Commodities

April
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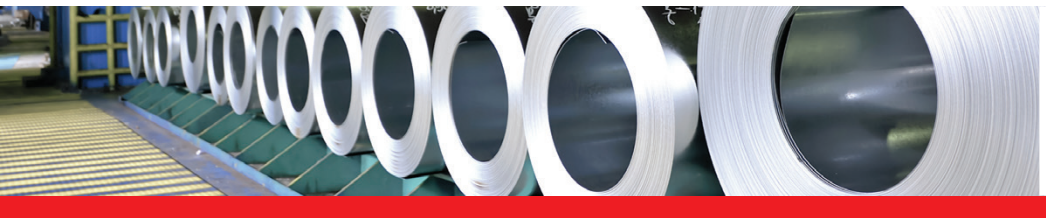
Court rules on LME's proposed queuing rule

In R (on the application of United Company Rusal plc) v London Metal Exchange (27 March 2014), the Administrative Court in London issued its judgment in the judicial review action brought by Russian aluminium producer Rusal plc, challenging the LME's proposed introduction of a rule aiming to deal with the so-called "queues" issue. The Court held that the LME's consultation was procedurally unfair and accordingly the rule, which was due to be implemented on 1 April 2014, will not (for the time being at least) come into force.

The proposed new rule (known as a linked load-in, load-out rule) effectively required that any LME warehouse with queues longer than 50 days must load-out more metal than was loaded into the warehouse. Rusal claimed that the rule would result in a short term fall in the global market price of aluminium, which would potentially cause hardship to producers.

Rusal had challenged the proposed new rule on three grounds: firstly, that the consultation process was procedurally unfair because the LME did not identify or explain why an alternative option for reducing warehouse queues had been discounted; secondly, that the LME's decision was made without adequate consideration of or enquiry into the effect the new rules would have on the price of metal and the consequent effect on metal producers; thirdly, that the decision was a breach of Rusal's human rights, being a disproportionate interference with Rusal's right to peaceful enjoyment of its possessions (namely goodwill or economic interest) or was otherwise discriminatory as between metal producers and warehouse operators.

The proposed change to the rules came about as a result of the "queues" issue which started in 2008 – namely the delay in obtaining physical delivery of metals ex-LME warehouses. This was acknowledged as having caused owners to be denied reasonable access to their metal (which it was suggested undermined the LME's role as a




market of last resort). In addition, the cost of rent during the period metal is held in a queue causes LME prices to be discounted further from the all-in price, thus damaging the role of the LME in discovering the true market price of metal. Further, the queues issue had (and may still have) potential regulatory consequences.

In response to complaints, the LME commissioned an independent report to assess whether the requirements for rates for physical delivery out in LME warehouses were satisfactory. The report set out in detail the damaging effect of long queues on price discovery and proposed five policy options to address the problem. The first four options proposed controls on stocks or load-out rates. The fifth option was to ban or cap rent for metal in long queues. The LME adopted the primary solution suggested by the report and increased minimum load-out rates with effect from 1 April 2012. However, this failed to resolve the problem.

The issue of queues was reviewed again in summer 2012 and also following the acquisition of the LME by Hong Kong Exchanges and Clearing Ltd in December 2012. The review included previously discounted proposals, but noted that *"any solution envisaging limiting warehouse incentives or capping metal deposited into any particular warehouse would likely be illegal under competition law"*.

At an LME board meeting in April 2013, the "linked load-in, load-out" solution was proposed. At this stage, the potential decrease in the "all-in" price of metal and the potential negative consequences to producers like Rusal were considered. The LME took the view that it could not meddle with price for the benefit of any particular part of the market. A consultation notice was proposed in July 2013. The LME

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received 33 written responses to the proposal and 70 meetings took place. A significant number of the responses proposed a ban or a cap on rent on metal in queues. A further LME board meeting took place in October 2013 and the LME announced its decision to implement the linked load-in, load-out proposal in November 2013.

The Judge considered various precedent cases which established the limits of the obligations on a public body to consult. He found that it is established law that a public body is not required to consult on every possible option, but is entitled to put forward its preferred option as a proposal for consideration. However, notwithstanding the case law, the LME's consultation was one where, in the particular (and perhaps exceptional) context in which it arose, fairness demanded that the consultation should encompass what the LME in due course recognised to be the *"most practical suggested alternative to the Proposal"* i.e. the banning or capping of rents. The LME having failed to do so, the Judge found that the consultation was procedurally unfair.

He went on to find that the fact that the LME had discussions about banning/capping rent with representatives of the warehouse companies during the consultation period was an aspect of the unfairness of excluding that option from consideration in the consultation.

