HFW

COMMODITIES BULLETIN
JULY 2021

Welcome to the second edition of our relaunched Commodities bulletin.

It is a privilege to introduce the bulletin from Singapore, with memories of contributing to our previous Commodities bulletin as a junior lawyer in London. Our global team has grown a lot since then, most recently with the addition of Peter Zaman and Dan Perera in Singapore and Matthew Cox in London, two of whom have contributed articles this month.

In this edition, we start with a look at the opportunities and challenges presented by the current state of the iron ore market. We then identify some lessons to be learned from the high profile commodities insolvencies and frauds of the last 12-18 months. Next is an update on proposals for increased due diligence and reporting obligations in Switzerland and the EU, on human rights and environmental risks. Finally, we consider the use of electronic documents in trade finance – all the more relevant in light of both COVID-19 and the various recent commodities frauds.

HFW was proud to sponsor the FT Commodities Global Summit in June. Brian Perrott spoke as part of a panel discussing responsible commodity trading. The event was a great success and, as ever, attended by many of the biggest names in the industry.

We hope that you find the bulletin useful – please do give us your comments, suggestions and feedback.

Adam Richardson, Partner

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"Iron ore has soared in value over 100% over the last 12 months, and has in recent weeks sustained a price level of close to, or over, US $200/ mt - a price which many market commentators had not believed would be achievable."

IRON ORE: GEOPOLITICAL TENSIONS GIVE RISE TO OPPORTUNITIES AND CHALLENGES

Over the last year or so we have seen some fascinating developments in the global physical iron ore market, largely driven by the impact of recent geopolitical tensions between China and Australia.

Iron ore has so far been a net beneficiary of these tensions: while China can rely on domestic supply, other global markets, or alternative products for energy sources such as thermal coal, to the detriment of Australian suppliers, the same is not true of iron ore. At present, there are two major centres of scalable production worldwide: Brazil and Australia. Reliance on only one of those sources to supply existing Chinese demand is not possible. As such, China still needs access to Australian iron ore. For now, at least.

The consequence? Iron ore has soared in value over 100% over the last 12 months, and has in recent weeks sustained a price level of close to, or over, US $200/mt - a price which many market commentators had not believed would be achievable.

What fuels China's immense appetite for iron ore?

Iron ore is an 'early cycle' commodity: China's demand for the metal is driven by the hundreds of Chinese steel mills which produce the various forms of steel used in the development of infrastructure and the construction of transport links and buildings required to create new urban centres - new towns and cities, and new local and regional economies. Without steady and reliable access to iron ore, new regional urbanisation in China, and critically China's multi-national One Belt, One Road project, would stall to a grinding halt.

Once those new buildings and critical infrastructure such as transportation links are in place, there will follow greater demand for 'late cycle' commodities such as copper, nickel and aluminium. These are used in air conditioning units; telecommunications and electrical wiring; solar cells; batteries; and the multitude of electrical appliances which are used in the fit-out of buildings. Increased demand for iron ore in the steelmaking process therefore generally precipitates increased demand for other metals of this nature.

So, what can we expect to see in the iron ore space over the coming years? Regardless of the prevailing geopolitical tensions, China is naturally keen to reduce its reliance on Australian iron ore. Many market commentators now anticipate a strong push from China to get more iron ore mines on stream in West Africa. If they are successful, this will achieve greater production capacity from a wider range of global sources then are presently available. Many Chinese companies, both private and state-owned, are ground-level investors in West African iron ore projects, with a particular focus on Guinea. These companies will provide the cash, heavy equipment, skilled manpower and technical knowledge to get new mines from concept to full production in as short a period as possible.

Opportunities and challenges

This scenario brings with it both opportunities and challenges. There will be opportunity for new market participants, as major producers of iron ore in Australia seek to place some of their billions of annual tonnes of seaborne iron ore into other markets – some existing, and some new. More opportunities will arise as other commodities like Australian thermal coal, impacted by Sino-Australian tensions, as well as China's desire to move to cleaner power generation from commodities such as LNG, are moved into new markets along the Belt and Road like Bangladesh and Vietnam. New centres for the production of iron ore will require their own infrastructure, including new and improved deep water ports. These construction projects will require a vast quantity of labour and entire economies which will be built around supporting that. Projects of this scale will bring many new opportunities to countries not presently active in major iron ore mining operations.

