



# LONDON METAL EXCHANGE

-----*From the Deputy Chief Executive*

To: ALL MEMBERS

Ref: 10/170 : A165 : R006

Date: 6 May 2010

Subject: **EXPLANATION OF METAL LENDING GUIDANCE**

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## Summary

1 The schedule to this notice replaces schedule 1 to LME notice 05/377, dated 15 December 2005, as an explanation of the Lending Guidance for LME metals contracts.

## Background

2 Market Aberrations: The Way Forward was published by the Exchange in October 1998 as an attachment to LME notice 98/363. Paragraph 13.24 of the Market Aberrations document sets out the Lending Guidance that applies to the holders of dominant long positions in the LME metals markets.

3 LME notice 05/377 formalised the rules and procedures relating to the operation of the Lending Guidance. Although referred to as guidance, compliance with the Lending Guidance is an LME rule.

4 Schedule 1 to that notice set out a clarification and explanation of a number of practical aspects of the Lending Guidance. The terms of the Lending Guidance are clear in their intent and in the behaviour expected of a dominant position holder. However, the Board recognised that trading on the LME markets requires a certain level of expertise and that it would be useful for participants in the markets if the Exchange set out a clarification and explanation of a number of practical aspects of the Lending Guidance.

5 LME notice 08/034, dated 31 January 2008, suspended the five-day rule under the Lending Guidance. That suspension is still in place and therefore the explanation of the Lending Guidance needs to be amended to reflect that. The schedule attached to this notice sets out an up to date clarification and explanation of the Lending Guidance for metals. The main changes to the text of the schedule are:-



- (a) a note to paragraph 1 that the five-day rule has been suspended;
- (b) a new paragraph 6 that expands the explanation on the aggregation of positions;
- (c) the two paragraphs on the five-day rule have been marked as not relevant while the five-day rule is suspended;
- (d) “LME Select” has been changed to “LMEselect”; and
- (e) a reference in paragraph 30 that all relevant LME notices are available on the LME website.

### **Origin of the Lending Guidance**

6 The market aberrations document dealt with a number of issues relating to the LME metal markets and their regulation. The document was the result of a consultation process that started in October 1997 and included the Solutions to Market Aberrations consultation document (attached to LME notice 98/007) published in March 1998. The full Market Aberrations document is available on the LME website [www.lme.com](http://www.lme.com) in a printable format.

7 The Solutions to Market Aberrations consultation document proposed a number of mechanisms for dealing with dominant positions in the LME markets. The Lending Guidance was formulated by the Board as the solution that best fitted the structure of the LME markets.

8 Prior to the introduction of the Lending Guidance, the Exchange’s response to the effect of dominant positions in the markets was to introduce backwardation limits. However, there were two aspects of this use of backwardation limits that were heavily criticised. First, the backwardation limits were not specific to dominant position holders and obliged all long position holders to lend their positions for a day at no more than a premium set by the Exchange. Secondly, the need to announce the imposition of the backwardation limits with immediate effect gave the markets no notice and made the application of backwardation limits unpredictable.

9 The Lending Guidance addresses both of these concerns. It creates an obligation on the holder or holders of a dominant position to lend at the required levels but creates no obligation on the holder of a long position that is not dominant. The Market Aberrations document provides that a dominant position can be created by two or more parties acting together. The circumstances in which the Lending Guidance takes effect are known in advance which introduces an element of predictability in the event that there is a dominant position in any of the LME markets.

10 It has been argued before the LME Special Committee that the Lending Guidance is in itself the cause of market distortion where warranted stocks are low. In the Committee's view, if there is such distortion, it is minimal and is



more than offset by the maintenance of orderly trading for the nearest prompt dates.