In addition, the LME's acceptance that it had commenced a fresh competition law review was found to be tantamount to an admission that it had failed to make sufficient enquiry and had failed to consider relevant matters prior to commencing the consultation. The consultation process was also unlawful on this basis.

The Judge did however find that it would be improper for the LME to take into account which category of its users would "win" and which would "lose" in any price effect of a proposed rule change.

In relation to the challenge based on Rusal's human rights, the Judge said: *"It is not necessary, or useful, even if I am wrong in my findings in relation to grounds 1 and 2 above, for me to consider the interesting but*

difficult question of whether causing a business a loss of future revenues is interference with "possessions" which qualify for protection under Article 1 of Protocol 1 of the ECHR".

The LME's decision to implement the proposed rule has been quashed and it has confirmed that the rule change will not come into force (although other reforms including a logistical review, new physical markets committee and new position data have proceeded as planned). The LME is considering whether to seek permission to appeal or proceed to a re-consultation. Assuming the EU competition law advice which the LME received remains unchanged, it remains to be seen whether the outcome will be any different even on a re-consultation. It is important to note that it is the procedure, not the substance, of the consultation which was illegal. Whether or not the continued queues issue causes increased regulatory scrutiny pending an appeal or re-consultation is also a matter for debate.

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Trading bulk cargoes – when does title pass?

English law generally allows sophisticated parties to commercial contracts the freedom to agree on key terms. However, in some limited instances, statutory provisions can override the parties' express contractual intentions: one example of this is in the context of passing of title to parcels of goods which form part of a larger bulk.

For contracts where the Sale of Goods Act 1979 (as amended) (the Act) applies, commodities traders buying or selling parcels of goods which form part of a larger bulk should bear in mind the impact of sections 16 and 20A of the Act on the point at which title to those goods can pass. It can have an unexpected effect.

S.16 of the Act states that, *"where there is a contract for the sale of unascertained goods, no property in the goods is transferred to the buyer unless and until the goods are ascertained"*.

The Act does not define "ascertained" but it is generally accepted that ascertained goods are existing, identifiable and not mixed with goods belonging to anyone else. By contrast, unascertained goods are generic goods which cannot yet be specifically identified, perhaps because the delivery date is in the future and the goods could be obtained from a number of sources, or because they are mixed with parcels belonging to other parties, on board a vessel or in large onshore storage tanks.

Until 1995, s.16 applied mandatorily to the passing of title to goods in an unascertained bulk under English law. Title could therefore only pass to each buyer when their specific parcel had become ascertained, either through:

- Separation of that parcel from the bulk (i.e. at the discharge port); or
- A process of exhaustion, (i.e. upon discharge of the penultimate parcel, leaving just one ascertained parcel on the vessel).

This presented a serious problem for commodities traders, especially for buyers who had already paid for goods but had not yet received title. If the seller became insolvent before the goods were ascertained or if the goods were arrested by a creditor of the seller, they were still the property of the seller, leaving the buyer in the unsatisfactory position of an unsecured creditor.

To address this problem, the Act was amended in 1995. S.20A was introduced to qualify the application of s.16 in certain defined circumstances. However, it does not offer a complete solution.

In summary, s.20A provides that:

If the contract is for the sale of a specified quantity of unascertained goods and:

- The goods form part of a bulk which is identified either in the contract or by subsequent agreement; and
- The buyer has paid the price for those goods,

then property in an undivided share in the bulk is transferred to the buyer and the buyer becomes an owner in common of the bulk.

The crucial condition for s.20A to apply is that the buyer must have *"paid the price for some or all of the goods which are the subject of the contract and which form part of the bulk"*. The earliest point at which property can pass is therefore when the goods have been paid for, regardless of contractual terms.

This can cause difficulties in the context of CFR contracts which may expressly provide for title and risk to pass upon loading. Typically CFR contracts provide for payment against tender of the relevant shipping documents, which will take place some time later. It is not possible to get around this requirement by the buyer paying a nominal sum for the goods: s.20A specifically provides that this would be treated as payment for a corresponding amount of the goods only.

When the conditions of s.20A are met, the buyer becomes an owner in common of the bulk, allowing him freely to on-sell all or part of his contractual quantity to a sub-purchaser. However, he will not gain sole ownership of his specific parcel until those goods become ascertained.

The same considerations apply to sales of unascertained bulk commodities while onshore, for example oil held in large storage tanks. Here property will only pass to a buyer when the price is paid under s.20A or when separation of the parcel or exhaustion occurs under s.16. Conflicts of laws issues may also arise where goods are held onshore, especially if the sale contract is governed by English law but the storage tanks are located in another jurisdiction. Usually the rules regarding transfer of property are governed by the law of the jurisdiction in which the commodity is situated.