The challenges associated with this new landscape are also clear. Many market participants – miners, traders, vessel owners and others – will be dealing with on-boarding new customers; trading along new trade routes; and encountering a variety of problems for the first time. These may be challenges of a physical or a legal nature, or a combination of the two.

Producers and traders will encounter new jurisdiction risk and issues relating to the creditworthiness and performance risk of new buyers. There may be the potential challenge of having to enforce arbitral awards in what are perceived as difficult or high risk jurisdictions. They will face the 'Know Your Client' issue, highly relevant to all major corporates whose stock is listed on major exchanges and who are therefore governed by the highest global standards relating to corporate governance; anti-bribery and corruption; anti-money laundering; and counter-terrorist financing. In addition, issues will arise as a result of the higher volumes of particular late cycle metals, such as nickel and lithium, being traded and the limited reliability of existing price indices and hedging options available for many of these metals.

Vessel owners and shippers will find themselves plying new trade routes for the first time, proceeding to new ports, and trying to limit the risks associated with particular geographical features such as monsoon conditions, which may be present. They will also have to deal with the (most likely) high moisture content of freshly mined iron ore from new, tropical, sources and the risk (and potentially horrific consequences) of cargo liquefaction which may ensue.

Risk mitigation key to success

Regardless of whether a particular market is doing well or poorly, macro-level issues of this nature have the ability to change the prevailing landscape significantly and in a very short period of time. The potential opportunities arising may be tremendous, but some of the risks associated with them could result in losses on a grand scale for many market participants, should they ever come to fruition. Being alive both to the opportunities and the challenges will be increasingly important for iron ore market participants over the coming years, in order to mitigate both physical and legal risks, and to maximise the potential upsides available.

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LEARNING LESSONS FROM FRAUDS AND INSOLVENCIES

In the past 12-18 months, there have been a number of high profile and very costly insolvencies and frauds in the commodities space, particularly in Singapore but also elsewhere. A number of bad practices have been exposed as a result – and it is clear that they had been going on for a number of years. These include multiple financings of the same goods; the use of fake documents to procure financing (in particular, the generation of fake receivables or the presentation of fake documents under letters of credit); and sales and purchases at a loss in order to raise short term liquidity.

Hin Leong is one of the most high profile examples where such practices have been alleged. Hin Leong was a Singapore based trading company that, along with various affiliated companies, collapsed in 2020 after the oil price plunge. A private company, it was founded by Lim Oon Kuin ("OK") and was one of Asia's top oil traders - owned and run by OK and his children. Hin Leong sought protection from its creditors in Singapore on April 17 2020. Proceedings and investigations are ongoing but in affidavit evidence provided by OK, he revealed a reality of trading losses that was in stark contrast to the company's official accounts. As matters emerged, the gap between the company's assets and its liabilities was found to exceed USD 3 billion. Singapore is the world's biggest hub for shipping fuel and the collapse of such a significant player - the third largest - was a major event. The company owes millions of dollars to more than 20 lenders. Its remaining assets became distressed very quickly. There is now a galaxy of litigation underway: in the last few weeks, a further 105 charges have been filed in the Singapore courts. There is no doubt that this saga will continue for years to come at considerable cost.

Allegations of fraud and insolvency are not new; but are there ways to minimise the opportunities available to fraudsters and the risks to which innocent parties are exposed? In this article, we reflect on what lessons can be drawn from this latest challenging period.

Warning signs

It is prudent to consider the following factors as significant, if not as red flags, then certainly as amber warning signs. This is especially so when more than one of the factors are present.

- Trades which make little commercial sense: for example, will the counterparty inevitably lose money in the trade without any clear benefit? Or is the volume or nature of goods for the proposed trade atypical?
- Use of documentation which is irregular or insufficient for the proposed trade: proposed trades which are evidenced by short, unsophisticated or unsuitable terms or which are missing key documents may raise questions as to their validity.
- Private companies: these are obviously less transparent than public companies as the auditing and reporting requirements to which they are subject are less stringent. Contracting with private companies therefore requires particular scrutiny.
- Family businesses: A family founded, owned and run private company will inevitably constitute a risk because it is less transparent.
- Integrated platforms: The so-called integrated platform to enable shipping, trading and storage, whilst a selling point for business, can be susceptible to manipulation and fabrication.
- The "How do you do it?" factor: unusual financial reporting or financial reporting that bucks the trend should give pause for thought.

