

LONDON METAL EXCHANGE

Diarmuid O'Hegarty
Deputy Chief Executive

Tel: +44 (0)20 7264 5671
Fax: +44 (0)20 7264 1707

8 July 2010

European Commission
Directorate General Internal Market and Services
Financial Services Policy and Financial Markets
Securities Markets

Dear Sirs

PUBLIC CONSULTATION ON SHORT SELLING

Introduction

1 The London Metal Exchange welcomes the opportunity to comment on the Commission's public consultation on short selling. The London Metal Exchange (LME) is a recognised investment exchange and a regulated market established in London since 1877 for the purpose of trading futures and options in base metals. These metals are primary aluminium, copper, lead, nickel, tin, zinc, two grades of aluminium alloy, steel billet, cobalt and molybdenum. The Exchange also has futures contracts in two grades of plastics. The LME contracts are based on physical settlement by the transfer of ownership of metal stored in LME licensed warehouses in a number of locations in Europe, Asia and North America.

General comments on consultation

2 The Scope Section of the consultation document sets out two options:-

Option A

Apply the rules uniformly to every type of financial instrument that is admitted to trading on a trading venue (i.e. a regulated market or an MTF) in the European Union and that can be subject to short selling.

Option B

Apply requirements be applied in relation to specific financial instruments which are admitted to trading on a trading venue in the European Union. For example, different rules would apply to different instruments such as:

DOH10046.DOC

- *EU shares in derivatives relating to these shares;*
- *EU sovereign bonds and derivatives relating to those bonds; and*
- *credit to full swaps relating to EU sovereign issuers.*

3 On the face of it, Option A suggests that commodity futures and options would be included within the scope but Option B suggests that commodity futures and options are not intended to be covered by the scope. The LME would urge that commodity derivatives are not included in the scope.

4 The issues relating to short selling in shares, bonds and their derivatives are different from the issues relating to short selling in commodity futures. Those involved in the markets in shares, bonds and their derivatives will be best placed to answer your questions about them. This letter only deals with your questions as they relate to the commodity derivatives markets.

The role of short selling in commodity derivatives markets

5 In commodity derivatives such as those traded on the LME short selling contributes to more efficient price discovery and increases liquidity, which in turn facilitates hedging and risk management by market users. For some in the physical market short selling is an essential part of trading on commodity futures markets. The most graphic illustration of this is that selling short on the LME is the natural strategy for a producer of metal who wants to hedge against his price risk. Below is an example:-

- A Chilean copper producer selling 100 tonnes of copper to a European copper consumer for delivery in six months time will agree to sell at the average of the LME cash settlement copper price published during the month of delivery plus whatever premium is agreed between the seller and the buyer.
- This means that the seller and the buyer do not know the exact price that will be paid on delivery. However, the LME copper settlement dates go out to ten years into the future. At the time that the deal is struck the LME will be publishing trading prices for LME copper futures for settlement dates from cash (i.e. two days forward) out to ten years.
- If the copper producer is concerned that the copper price may drop in the next six months he can lock in the current LME future price for six months forward by selling 100 tonnes of six-month LME copper futures contracts. This is an uncovered short: the copper producer will not want to deliver his copper against his LME copper futures contracts because he is contractually obliged to deliver the copper to his European customer.
- The copper producer will close out his price hedge on the LME by buying 100 tonnes of LME copper futures for the same settlement date before his LME copper futures sale contracts expire.
- Similarly, if the European copper consumer is concerned that the copper price will rise during the next six months he can buy six-month LME copper futures

contracts with the intention of closing out that price-hedge before it expires. He will equally not want to take delivery of the copper from his LME copper futures because he is already contractually bound to pay the copper producer for 100 tonnes of copper.

- The copper producer and the copper consumer agree to buy and sell copper for six months time on the basis of the average of the LME cash settlement copper price at the time of delivery because it allows each of them to manage their price risk during that six month period. Both may choose to hedge or neither may choose to hedge depending on their perception of their price risk.

6 LME contracts are based on physical settlement by the transfer of ownership of metal stored in licensed warehouses because this guarantees price convergence as the far futures settlement dates converge on the cash settlement date (i.e. two days from the trade date). The ability to make or take delivery of metal against an LME futures contract on the settlement date means that any divergence between the LME settlement price and the physical metal price can be easily closed. For example, 60% of world production of Grade A copper is good delivery against the LME copper futures contract.

7 Making delivery of metal into LME listed warehouses and taking delivery of metal from LME listed warehouses is a last resort for the physical producers and consumers of metal. Increases in LME metal stocks are a sign of oversupply in the physical metals markets and decreases in LME metal stocks are a sign of undersupply in the physical metals markets. Large volumes of metal move through LME listed warehouses as a reflection of general changes in supply and demand and also differences in supply and demand between Europe, Asia and North America.

Specific answers to consultation questions

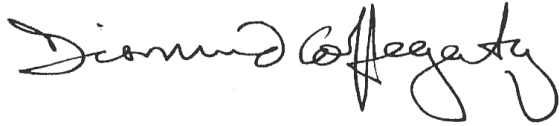
8 The relevant questions for commodity derivatives would appear to be: (1), (2), (4), (5), (12). The LME's answers to those questions are:-

- (1) There is no evidence that short selling is detrimental to the operation of commodity derivatives markets. Far from being detrimental, short selling is essential for the proper functioning of a commodity futures market.
- (2) It is the LME's preferred option that commodity derivatives are not included in the scope of instruments to which measure should be applied.
- (4) The type of transparency proposed would bring no benefits to the commodity derivatives markets and therefore the LME would prefer if proposed new transparency requirements were not applied to commodity derivatives.
- (5) It would not be proportionate to apply the proposed new transparency requirements to commodity derivatives.
- (12) There is no evidence that uncovered short sales on commodity derivatives markets are detrimental to those markets. As illustrated in the example at

paragraph 5 above, the nature of price hedging means that metal producers would be unable to hedge their price risk if they were unable to make uncovered short sales on the LME.

9 If there is anything in this letter that you would like to be further explained or expanded please let me know.

Yours faithfully

A handwritten signature in black ink, reading "Diarmuid O'Hegarty". The signature is written in a cursive, flowing style with a large, stylized 'D' and a long, sweeping tail on the 'y'.

Diarmuid O'Hegarty