**Diarmuid O'Hegarty**

cc: Board directors  
Special Committee



## Schedule

### LENDING GUIDANCE

#### CLARIFICATION AND EXPLANATION

6 MAY 2010

#### LENDING GUIDANCE

1 Paragraph 13.24 of Market Aberrations: The Way Forward (published by the Exchange in October 1998) sets out the terms of the Lending Guidance as follows:-

- [a] If at any time a member or client holds 50% or more of the warrants and/or cash today/cash positions in relation to stocks, he should be prepared to lend, if asked, at no more than a premium of  $\frac{1}{2}\%$  of the cash price for a day. [*After five successive days, he should be prepared to lend, if asked, at no more than a premium of  $\frac{1}{4}\%$  of the cash price for a day.*]
- [b] If at any time a member or client holds 80% or more of the warrants and/or cash today/cash positions in relation to stocks, he should be prepared to lend, if asked, at no more than a premium of  $\frac{1}{4}\%$  of the cash price for a day. [*After five successive days, the maximum premium would fall to 0.15%.*]
- [c] If at any time a member or client holds 90% or more of the warrants and/or cash today/cash positions in relation to stocks, he should be prepared to lend, if asked, at no more than the cash price.
- [d] As with the publication of large position information, in determining the application of the guidelines, it would be appropriate for the LME to aggregate the positions of a client across all brokers in reaching its estimate of dominant positions. Likewise it would be appropriate to aggregate the positions of a member, its related group companies and its clients unless the firm could demonstrate that the positions were independent.

\* *Five-day rule suspended: see LME notice 08/034, dated 31 January 2008*

#### HOW TO CALCULATE A DOMINANT POSITION

2 The basis of a relevant position in any metal for the purposes of the Lending Guidance is the total of a person's warrant holding ("W"), net Tom trading positions ("T") and net cash trading positions ("C"). This is referred to as the net WTC position and is expressed in lots. That net WTC position is



divided by the number of live LME warrants for that metal. The result of  $(W + T + C) \div$  (live warrants) is expressed as a percentage to two decimal places. For example, a warrant position of 123 warrants, a net Tom position of 456 lots and a net cash position of 789 lots will equal 1,368 lots. If the total number of live LME warrants were 1,500, the WTC position would be 91.20%.

$$\frac{(123 + 456 + 789)}{1,500} = 91.20\%$$

3 The denominator used is live warrants rather than total stock. Total LME stock in each metal is the sum of live warrants and cancelled stock. This means that if a dominant position holder reduces his warrant holding by cancelling warrants, he will also be reducing the denominator used to calculate the size of his dominant position.

4 The resulting percentage forms the basis for calculating the number of lots that a dominant position holder must be prepared to lend. The Lending Guidance treats a WTC position of 50% and above as dominant. This means that a position holder is subject to the Lending Guidance until his WTC position is reduced to 49.99%. For practical reasons, these percentages need to be expressed in lots as whole numbers. In the above example, 50% of 1500 lots equals 750 lots. Therefore, 749 lots equals less than 50%. The dominant WTC position  $(123 + 456 + 789)$  equals 1,368 lots. The holder would have to be prepared to lend 619 lots to reduce his WTC position down to 749 lots. Expressed as percentages, this means that the dominant position holder must be prepared to lend 41.21%, rounded up to the nearest lot.

5 The figures used in calculating a WTC position are those reported by members to the Exchange by 8.30am each business day. The figures relate to the WTC positions as at the close of business on the previous business day. Each member's reports separately identify the W, T and C positions held on behalf of the member and the W, T and C positions held by each of its clients, including any of the member's affiliate companies. This enables the Exchange to aggregate the WTC positions held by a client across two or more members.

6 The Exchange automatically aggregates the WTC positions of companies in the same group. The Exchange will also aggregate the WTC positions of unconnected parties if the LME Compliance Department believes that there is a common purpose. In such cases the Exchange will inform the parties either direct or through the members with whom they trade. LME notice 99/075, dated 26 February 1999, sets out the basis on which the Exchange will aggregate the positions of two or more parties. LME notice 01/122, dated 23 March 2001, sets out the Exchange's approach for attributing and aggregating warrant holdings for the purposes of the Lending Guidance.

