by warehouses in connection with distortive inducements and unreasonable charges leading to the creation of queues. Further, and in particular, Clause 9.3.5 expressly provides that any behaviour which has the effect of creating or maintaining a disorderly market, or a queue, may result in disciplinary action by the LME.
- 18 It is noted that the analysis of warehouses' inducements and charges will likely present challenges given their diversity, and may make comparison as to the effect of such charges and inducements difficult. The presence of a queue, even combined with high inducements, may not be manipulative or distorting of the market, in certain circumstances. Accordingly, the LME may have recourse to external advice and guidance on the relevant market conditions so as to objectively assess the extent to which disciplinary action would be appropriate in a given circumstance.
- 19 Clause 9.3.4 currently provides that the LME may impose additional load-out requirements on a warehouse which the LME considers to have "intentionally created or caused, or attempted to create or cause, a queue by the use of inducements or any other method". The requirement to prove intent sets a relatively high threshold for the LME in taking disciplinary action. In order to prove intent, the LME would need to establish more than that the queue was due to an inducement, but rather that it was the intent of the warehouse to create the queue with that incentive structure. The LME, therefore, proposes replacing this provision with the new Clause 9.3.5, which states that "the Exchange may take disciplinary action and / or, in its discretion, impose additional load-out requirements on a Warehouse whose behaviour the Exchange considers may have, or has had, the effect of creating or



maintaining a Queue and / or which has led to market manipulation or distortion; or otherwise created or maintained a disorderly market". This would make Clause 9.3 consistent with the Warehouse Agreement generally which would, if accepted, establish a market conduct standard and would provide for a lower threshold for the LME to establish that there has been abuse.

- 20 Clause 9.3.6 clarifies that all information received pursuant to Clause 9.3 shall be treated confidentially by the LME subject to the exceptional circumstances set out.
- 21 Pursuant to Notice 14/039 : A037 : W024 dated 5 February 2014, the LME Special Committee will remain ultimately responsible for sanctioning any additional load-out requirements imposed on a warehouse under Clause 9.3.5. Any disciplinary action would be brought by the LME in accordance with Clause 8 of the Warehouse Agreement and the Disciplinary Procedures.

Tom Hine
General Counsel & Head of Enforcement

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



List of Appendices

APPENDIX 1 Mark up of the Warehouse Agreement

APPENDIX 2 Clean version of the Warehouse Agreement