Commodities

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COMMODITIES BULLETIN

Transparency directive: EU brings in new measures

Transparency was a key theme of the recent G8 summit and continues to receive media coverage. EU companies involved in the development of oil, gas, mining and logging resources will shortly need to consider how best to comply with forthcoming EU legislation which will require them to report payments made to governments in a bid to improve transparency in their industries.

The EU Parliament has approved a draft Directive, which will now go to the EU Council and the Commission. Assuming they adopt the Directive in its present form, it will be published in the Official Journal and enter into force on the twentieth day of its publication. Member States will then be required to adopt the necessary measures to transpose the Directive into national law within two years.

What is the effect of the new rules?

The recent Directive brings the EU in line with international developments in this area, in particular the requirement to report payments to governments set out in the US Dodd-Frank Act.

Once the new Directive is adopted into national legislation companies will be obliged to report, on an annual basis, payments of more than EUR100,000 (around £85,000) made to governments in the countries in which they operate. They must disclose payments made at a project level. Therefore a company with multiple extractive operations in say, Nigeria, must disclose payments made to the Nigerian government relating to every project it operates in that country. Reports must be published within six months of the end of each financial year and made publically available for at least ten years.

The EU hopes that this will allow communities in resource-rich countries to be better informed both about the level of government income gained from licensing such activities and also as to whether the cost to the local and national population is being adequately compensated.

The Directive does not include any reporting obligations in respect of so called ‘conflict minerals’ but we understand that this is the subject of a separate EU Commission review.

Who will it affect?

The Directive applies to EU "registered" companies (which includes not only listed companies but also large unlisted companies) with activities in the extractive industry and the logging of primary forests. A 'large' company is defined as one which satisfies two out of three criteria: (i) a turnover of more than EUR40 million; (ii) total assets of more than EUR20 million; and (iii) more than 250 total employees.

By imposing the reporting obligations on large unlisted and logging companies, the EU Directive has gone further than the US Dodd-Frank Act.

The new EU obligations, taken together with the US requirements, will apply to approximately 70% of the global extractive industry (by value). This percentage looks set to increase with recent reports that the Canadian government is now seeking to enact similar legislation.

Are there any exemptions?

One significant aspect of the EU Directive is the lack of any exemptions. Companies within the oil industry advanced strong arguments for an exemption on the basis that some countries forbid the disclosure of payments to governments in their criminal legislation. These arguments were rejected by European MPs.

What if a company is caught by both the US and EU rules?

In order to eliminate the administrative burden which could stem from multiple reporting obligations under different legislation (e.g. rules in the EU and the US), the EU legislation is expected to include an 'equivalence clause'. This will allow a company to publish a single report on the basis of the mandatory requirements of a third country, provided that these are considered to be equivalent to the EU requirements. The Commission will have power to make decisions about "equivalence" and will take into account specific criteria, including the content and frequency of the reporting obligation.

Conclusion

The new EU reporting requirements have already received considerable press coverage and are likely to remain high profile. The consequences of failing to adhere to them will be determined by national legislation, but are likely to include large fines. Companies affected by this legislation will need to plan for additional internal controls and record keeping so as to ensure that a detailed record is maintained of any and all payments made to governments in the countries in which they currently have extractive or logging projects, and that these records can be made public within six months after the end of each financial year.

We are keeping the situation under review and will publish further alerts as this important legislation progresses.

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Companies affected by this legislation will need to plan for additional internal controls and record keeping so as to ensure that a detailed record is maintained of any and all payments made to relevant governments.

DANIEL MARTIN

Major new derivatives regulation – practical steps towards compliance

Global implementation of derivatives reform is well advanced, with all types of transaction counterparties already subject to new obligations in the US, EU and elsewhere. Rules, guidance and safe harbours are being finalised (in many countries this process is largely complete) and phased application of the rules is underway. Any business using derivatives needs to understand how the requirements apply to them and to plan and implement an appropriate compliance programme. If you are not already doing this, you need to start now. This article gives a broad outline of the global changes and some practical suggestions on how to respond.

The new requirements implement a G20 agreement that:

- All standard derivatives contracts should be cleared through central counter-parties (CCPs) – with regulators to decide which contracts fall into this category.
- They should be traded on exchanges or electronic trading platforms where appropriate – again, with regulators to decide.
- Derivatives executed off-exchange or over-the-counter (OTC) should be reported to trade repositories.
- Non-centrally cleared contracts should be subject to requirements for higher capital and other risk mitigation.