7 The net WTC positions are divided by the number of live warrants as at the same point in time, the close of business the previous day. The live



warrant figures used are the same as those included in the stock figures published by the Exchange at 9.00am each business day.

8 As WTC positions are calculated each morning on the basis of figures as at the close of business on the previous day, the reported T trading position will have become a delivery obligation for that day and the reported C position will have become a Tom position for that day. In order to reduce that reported WTC position in line with the Lending Guidance, the dominant position holder should be prepared “to lend” Tom/next (or one of the Tom date carries).

## HOW A DOMINANT POSITION TRIGGERS THE LENDING GUIDANCE

9 The Lending Guidance operates in three effective bands. The first is where a WTC position is 50% or more but less than 80% of live warrants. The second band is where a WTC position is 80% or more but less than 90% of live warrants. The third band is where a WTC position is 90% or more of live warrants.

10 The effect of this banding is that where a person’s WTC position is above 90% of live warrants he should be prepared to lend for a day:

- (a) at no premium (i.e. “level”) a sufficient number of lots to reduce his position below 90%;
- (b) at a premium of no more than ¼% of the cash price a sufficient number of lots to reduce his position below 80%; and
- (c) at a premium of no more than ½% of the cash price a sufficient number of lots to reduce his position below 50%.

11 The cash price used to calculate the premium each business day is the LME official cash settlement price published the previous business day. The maximum premium percentage is expressed as a US dollar amount rounded down to the nearest cent.

12 In the following example the notional WTC figures are the same as those used in paragraphs 2 and 4 above, i.e. the dominant position of 91.20% requires the holder to be prepared to lend 619 lots to reduce his position below 50%. The notional cash price being used is \$2,000.

<b>Lending Guidance Percentage Bands</b>	<b>Position Holder’s Dominance in lots</b>	<b>Maximum Premium</b>
90% and above	19	level
80% to 89.99%	150	\$5.00
50% to 79.99%	<u>450</u>	\$10.00
	<b>total 619</b>	



13 The Lending Guidance states that a dominant position holder “should be prepared to lend, if asked”. This expression means that the dominant position holder should respond to demand in the market for borrowing at the premium set by the Lending Guidance. The dominant position holder is not obliged to lend if the market demand for Tom/next borrowing is at a backwardation premium below that specified by the lending guidance. In the example at paragraph 11 above, the dominant position holder should be prepared:-

- (a) to lend at least 19 lots at level if the Tom/next backwardation premium bid in the market reaches level. If the backwardation premium bid in the market stays below \$5.00 he is not obliged to lend more than those 19 lots;
- (b) to lend an additional 150 lots at a premium of no more than \$5.00 if the backwardation premium bid in the market reaches \$5.00. If the backwardation premium bid in the market stays below \$10.00 he will not be obliged to lend more than 169 lots (i.e. 150 lots at no more than \$5.00 and 19 lots at no more than level);
- (c) to lend an additional 450 lots at a premium of no more than \$10.00 if the backwardation premium bid in the market reaches \$10.00. Once he has reduced his position below 50% he is no longer obliged to lend and those who wish to borrow will have to bid out the price until someone is prepared to lend.

14 If the dominant position holder chooses to continue lending, the maximum backwardation premium does not apply to any additional lending done after he has reduced his position below 50%.

15 Lending Tom/next involves selling for the Tom Prompt Date and buying for the cash Prompt Date. Where a dominant position holder reduces his WTC position on one day by lending Tom/next, he will be adding to his C position for the purposes of calculating his WTC position the next morning. This explains how a person may abide by the Lending Guidance but maintain a dominant position on successive days.

