

A Primer on LME Warrants

The London Metal Exchange (LME) is the world's largest metal options and futures market. The LME has 600 designated warehouses in 33 locations across the USA, Europe and Asia. However, they do not directly own or operate these warehouses themselves, nor the material held in them; rather, the LME simply authorises the warehouses to store LME-approved metal.

The metal quality is strictly controlled, and these specifications are updated from time to time to ensure that the contracts best serve industry needs. Metal at an LME-approved warehouse can be stored on-warrant or off-warrant.

On-warrant

LME warrants are legal documents of title that represent an entitlement to a specific amount of LME-approved metal. This means the holder of the warrant is also the owner of the underlying metal. Having metal on-warrant allows the commodity to be deliverable against an LME contract (usually a futures or options contract). The clearing and settlement occur electronically through a system known as LMEsword, which facilitates the transfer of ownership and provides stock reporting. The LME member who holds a net outstanding short position on the settlement date makes their warrants available on LMEsword. Those with the outstanding long position receive their warrants electronically. Most of these trades are closed out before physical settlement.

Because LME warrants are liquid, financing is cheaper for metal on-warrant versus off-warrant. However, the warrant holder is responsible for the payment of storage fees of the underlying commodity, making the holding of on-warrant metal more expensive than off-warrant metal.

During the settlement of warrants through clearing, the "to be owner" doesn't know the brand and location of the metal until the settlement day when the warrants are assigned by the LME to the long investors on an 'allocated basis' (Allocated metal is outright ownership of a specific amount of metal, rather than a right to a pool of metal owned by the custodian). This can cause potential problems, such as a French consumer being allocated metal stored in Singapore!

Rather than going through the LMEsword clearing process, to have certainty on the brand and location of the warrant being delivered individuals can enter the warrant market. Here, warrants are sold for a premium to the LME cash price depending on the brand and location and relevant demand.

Off-warrant

Metal is not deliverable against an LME futures or options contract but still needs to be stored in an LME-approved warehouse. Off-warrant metal does not need to come from an LME approved producer, nor does it need to conform to the LME rules with respect to commodity grade, quality, or shape.

Storing metal off-warrant is attractive because it can be stored in an LME-approved warehouse while paying lower rent. A holder of off-warrant metal has three options at their disposal: putting the metal back on-warrant (providing it conforms to LME standards), selling the metal privately on the physical market or removing the metal to a non-LME-approved warehouse.

In Summary

Storing base metals in an LME-designated warehouse allows an individual to place the metal on-warrant, to access the LMEsword electronic system, allowing for clearing via options or futures. However, this has downsides such as high storage costs and not knowing the location of the metal until cleared. Off-warrant metal need not conform to LME standards and allows for lower rent costs and greater flexibility in its disposal.