Forewarned is forearmed

There are some steps which parties can take in advance to reduce the risk of falling victim to fraud.

- Due diligence: for example, make inventory visits; appoint an independent third party to monitor stock; and trace vessel movements to ensure that the voyage as described in the bill of lading is taking place.

- Beware the letter of indemnity: discharging cargo on the strength of a letter of indemnity (LOI) or relaxing the rules for submission of documents under a letter of credit in return for an LOI will expose you to risk.
- Consider going digital. Paper is easy to alter, amend, corrupt or lose – consider using electronic documents where you can. Momentum is building on this. See our briefing **here** and Matthew Cox's article elsewhere in this bulletin.

Positive action

It is encouraging to see some positive steps being taken to restore confidence to the commodity financing sector.

In November 2020, the Monetary Authority of Singapore (MAS) and the Association of Banks in Singapore (a group of 28 banks) launched the Code of Best Practice for Commodity Financing. The Code lays out key principles governing prudent commodity trade financing practices and provides a benchmark for banks' lending standards in the sector. Banks are expected to put in place appropriate and risk proportionate policies, procedures and controls to allow them to observe the principles in the Code.

The MAS is also working with a group of banks on a trade finance registry. This is a blockchain solution aimed at preventing double financing of invoices and other documents. The intention is that it will be possible to check on the registry whether documents which are offered by a customer to a bank have already been offered to another institution.

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"The recent developments in relation to the measures in Switzerland and Europe is evidence that the world is moving towards an enhanced regulatory environment in ESG."

ESG UPDATE: INCREASED DUE DILIGENCE AND REPORTING OBLIGATIONS IN SWITZERLAND AND THE EU

Switzerland

From a Swiss perspective, by early 2022 there will be greater due diligence and reporting duties for members of management bodies of relevant businesses in Switzerland.

Swiss Responsible Business Initiative

Last autumn, we published a briefing on the Swiss Responsible Business Initiative (RBI). Had it passed, the RBI would have required Swiss based entities to follow due diligence procedures, identify potential risks to human rights and the environment throughout the entire value creation chain and take effective measures to counter these risks. In the event of a violation of human rights or environmental standards, Swiss based companies could have been held liable in plaintiff-style claims for damages in the Swiss courts. However, on 29 November 2020, the RBI was rejected by popular vote.

Counter-Proposal: new obligations

Alongside the RBI, the Swiss Federal Council prepared a counter proposal (the **Counter-Proposal**), which is in line with regulations currently in force in the EU. This imposes on Swiss companies due diligence and reporting obligations relating to the protection of human rights and the environment; conflict minerals and metals; and child labour.

A referendum to have the Counter-Proposal submitted to a public vote can be requested up until 5 August 2021. If no request is made, it will enter into force. Its provisions will become applicable one year after that. The Counter-Proposal is thus likely to take effect in early 2022, with the first reports required under the new legislation to be published in 2024, covering due diligence steps taken by companies in 2023.

The Counter-Proposal is more limited in its reach than the RBI. There will be no civil liability for Swiss based entities in the event of a breach of human rights or environmental standards by their subsidiaries or economically controlled sub-contractors. Criminal liability for non-compliance will be limited to particular individuals, rather than extended to the entire organisation (this differs from current criminal standards for organised crime, financing terrorism, money laundering and certain bribery offences). Criminal penalties will involve fines of up to CHF100,000, which may be levied on members of management bodies if reporting obligations are violated, or if the reports contain false information.

Ordinance: guidance on implementing the Counter-Proposal

A consultation is now underway in relation to the draft ordinance which accompanies the Counter-Proposal (the **Ordinance**). The Ordinance provides further guidance on the implementation of the due diligence obligations in the Counter-Proposal. It will in particular:

- define which companies must comply with the new conflict minerals and metals and child labour requirements
- set volume exemption thresholds
- list exceptions for SMEs and low risk companies in the area of child labour
- detail the due diligence duties and list the international standards applicable.