\* *The following two paragraphs are not relevant while the five-day rule has been suspended.*

*[\*Dominant positions are also subject to reduced maximum premiums after the dominant position has been held for more than five successive business days. On the sixth and subsequent successive business days a WTC position of 50% or more but less than 80% of live warrants is subject to a maximum premium of ¼% of the cash price. On the sixth and subsequent successive days a WTC position of 80% or more but less than 90% of live warrants is subject to a maximum premium of 0.15% of the cash price. The purpose of this reduction in the maximum premium is to take account of the effect of a dominant position over time.]*



*[\*If, for example, a dominant position has fluctuated between 60% and 85% for five successive days, the reduced maximum premium of ¼% will apply to the WTC position of 50% or more but less than 80%; no reduction will apply to the position of 80% or more until that has been maintained for five successive days. The calculation of successive business days recommences following any day on which the Tom/next market in the relevant metal did not trade at a backwardation but only traded at level or at a contango.]*

## **HOW TO COMPLY WITH THE LENDING GUIDANCE**

16 The Lending Guidance is an obligation placed on those who hold a dominant long position in any of the LME metal markets. The holder of the dominant position is ultimately responsible for his own compliance with the Lending Guidance. This is the case both for members and non-members. In the case of a non-member, compliance with the Lending Guidance requires the non-member to give appropriate instructions to one or more of his brokers.

17 The LME Compliance Department calculates dominant positions on the basis of position reports submitted electronically by members. Members must notify the Exchange of the identity of all position holders and of any connections between two or more position holders. Details of new account holders must be notified to the Exchange before that new account starts trading. Where the LME Compliance Department identifies a dominant position, the holder of that position will be contacted both to confirm the figures used to calculate the dominant position and to discuss any steps to be taken. These steps could include adjustments to a WTC position to account for OTC business being brought on Exchange that day. Many non-members prefer to have these discussions direct with the LME Compliance Department rather than go through one or more of their brokers. Although, both members and non-members may discuss their WTC positions with the LME Compliance Department, the holder of a dominant position is best placed to know the size of his own WTC positions. Once the LME stock figures are published at 9.00am, a position holder is able to calculate whether or not his net WTC position triggers the Lending Guidance.

18 Increases or decreases in the LME warrant figures from the previous day's figures may affect whether a WTC position is dominant or whether the dominance exceeds the 80% or 90% thresholds and by how many lots. For this reason a dominant position holder is entitled to wait until the LME stock figures are published before complying with the Lending Guidance. However, if a dominant position holder chooses to lend before 9.00am, that lending must be in compliance with the Lending Guidance. If there has been a material change in the live warrant figures, the dominant position holder may have to adjust some of the trades he did before the LME stock figures were published in order to ensure that his lending has complied with the Lending Guidance.



19 Lending in compliance with the Lending Guidance must be done in the correct order. If a dominant WTC position is above 90%, the position holder must lend at level a sufficient number of lots to bring his position below 90% before he may lend at a premium of  $\frac{1}{4}\%$  of the cash price. Similarly, he must lend at a premium of no more than  $\frac{1}{4}\%$  of the cash price a sufficient number of lots to bring his position below 80% before he may lend at a premium of  $\frac{1}{2}\%$  of the cash price. He must have reduced his position below 50% before he may lend at a premium greater than those specified by the Lending Guidance.

20 The LME provides three forums for trading: in the ring, on LMEselect and on the telephone. A dominant position holder should be prepared to respond to requests for borrowing in all three forums. A dominant position holder is not obliged to verify if the person borrowing from him is doing so to cover a short. However, the purpose of the Lending Guidance is to address the effect of his dominant position on those who are short. It would be an abuse of the Lending Guidance for a dominant position holder to contrive to lend to another person at the specified premium with the intention that that other person could lend in the market at a higher premium.