All types of derivatives are affected, whether the underlying assets are commodities, financial (e.g. interest rates or currencies), or indices (e.g. freight and weather). Although the reforms focus on OTC derivatives, exchange-traded derivatives have also been affected, especially by changes in clearing and collateral rules and, in the EU, by the extension of trade reporting to all derivatives.

A particular challenge is that the G20 nations are implementing these high-level principles differently. Despite efforts to agree common – or at least consistent – approaches, inconsistencies remain. A further complication is that some requirements, particularly under the US Dodd-Frank Act and the EU's "EMIR" regulation, have extra-territorial effect, particularly on foreign entities with US/EU counterparties.

How the new regulations apply generally depends on the role and categorisation of the participant concerned – e.g. whether it is a financial firm, a non-financial firm that is a large-scale participant in OTC derivatives markets, or an end-user using derivatives markets only to hedge. Even intra-group transactions must be considered, although some safe harbours are available for these. The definitions, obligations and available exemptions applying to each participant vary from one jurisdiction to another.

In order to respond appropriately to these changes, we recommend the following action, even if you are an end-user (or, in the EU, a non-financial counterparty below the clearing threshold):

- Carry out an impact assessment:
  - What types of transactions do you enter into, with whom, how, where and on what scale?
  - What is your status or category under the applicable rules - might it change over time?
  - How do hedging and treasury financing safe harbours apply to your group?
  - What requirements of which jurisdictions apply to your business?
- Consider whether you should change the way you structure and execute derivatives transactions, for example OTC versus exchange-traded, cleared versus uncleared, booking vehicle, counterparty types, deal structures, etc.
- Develop and implement procedures to confirm OTC derivatives promptly.
- Mark-to-market uncleared derivatives (if this requirement applies to you).
- Consider whether you need a model in case of market disruption.
- Obtain official "legal entity identifiers" (LEI) for each relevant entity:
  - You will need these to report and clear trades.
  - Eventually, LEIs will be harmonised internationally so that only one will be needed.
- Report (or prepare to report) your derivatives transactions to a trade repository, unless you have properly delegated this, or it is clearly the other party's responsibility.
- Consider which trade repositories you will use.
- Plan for more onerous requirements to collateralise trades, whether or not cleared:
  - Parties not directly subject to collateralisation requirements may be indirectly impacted.
  - Margin credit may become less available.
- Address new documentation requirements:
  - Existing agreements may need to be supplemented by new documents and amended in other ways.
  - Consider which industry standards will work for you and engage with counterparties about this.
- Develop policies, procedures, processes and related IT changes to ensure trading and operations comply:
  - Consider benefits, scope and pre-requisites for outsourcing some processes.
  - Compare prices and offerings of services providers.

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- Ensure you are set up for mandatory clearing when and where this applies:
  - Clearing obligations are already coming into force in the US and are expected in the EU from mid-2014.
  - Plan your approach to position and margin/collateral segregation.
- Consider and plan for cross-border issues arising.
- Monitor for change: detailed rules and guidance are still being issued and other pending regulatory changes (such as the Basel III implementation) may significantly impact derivatives business.

Depending on how many jurisdictions affect your derivatives business, there are hundreds if not thousands of pages of law, rules, guidance etc. to navigate. Developing and implementing a compliance programme represents a challenge for many businesses. It is critical to start now and seek professional help.

This article is based on a recent HFW Briefing, "Major New Derivatives Regulation – The Science of Compliance", available on our website at: http://www.hfw.com/Major-New-Derivatives-Regulation-June-2013.

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Conferences and Events

HFW Energy and Resources seminar series
HFW Perth
(10 July 2013)
James Donoghue, Hazel Brewer, Matthew Blycha, Julian Sher

Commodities Networking Event
Bounce, London
(10 July 2013)
HFW London Commodities Team

GTR's 10th Anniversary Celebration
The Grange, St Paul's London
(16 July 2013)
Damian Honey, Spencer Gold

Australian Grains Industry Conference
Crown Conference Centre, Melbourne
(29-31 July 2013)
Chris Lockwood, Stephen Thompson

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