The Ordinance will be amended as needed throughout the consultation process, which ended on 14 July 2021.

Other reporting obligations

In addition to these new measures, the Swiss Code of Obligations now provides for yearly reporting obligations in relation to payments to state bodies for companies subject to ordinary audit and involved in the extraction of minerals, oil or natural gas or in the harvesting of timber. These provisions entered into force on 1 January 2021.

The EU

In brief, the major EU laws and regulations covering matters comparable to those dealt with in the Counter-Proposal are:

- EU Directive 2014/95 (the Non-Financial Reporting Directive, NFRD), which came into effect on 5 December 2014

- EU Regulation 2017/821 (the Conflict Minerals Regulation), which came into effect on 1 January 2021
- EU Regulation 2019/2088 (the Sustainable Finance Disclosure Regulation, SFDR), which came into effect on 10 March 2021

On 21 April 2021, the European Commission (the **Commission**) adopted a proposal for a Corporate Sustainability Reporting Directive (CSRD), which aims to extend the existing reporting requirements of the NFRD. It envisages the adoption of EU sustainability reporting standards by October 2022.

There has been a recent, relevant development on the Commission's Sustainable Corporate Governance Initiative. This Initiative calls for the urgent adoption of an EU directive that ensures companies are held liable when they violate human rights, environmental or good governance standards. On 10 March 2021, the European Parliament made recommendations to the Commission on corporate due diligence and accountability. The report proposes the introduction of mandatory corporate due diligence obligations on non-financial matters in business supply chains and recommends that direct civil liability apply where companies' actions result in *actual or potential adverse* human rights and environmental impacts. The Commission was expected to submit a legislative proposal to the European Parliament in Q2 this year. The future legislative framework is likely to be broad in scope and apply to (i) all large companies governed by EU law or established in the EU, including those providing financial services, (ii) publicly listed SMEs and high-risk SMEs and (iii) foreign companies when they operate in the internal market selling goods or providing services.

HFW Comment

The recent developments in relation to these measures in Switzerland and Europe is evidence that the world is moving towards an enhanced regulatory environment in ESG. Both trading partners and clients of EU or Swiss based entities will need to keep abreast of developments. It is more important than ever to implement comprehensive ESG policies and build a culture of compliance towards more sustainable business.

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"The finance industry has become increasingly embarrassed that it cannot find a way to "go digital". Bankers no longer go to work in a horse and carriage, so why are they still using Victorian technology for trade finance?"

DIGITALISATION OF TRADE FINANCE INSTRUMENTS: WHAT'S THE BIG DEAL?

On 30 April 2021, the England and Wales Law Commission (the Commission) published a consultation paper, addressing the issue of whether electronic trade documents should have the same effect in law as their paper equivalents. The consultation will be open until 30 July 2021.

You might be forgiven for thinking this is not earth shattering news. If so, the purpose of this article is to change your mind. Digitalisation is not just about ease of use and simplification. It will result in a profound change to the distribution of risk in the international trade finance markets.

What's the problem?

Trade documents are used by traders and financiers to facilitate and finance the trade of physical goods and commodities. They include bills of exchange, promissory notes, bills of lading and many others.

The rules governing the use of these instruments have not changed for a very long time. The UK Bills of Exchange Act 1882 still provides the legal framework for billions of dollars of international trade finance utilising bills of exchange and negotiable promissory notes every year. The finance industry has become increasingly embarrassed that it cannot find a way to "go digital". Bankers no longer go to work in a horse and carriage, so why are they still using Victorian technology for trade finance?

It is not for want of trying. In recent decades, several digital platforms utilising electronic documents have launched. Whilst they have had some success, none has come close to replacing the established paper based systems.

The great benefit of paper bills of lading and bills of exchange is that English law (and many other legal systems) recognises the negotiability of these documents by way of indorsement (ie execution by wet ink signature) and physical delivery. This offers great flexibility: mere possession (with the necessary formalities) will give the holder of a bill of lading the right to delivery of a ship's cargo and the holder of a bill of exchange the right to payment at maturity.

This great benefit is paradoxically also the key obstacle to digitisation. The problem is that English law does not currently recognise the ability of a person (i) to indorse or (ii) to have "possession" of an electronic document.

