

Financial Law — Panel —

The London Metal Exchange and LME Warrants

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THE LONDON METAL EXCHANGE AND LME WARRANTS

The aim of this paper is to explain the role played by LME Warrants in the trading of metal on the London Metal Exchange. It will be of interest primarily to those involved in buying and selling metal on the LME. It will also be relevant to those who use LME Warrants for other commercial purposes outside the exchange.

LME contracts are governed by English law. This paper is written on the basis that English law applies to all aspects of the dealings with these contracts and with LME Warrants. If the law of other jurisdictions is relevant (for example, because the metal concerned is held in an overseas warehouse) the legal position might be different.

The components of a contract of sale

A contract for the sale of goods deals with two separate concepts:

- ownership of the goods, and
- possession of the goods.

When goods are sold, ownership of the goods may be transferred from seller to buyer at a different time from the transfer of possession.

Ownership

The Sale of Goods Act 1979 sets out rules which determine when ownership of goods (sometimes called 'title to the goods') passes from seller to buyer under a contract of sale. The basic rule is that ownership passes when the buyer and seller intend it should pass.¹

¹ S.17(1).

Possession

A person is in possession of an item of property if he or she has exclusive physical control of the property. Possession can take several forms:

- A person is clearly in possession of an object in his pocket.
- He has possession of an object in his house, even when he is absent. By holding the keys to his house he has control over the objects inside it.
- By extension, a person can be in possession of goods if they are under the physical control of his agent. A simple example is where goods are deposited in a warehouse under the terms of a contract between the depositor of the goods and the warehouse company. As far as the outside world is concerned, physical control by the warehouse amounts to possession by the depositor for whom the warehouse is acting.

LME Contracts

An LME Contract is the form of contract under which metal is sold in trades made on the LME. Buyers and sellers are free to use their own contract forms, but every contract for a sale on the exchange must have the same specified basic terms. The LME has developed detailed regulations with which every LME Contract must comply, and these are set out in the LME rule book.

Ownership of metal traded on the LME is transferred from seller to buyer under the terms of an LME Contract. An essential part of all LME Contracts is an agreement as to the date (the 'Prompt Date') on which metal of the agreed specification and amount will be paid for and delivered. Although the LME rule book does not specify when title to the metal passes from

seller to buyer, the general view is that, since payment for and delivery of the metal take place on the Prompt Date, it is clear that the parties also intend ownership to pass on the Prompt Date.²

The LME Contract provides that the seller's obligation to deliver the metal sold (i.e. to transfer possession to the buyer of the metal sold under the contract) is fulfilled by the seller delivering to the buyer LME Warrants representing metal which complies with the contract specification.³ Indeed, under an LME Contract, this is the *only* way in which the delivery obligation can be met. Delivery of the LME Warrants is not an alternative to delivery of the metal sold – because of the terms of the LME Contract and the nature of LME Warrants, delivery of Warrants *amounts to* delivery of the metal.

An LME Warrant can be issued only by a warehouse which has been authorised by the LME. Under the LME regulations, which a warehouse must accept before obtaining authorisation, an LME Warrant relates to a specific lot of metal, identified in the Warrant, which has been deposited with the warehouse under a contract for storage. The warehouse agrees that its obligations under the contract of storage relating to the metal specified in the Warrant will be owed to the bearer of the Warrant. Accordingly, the authorised warehouse is under a contractual obligation to deliver to the holder of the LME Warrant on demand the metal specified in the Warrant. The effect of this is to make the holder of the Warrant the possessor of the metal.

Thus, when an LME Contract is completed on the Prompt Date and the buyer pays the price:

- **ownership of the metal passes from the seller to the buyer and the seller warrants that he owns the metal sold; and**

² The regulations governing SWORD (see below) repeat the general rule, so far as that system is concerned.

³ LME rules and regulations, part 4 regulation 5.1.

- **the seller delivers a Warrant for the metal sold. Possession of that Warrant gives the buyer possession of the metal which it represents, so that possession of the metal also passes on the Prompt Date.**

The importance of the distinction between ownership and possession can be shown clearly in a hypothetical example: an LME Warrant is issued to a thief in respect of metal he has stolen and deposited in a warehouse in England. The person from whom the metal has been stolen will remain the owner of the metal. The thief will, however, be in possession of the stolen metal. He can transfer possession by delivering the LME Warrant. However, the thief does not own the stolen metal and, therefore, cannot transfer ownership. A purported sale by the thief will not, in general, prevent the true owner from claiming the metal back. This situation is, of course, very rare in practice and, indeed, there are situations where someone who is *not* the owner of the metal can transfer title to a buyer.