### **Lending on LMEselect**

21 A bid on LMEselect is a request to the market. A dominant position holder must respond to bids on LMEselect where those bids reach the premium at which the dominant position holder must be prepared to lend. The mechanisms for ensuring orderly trading on LMEselect mean that a lower offer entered into the system will trade with an existing higher bid. If there is a bid in LMEselect that is at a higher premium than that prescribed by the Lending Guidance, a dominant position holder must trade with that bid to identify the borrower and subsequently adjust the price back to the correct premium. This adjustment cannot be done on LMEselect but requires a reversal trade and a new trade at the correct premium to be agreed on the telephone. If the circumstances suggest that bids for Tom/next borrowing on LMEselect will be higher than the backwardation premiums at which the dominant position holder will be obliged to lend, the dominant position holder should behave prudently and consider placing offers on LMEselect to anticipate bidding. This will avoid the need for adjustment trades.

22 If the dominant position holder is not a clearing member, he must make arrangements with his broker to take the necessary steps to respond to bids on LMEselect and to make adjustments where necessary.

### **Lending in the Ring**

23 A bid in the ring is also a request to the market. The first ring session for each metal is the last opportunity to lend or borrow Tom/next by open outcry. A dominant position holder who has not reduced his WTC position below 50% by the start of the first ring must respond to bids in the ring where those bids reach the premium at which the dominant position holder must be prepared to lend.



24 The mechanisms for ensuring orderly trading in the ring mean that once a bid to borrow has been made a lender must either accept that bid or make a higher offer. It is a breach of the ring trading regulations to make an offer that is lower than a prevailing bid. If a dominant position holder's WTC position remains at 50% or above by the start of the first ring, he must ensure that he responds to bids and that any lending he does is at premiums no higher than the premium prescribed by the Lending Guidance. In order to ensure this and to abide by the ring trading regulations, it may be necessary for the dominant position holder to offer to lend. If the circumstances suggest that Tom/next trading in the ring is likely to start at higher premiums, the dominant position holder should be prepared to open the ring with an offer before any bid is made.

25 If the dominant position holder in these circumstances is not a ring dealing member, he must make arrangements in good time for a ring dealing member to effect the necessary lending on his behalf.

### **BROKERS INSTRUCTED BY DOMINANT CLIENTS**

26 There are a number of considerations that a member must take into account when acting for a client who is dominant. In particular, the member must ensure that his actions comply with the FSA Code of Market Conduct and the FSA Conduct of Business Rules.

27 If a member is instructed by a client to lend a number of lots at a particular backwardation premium, that instruction is an order for the purposes of FSA rules. In executing that order, the member must manage any conflicts of interest, must not misuse customer information or breach the FSA Code of Market Conduct. For example, it is clearly wrong for a member who is acting for a dominant position holder to borrow from that dominant position holder, or to collude with someone else to borrow from that dominant position holder, at the premium prescribed by the Lending Guidance with a view to lending in the market at a higher premium. Nothing that the member does should frustrate the dominant client's willingness or ability to lend to bidders in the market.

28 A member who receives an order from a client to lend in accordance with the Lending Guidance may already have orders from other clients to borrow. In situations like that, the member must be careful to comply with the FSA's rules on order priority and fair allocation. In those circumstances the member must also keep in mind the responsibility on a dominant position holder to respond to bids on LME Select or in the ring. If he receives an order from a client to lend in accordance with the Lending Guidance and already has a bid on LMEselect that represents a client wishing to borrow he should cancel that bid on LMEselect before crossing the borrowing client's order with the dominant client's lending order.

29 When a member receives instructions from a client to lend in accordance with the Lending Guidance, that member will be in possession of privileged customer information. The member must be careful not to take



advantage of that information and should give priority to his own clients who are short and to bids on LMEselect or in the ring over his house shorts.

## **CONCLUSION**

30 All LME notices referred to in this document are available on the LME website. Those who would like any further clarification or explanation of the Lending Guidance should contact the Market Surveillance division of the LME Compliance Department at the Exchange: [marketsurveillance@lme.com](mailto:marketsurveillance@lme.com).