Why the reluctance to change?

This may seem puzzling. Given how easy it is to forge paper documents and wet ink signatures and given that physical bills of lading are in practice routinely replaced with letters of indemnity, surely there is an incentive to move to using electronic instruments, thereby reducing the risk of fraud and loss and negating the need for letters of indemnity?

There are very good reasons why English law has been slow to change. The main one is that case law and market practice has developed over many years to support the current system; change could bring uncertainty, legal risk and new opportunities for fraudsters.

Solution 1: Digital platforms

Some digital platforms, including Bolero, essDocs and E-Title, have been launched for electronic trading. They operate by means of a contractual framework. Members of the platform agree to recognise the electronic instruments it uses as replicating the functionality of equivalent paper trade instruments. For example, they can agree that electronic indorsements will be recognised and that electronic delivery of an instrument on the platform will give the recipient valid possession.

The major drawback is that on an insolvency, third party creditors can argue these arrangements are merely contractual and not recognised by local law, such that transactions on the platform can be challenged as unenforceable. Several platforms have tried to mitigate this risk by allowing electronic documents to be printed as physical documents if necessary - but this negates the purpose of using electronic documents in the first place. The result is that use of electronic platforms has been limited.

Solution 2: Government response

It has long been argued that the widespread adoption of electronic trading would require national governments to change their laws. It is therefore significant that several governments have begun to do just that:

- In 2017, the UN Commission adopted the UNCITRAL Model Law on Electronic Transferable Records (MLETR), enabling the legal use of electronic transferable records (ETRs) both domestically and internationally. The MLETR sets out a template which nation states may adopt as part of their national laws. However, at the time of writing, only the Abu Dhabi Global Market, Bahrain and (recently) Singapore have adopted the MLETR.
- Singapore passed the Electronic Transactions (Amendment) Act this year. It adopts the MLETR with slight modifications and amends several pieces of existing Singapore legislation. It gives recognition to ETRs, including bills of lading, promissory notes and bills of exchange such that these documents will not be denied legal effect, validity or enforceability solely because they are in electronic form.
- The UK Law Commission's draft proposals seem likely to result in a new UK act of parliament (to be called the Electronic Trade Documents Act 2021) which will give paper and electronic documents equivalence under English law.

The UK Law Commission's consultation paper is not seeking a revolution in the way electronic trade documents operate. It proposes recognition of electronic equivalence for a limited number of paper trade documents without seeking to change the fundamental rules governing those documents. This would be achieved by recognising electronic indorsement and possession as equivalent to physical indorsement and possession. It is hoped that this minimalist approach (albeit with potentially revolutionary impact) will retain legal certainty for market participants.

A further benefit is that the existing digital platforms should meet the criteria for equivalence, boosting their credibility in the eyes of traders and the credit and risk teams of their financiers.

The need for a global response?

Can digitisation of trade documents succeed without full global recognition? After all, there are at least three parties to every bill of lading and every bill of exchange and, as these instruments are designed for cross-border trade, at least two of them will be in different jurisdictions.

In our view, it can. The proposed changes to English law should have a significant impact, given that it remains the governing law and dispute jurisdiction of choice for many trade documents. In addition, our view is that the action taken by other major hubs such as Singapore will spread: global finance hubs are in competition to support fintech initiatives and so the incentive to recognise electronic trade instruments will grow.

In conclusion, digitalisation in international trade finance is a big deal. The current efforts of national governments to support it are a very welcome development and we expect to see it expand at pace.

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WHERE YOU CAN MEET THE TEAM NEXT

27 July 2021
Grain Trade Australia Advisory and Compliance Day
Speaker: Ranjani Sundar

28 July 2021
Gafta and HFW: Digitisation of Trade
Speakers: Damian Honey, Adam Richardson

23 September 2021
GAR Live: Paris Arbitration Week
Speaker: Dan Perera

OTHER TEAM NEWS

Philip Prowse and Andrew Green have written an article for the Butterworths Journal of International Banking and Financial Law on supply chain finance in the wake of the insolvency of Greensill. The article was published on 4 June 2021.

HFW has over 600 lawyers working in offices across the Americas, Europe, the Middle East and Asia Pacific. For further information about our commodities capabilities, please visit hfw.com/Commodities

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