In passing, it is worth making two points about the form of an LME Contract:

- Market participants often make contracts with each other off-exchange ('OTC Contracts') which adopt the same structure and form as LME Contracts, but which cannot technically qualify as LME Contracts because they do not meet all of the requirements of the LME rules and regulations (for example, because they require delivery on a date which is not a Prompt Date). The legal analysis of the transfer of ownership and the use of LME Warrants to transfer possession is, however, the same for those OTC Contracts as for LME Contracts.
- The LME has recently introduced an electronic system for dealing with Warrants called 'SWORD'. In the process, a SWORD account holder is able to place LME Warrants with the depositary appointed by the exchange, and the records show that the particular Warrants are held on behalf of the identified account holder. When the account holder completes an LME Contract (or other transaction), it can perform its delivery obligations by instructing the depositary to hold on behalf of the buyer the Warrants for the metal to

be delivered. Placing the Warrants with the depositary does not change the basis of the legal analysis: the warehouse holds the metal for the depositary (as holder of the Warrant). The depositary is accordingly in possession of the metal. The depositary, in turn, holds the Warrant for the account holder shown in its books.

The account holder is in possession of the metal under SWORD just as it would be, if it held the Warrant itself.

The use of LME Warrants for other purposes

When metal is sold on the LME, ownership and possession are transferred to the buyer at the same time. Warrants are also ideally suited to transactions which involve the sale and purchase of metal, but where it is unnecessary for the buyer to take physical possession. In addition, because delivery of an LME Warrant on its own transfers only possession of the metal which it represents, LME Warrants are a convenient mechanism for use in those transactions where the parties wish to transfer possession of metal, but do not want to transfer ownership.

Two examples of the use of Warrants are:

Trade Finance

Where a bank lends money to a trader to enable the borrower to buy metal, the bank may take a pledge over metal owned by the trader. The pledge is made by the transfer to the bank of possession of the pledged metal (effected by the delivery of the LME Warrant which represents it). The trader remains the owner of the metal, although the bank has possession of it. In the pledge agreement, the owner of the metal gives the bank the right to sell the metal as if it were the owner, should the trader default on his loan. The bank's right of sale comes from its pledge agreement with the owner. However, it is the fact that the bank is the holder of Warrants representing the metal which gives the bank the ability to exercise its sale rights on default.

Metal Lending

Metal lending serves the same function in the metal markets as stock lending performs in the securities markets. A market participant which has an obligation to deliver metal under a contract of sale may not own, on the delivery date, metal of the kind and/or in the amount required. It can, of course, buy the necessary metal in the market and use that metal to satisfy its obligations. This may be inconvenient. For example, the trader may be expecting to receive metal of the relevant kind shortly after the date of its own delivery obligation and would wish to find himself square at the end of the process.

Metal lending is the solution. The trader 'borrows' metal and uses it to complete its delivery obligation. When it receives metal from another source it uses the metal received to 'repay' the loan.

The wording is misleading. A 'loan' of metal is in reality a transfer of both ownership and possession to the borrower. In return, he undertakes to transfer to the lender at a later date both ownership and possession of equivalent metal. Pending the fulfilment of his re-transfer obligation, the borrower may provide collateral to the lender to cover price fluctuations. Collateral may take the form of cash or the grant of a pledge over other metal.

LME Warrants make this operation very simple to perform. The ease with which possession of large amounts of metal can be transferred makes the delivery and re-delivery process simple. It also makes the complex task of collateral management much more straightforward than it would otherwise be.

Why are LME warrants called "Documents of Title"?

Having title to property means the same as owning it. As discussed above, an LME Warrant does not give its holder ownership of the metal specified in the Warrant. It gives him possession and the ability to deliver possession. Whether the holder of the Warrant is also the owner of the metal depends on other facts (for example, he may have become the owner by buying the metal

under an LME Contract). Therefore, the use of the phrase “Document of Title” in relation to LME Warrants can be misleading. Although, in dealings on the LME, the holder of a Warrant will usually be the owner of the metal which it represents, possession of the Warrant itself does not show that he is the owner of the metal which it represents.

Conclusion

The LME was set up to facilitate trade in metal, which it has done since 1877. Trading operations on the LME are based on a simple legal structure which has been proved to work well over time. The role of the LME Warrant is to provide a convenient way to effect delivery of vast quantities of metal. It fulfils this role in a simple and convenient way.

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