Some of the oil majors have tried to address the issues raised by s.16 and s.20A in their general terms and conditions, for example at sections 2.1 and 8.1.1 of the BP Products 2007 GTCs and at sections 3.1 and 10.1 of the Shell Products 2010 GTCs.

Commodities traders should bear in mind the following potential problems if, under the provisions of the Act, title in fact passes at a different time to that set out in the relevant sales contract:

1. **Onsales.** A buyer cannot on-sell if he does not yet have title himself. This could affect chain contracts.
2. **Jurisdiction.** If property passes at a later time than expected, for example on discharge or exhaustion, title may pass in an unforeseen jurisdiction, giving rise to unexpected tax exposure, trading licence/permit requirements etc.
3. **Insurance.** The incorrect party may have insurance coverage at the time of an incident.

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FCA publishes its approach to commodity market regulation

The UK's Financial Conduct Authority recently published a guide to its role in regulating commodity markets, together with an "update" setting out its views on the regulatory challenges arising from commodity derivatives markets and how it aims to address them through its approach to market policy and supervision.

This article looks briefly at the FCA's guide and update. The two documents are accessible through a new set of web-pages that outline how the FCA regulates commodity markets. These summarise the scope of FCA regulation in this area, the regulator's focus and priorities and the influence of international developments, particularly G20 commitments, EU legislation and the work of the International Organisation of Securities Commissions (IOSCO). Historically, the UK regulator has taken a leading role in international policy work in commodity derivatives, and in the update the FCA commits to continuing this.

The FCA guide

The guide presents the historical backdrop to the current regime for regulating commodities markets in the UK, summarises that regime, and briefly looks forward to four pieces of EU financial legislation that will particularly impact the regulatory framework for commodities – namely:

- **EMIR.** This is already being implemented (see overview at http://www.hfw.com/Major-New-Derivatives-Regulation-June-2013).



- **MiFID II.** The revised MiFID directive and accompanying regulation (MiFIR) which have been agreed and will be formally adopted by mid-June (see the summary in our January 2014 Commodities bulletin at http://www.hfw.com/Commodities-Bulletin-January-2014).
- **MAR.** The new Market Abuse Regulation and accompanying directive imposing criminal sanctions, again agreed and shortly to be adopted formally – the FCA notes that MAR will cover manipulative behavior in physical commodity markets and comments, *"MAR will significantly increase the regulatory grip over conduct on commodities markets."*
- **Benchmarks regulation.** A controversial proposal published by the European Commission last September and now proceeding through the EU legislative process – though currently stalled in the European Parliament until after the forthcoming elections.

The guide is an overview, and contains little of surprise to those who are familiar with this territory. However, the following remarks by the FCA are worth noting:

- *"Commodity markets are unique in how their market activities straddle the regulatory boundary so that behaviour in the physical market can affect the financial markets and vice versa. This physical market activity is an increasingly key influence on the real economy."*
- This together with the EU regulatory changes mentioned above add up to *"a situation of unprecedented complexity, which is a key driver of the direction of market development."*

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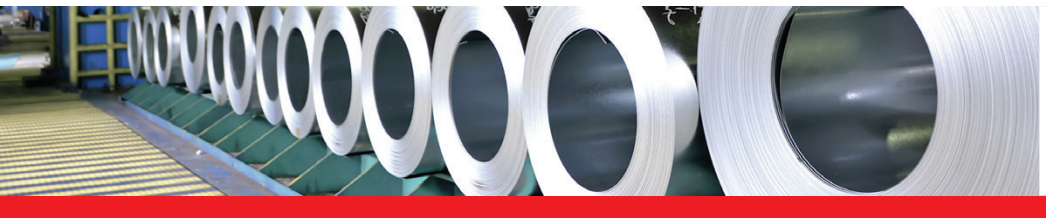
- Last year's division of UK financial regulation between the Prudential Regulation Authority (as prudential regulator of banks (including the larger investment banks) and insurer/reinsurers, and essentially part of the Bank of England), and the FCA (as conduct regulator and prudential regulator of other firms) *"has had no significant impact on how commodity markets are regulated within the UK."*
- However, while the FCA continues to supervise recognised investment exchanges (RIEs) and multilateral trading facilities (MTFs), under a "common template", clearing houses are now subject to the Bank's Financial Markets Infrastructure supervision and we at HFW see that having an impact on the evolution of cleared OTC and exchange-traded commodities business.
- Of particular interest currently, the FCA notes that, while the operation of warehouses approved by exchanges is not regulated by the FCA, the regulator has *"a formal interest in warehousing in relation to commodity markets because of the role it plays in ensuring that those RIE derivative contracts which incorporate warehouse arrangements are anchored to the price of the underlying product and have effective settlement arrangements."* The update was published before the 27 March High Court judgment reviewed at the start of this Bulletin, and the FCA notes that it has been *"fully engaged with the LME's consultation process and will seek to ensure that the impact on market integrity/orderliness has been fully addressed."* Interestingly it also notes, *"the interest in [warehousing] issues is generating momentum internationally, and so a coordinated regulatory response may be desirable."*
- Because the UK chose to retain a regulatory perimeter beyond the scope of MiFID, the UK's Financial Services and Markets Act 2000 captures many firms that are not within MiFID's scope. The FCA maintains various regimes for commodities firms of different kinds, and this makes *"the architecture of firm supervision more complex."*



