



LONDON METAL EXCHANGE

12 March 2003

Mr Fabrice Demarigny
Secretary General
CESR
11/13 Avenue de Friedland
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France
Room ASP 14E 116

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Dear Mr Demarigny

MARKET ABUSE: SECOND CALL FOR EVIDENCE

The London Metal Exchange (LME) welcomes the invitation by CESR to submit its views on the areas that CESR should address when giving its advice to the European Commission on technical implementing measures under the Directive on Insider Dealing and Market Manipulation (Market Abuse).

As you are aware, the LME was one of several EU commodity derivatives markets that accepted an invitation from Mr Stavros Thomadakis, Chairman of the CESR expert group on market abuse, to attend a meeting in Paris on 3 March 2003 to provide input on drafting the advice on level 2 implementing measures under the Directive in relation to article one and inside information on commodity markets. At that meeting we detailed the key issues that we believe CESR should take into account when drafting its position paper for the CESR Chairmen on 21 March, and the Consultative Paper that it plans to issue on 15 April or thereabouts. This letter reaffirms points made at the meeting by the LME. It also includes certain comments on 'accepted practices', which was not discussed on 3 March.

The LME

The LME is a UK Recognised Investment Exchange (RIE) and is the world's premier non-ferrous base metals derivatives market. Its contracts and methods of trading have developed over the last 125 years to meet the needs of its core users. These are mines, smelters, refineries, fabrication works, metal merchants, banks, business consumers of metal (for example, motor manufacturing companies), metal traders, and an increasing number of professional investors who use the market to manage portfolio risk. Although based in London, the LME is international in its membership, sphere of business and operations.

Its importance to its users is reflected in its prices being used throughout the world as reference prices for the pricing of contracts for the sale and purchase of those base

LME

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metals on which it offers trading in derivatives (forwards, options, and average price options). Its competitors lie outside the European Union, with the key ones being NYMEX in the United States and The Shanghai Metal Exchange in China.

Insider Dealing in Commodities

General

Commodity derivatives markets have no direct contractual relationship with producers or consumers of commodities that requires disclosure by them to the markets of relevant, announceable, or disclosable information about supply or demand of the commodities on which the markets trade derivatives. However, the markets do obtain or receive price sensitive information, certain of which they disclose to market users. Commodity derivatives markets use information obtained by and/ or disclosed to them in several ways.

Order, Trade, Open Interest and Volume Information

The most common disclosure by commodity derivatives market authorities is of order and trade information - bid and offer prices, and prices of trades. This information is made available simultaneously to all market users, perhaps with a time lag, depending on market and/or competent authority rules on, say, the size of trades. It is not usual to disclose the names of counterparties to trades.

On a daily basis it is also common for market authorities to publish in paper form or on the Internet or via quote vendors traded volume and open interest figures, possibly broken down by derivative type (futures, forwards, options, etc).

The accepted practice is that market users expect that they will be able to access order, trade, volume and open interest information at the same time as all other market users.

Market authorities monitor order information, trade information and volumes and open interest to ensure that markets are proper and orderly.

Stock Information

Commodity contracts can be settled by physical delivery or by cash. For example, on the LME, a seller's obligation to deliver metal sold is fulfilled by the seller delivering to the buyer LME warrants issued by the warehouses on specific lots of metal placed on warrant, with the warrants representing standardised quality and quantities of metal that comply with contract specifications set by the LME. Where contracts are satisfied by physical delivery of the underlying commodities, warehouses listed (approved) by the regulated market provide periodic returns, usually daily, to the regulated market of all deliverable stock that they hold. The LME publishes daily aggregated stock figures of all metal on LME warrant in LME listed warehouses. Large variations in the volume of the commodity on LME warrant can affect the prices of commodity derivatives traded on the market. Hence, market users expect simultaneous disclosure to all users, with dealing ahead of disclosure viewed as a form of market abuse.

Position Information

Regulated commodity derivatives markets might require their members to provide information to them on positions held by their named clients in the market. This might be to simply assist the market authorities in oversight of the market. However, market authorities such as the LME might publish position information in a summarised and/ or anonymous form to give market users information that might assist them in reaching investment or disinvestment decisions. For instance, the LME requires its members to provide it with information on large positions held by their clients - a large position varies according to market rules, with the LME requiring

details for all positions in, say, Tin, but only positions in excess of 1,000 lots for Primary Aluminium. The LME publishes this information on an anonymous basis, i.e. on a 'no names' basis, to alert market users to potentially dominant positions in the market. The Exchange also uses this data, which is aggregated for clients across all members, to monitor positions and to require large position holders to take certain action where it believes this is necessary. Compliance by large position holders with the instructions of the LME is a 'safe harbour' under the FSA's Code of Market Conduct.

Periodic Disclosure

Board members and staff of a regulated market or its clearing house learn frequently in advance of the market of changes to the terms and conditions of contracts, or of changes to margins payable for contracts, or of market interventions planned by market authorities, for example to limit positions or impose backwardation limits. Such changes can impact contract prices. Market users would not deem it acceptable for 'insiders' to trade ahead of the public announcement of such information.

Accepted Practices

General

No two commodity derivatives markets in the EU have market users or participants that are identical. Historically, all the markets developed to meet the needs of users of the physical commodities - be they producers, merchants, industrial consumers, financiers, or the many others using the physical commodities who are exposed to price, supply and demand risk - by providing them with risk management services on regulated markets.

Given their history and subsequent development, the various markets have unique contracts with differing methods of contract settlement and delivery, and different methods of dealing that matured over time to meet user needs.

Commodity derivatives markets can be agency markets, principal markets, dealer markets, market maker markets, or order or quote driven markets. They can permit dealing by any or all of telephone, open outcry, or electronic means. They might permit deals transacted off-exchange to be brought on exchange and registered as exchange contracts. They might allow the exchange of futures for physicals or, a variation, metal swaps. There are other variations.

The regulated commodity derivatives markets are responsible for contract design and trading, perhaps within parameters set by their competent authorities. Settlement of contracts (instruments) traded on the markets might be in cash or by delivery through the clearing house acting for the exchange, which might be independent of the market or part of or affiliated to it. If there is physical delivery, the exchange determines how delivery must be fulfilled. Certain regulated markets list or approve warehouses, which could be located in selected locations worldwide, for storing of commodities approved for delivery.

Given the diversity and historical uniqueness of the commodity derivatives markets in Europe, most of which face competition from non-EU markets rather than from other EU markets, it is probable that there is no clear definition of accepted practices that applies equally to all markets. Hence, to determine what is 'accepted practices' must be on a market-by-market basis. The implication is that competent authorities in each Member State should have the responsibility for working with the markets, their members, and their users, to establish what they deem to be accepted practices. The competent authorities should then decide if these practices are acceptable, within guidelines or standards set by CESR.

Recommendation on Insider Dealing and Accepted Practices

In respect of insider dealing, CESR should acknowledge that commodity derivatives markets are quite different to securities and security derivatives markets, principally in the absence of a direct relationship between the markets and the producers and consumers of the commodities traded, which is quite different to the relationship existing between issuers and securities markets. Nonetheless, there are certain types of price sensitive information that users expect to receive simultaneously (as mentioned above) and on which they would not expect to see dealing pre-announcement.

Turning to 'accepted practices', we recommend that CESR should seek to establish general guidelines that meet the requirements of the Commission, but which acknowledge that accepted practices vary across markets due to their unique contracts, user base and historical development, often taking place to meet directly user need. The guidelines or principals should allow competent authorities for the relevant markets in each Member State to determine in consultation with the markets, their members and their users the acceptability of generally 'accepted practices'.

I apologise for the delay in giving our comments, but trust that they will be relevant to CESR in drafting its position paper and consultation paper.

Should you wish to discuss the contents of this letter, you can contact me by telephone (+44 (0)20 7264 5675), by fax (+44 (0)20 7264 5513), or by e-mail (neil.mcgeown@lme.co.uk).

Yours sincerely

A handwritten signature in black ink, appearing to read 'Neil McGeown', written in a cursive style.

Neil McGeown

LME Regulation & Compliance