- Although the FCA emphasises that it regulates commodity derivatives and not the underlying physical markets, it concedes that the regulatory perimeter includes business that some would regard as physical, such as some physical forward transactions.
- Market abuse:
  - Last July, the FCA concluded its first enforcement action in commodities in relation to a finding of market abuse against an oil trader and recently imposed an order in relation to one of a number of enforcement actions taken by the FCA's predecessor (the FSA) for abuse in the oil and coffee markets, permanently prohibiting the trader concerned from performing any function in relation to financial services regulated activities.
  - Although Ofgem has the responsibility for UK enforcement of the physical gas and power market abuse regime introduced by the EU Regulation on Wholesale Market Integrity and Transparency (REMIT), the FCA monitors related derivatives markets and has long-standing cooperation arrangements with Ofgem. In the FCA's Commodity Markets Update, it commits to develop bilateral dialogue with other physical regulators.

The FCA update

The update is an insightful and accessible explanation of how commodity markets are changing and how the FCA is responding. The FCA looks at key trends in commodity derivative markets, particularly changes in the balance of market participants and the nature of their participation, and specific regulatory challenges these pose. It also identifies the main strands of the FCA's market supervision in commodity markets, how it has adjusted its approach to reflect changes in market participation, and the key changes that are being or are likely to be introduced.

The interaction of physical and financial commodity markets gives rise to a range of risks, not least because activity that is not directly subject to financial services regulation affects the FCA's objectives. In particular, the FCA identifies the following:

- *"Market integrity is affected by price formation taking place in the underlying physical market, and by physical delivery and storage mechanisms.*
- *Physical market participants not regulated by the FCA affect prevailing standards of market conduct.*
- *Abusive behaviour can occur in the physical commodity markets which in turn can have an impact on, or be directly linked with, financial market activity and prices."*

"In addition, commodity markets are crucial to the real economy and are therefore subject to considerable and increased political and public scrutiny. These factors combine to present challenges for regulators, firms and market operators."

Interestingly, the FCA admits that the regulatory changes initiated in response to the financial crisis are now themselves driving market evolution, yet also acknowledges that the markets have changed since the G20 decisions in 2009 that have led to these same regulatory changes: *"the risks now are less about growing markets and a rising tide of speculative activity and more about a lack of liquidity and a retreat by classes of participants [banks]".*

Referring to trading houses as representing a "known unknown", the FCA remarks that *"the rise in proportion of activity on London markets by unregulated, overseas entities poses a challenge to our market supervision, alongside risks to market standards and integrity,"* and analyses these challenges at some length. It seems to doubt they pose systemic risks as claimed by some regulators and market participants. The FCA has received a "constructive response" to its initiative to develop a dialogue with trading firms.

These documents are neither consultation nor formal guidance, but a helpful, concise overview of the UK's regulatory regime and supervisory approach in this area, and of forthcoming regulatory changes at national, EU and global level.

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hfw Conferences and events

Commodities Breakfast Seminar
HFW Dubai
5 May 2014
Presenting: Simon Cartwright, Hari Krishna and Jemma Hill

EBOTA/The REACH Centre Operator Training
HFW London
27 May 2014
Hosting: Judith Prior and Eleanor Midwinter

SIAC Congress
Singapore
6 June 2014
Presenting: Paul Aston
Attending: Chanaka Kumarasinghe

Impact on Swiss traders of recent developments in international trade sanctions
HFW Geneva
12 June 2014
Presenting: Daniel Martin and William Hold

International Trade and Commodities Seminar
HFW Hong Kong
18 June 2014
Presenting: Guy Hardaker, Andrew Johnstone and Brendan Fyfe

London Arbitration Seminar
HFW London
18 June 2014
Presenting: Damian Honey

FLNG
Singapore
25–26 June 2014
Presenting: Matthew Blycha
Attending: Paul Aston

SCoTA Seminar
London
25 June 2014
Presenting: Damian Honey and Rebecca Lindsey

Marine Money Geneva
Geneva
26 June 2014
Presenting: Spencer Gold

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