Commodities

April 2016

COMMODITIES BULLETIN
BREXIT – KEY QUESTIONS FOR THE COMMODITIES SECTOR





Welcome to the April edition of our Commodities Bulletin

"The internal market shall comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaties."

ARTICLE 26(2) OF THE TREATY OF THE FUNCTIONING OF THE EUROPEAN UNION (TFEU)

The UK will vote on whether to stay in the European Union on 23 June 2016. If there is a "yes" vote for "Brexit," the potential impact on the commodities industry is likely to be significant, but the details of any impact are currently very uncertain: they will depend on the way in which the eventual relationship between the UK and the EU is structured.

This uncertainty is easily demonstrated. Post-Brexit, what customs tariffs and storage charges would a metals trading company have to pay to transport metals from the EU and store them in a warehouse in the UK; or would EU legislation like REACH continue to apply to UK based commodity traders; or will EU sanctions still apply to a UK based oil trader?

This edition of the Commodities bulletin considers a number of the potential questions that those operating in the commodities sector may have and looks at whether and how (if at all) they can start to plan for a possible Brexit. We hope you find it useful. Should you require any further information about any of the issues raised here, please do not hesitate to contact the author of the relevant article (you will find contact details at the end of each article), one of us, or your usual contact at HFW.

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The context for all the questions covered

In the event of a vote to leave the EU, the maximum amount of time between the UK notifying the European Council that it wishes to leave the EU and its actual departure will be two years, unless all member states and the UK agree to an extension. This two year period is referred to in this bulletin as "the transition period".

Brexit would not, of itself, affect UK national legislation such as the Sale of Goods Act 1979. EU Directives which have been implemented into UK law would also remain in a post-Brexit environment[1] unless the implementing legislation is repealed. However, EU Regulations have direct effect in member states. If the UK left the EU, these would no longer have effect unless the UK government took action to introduce equivalent domestic legislation or, for those Regulations which have been incorporated into the EEA Agreement, unless the UK remained part of the EEA.

Two areas of uncertainty arise: first, how UK courts would apply and interpret UK law when no longer subject to EU law or higher EU courts; and second, in respect of EU Regulations, the extent to which the UK government would take action to introduce equivalent domestic legislation. At present we do not know what form the relationship between a post-Brexit UK and the EU would take. There are a range of possible options, including in particular:

- The "Norway model" – if the UK continued its membership of the European Economic Area (the EEA), joining the European Free Trade Association (EFTA) for the purpose.
- The "Swiss model" – joining EFTA but not the EEA, with negotiated bilateral agreements defining the UK's access to EU in a range of sectors.
- A comprehensive free trade agreement (FTA) – a looser arrangement than Switzerland's, allowing access to the EU market in certain sectors.
- World Trade Organisation (WTO) rules – this would be the UK's fall back position if none of the above models were settled by the time of Brexit. The UK would resume its standalone membership of the WTO (whilst currently a member, like all member states, the UK is represented by the EU at the WTO).

1 EU Directives must be implemented by domestic legislation in order to have effect.

hfw Question 1: I am a commodity trader based outside the EU. How will my trade with UK counterparties be affected?

There is unlikely to be significant change in terms of accessibility to the UK market.

As regards the wide range of commodity contracts covered by UK financial services regulation, non-EU firms have been able to rely on a safe harbour for "overseas persons" when dealing with UK counterparties and commercial/professional clients. This is unlikely to become more restrictive.

On the other hand, reversion to WTO rules could substantially increase tariffs on UK imports and exports of goods, until the UK can replace the trade deals the EU currently has with third countries.

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Question 2: I am based in the UK and deal in commodities with EU counterparties. Will I be able to continue this business post-Brexit?

This depends mainly on the types of commodity contracts traded and the basis for the UK's future relationship with the EU. Trade in physical goods will most likely be permissible (so long as contracts are not executed on a trading platform and have no option for financial settlement) but new requirements may be introduced. Taking each of the possible models for a post-Brexit UK-EU relationship in turn:

- The "Norway model" – banks and firms authorised under the Markets in Financial Instruments Directive (MiFID I or, from 2018 MiFID II) could continue to rely on the current passporting regime. However, few commodity firms are authorised under MiFID.
- The "Swiss model" – continued access would depend on the UK maintaining regulation equivalent to MiFID and being assessed as doing so – to date no third country (non-EEA state) has been so assessed, although MiFID II is intended to facilitate this, and there is no regime for bank access.
- FTA – No existing FTA provides full access for services or agriculture and again, maintaining equivalent regulation would be a pre-requisite of access for MiFID activity/services – and MiFID II will cover a wider range of commodity contracts.

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ROBERT FINNEY, PARTNER

- WTO rules – Unlike the EU's internal market, there would be non-tariff barriers to trade in goods and the rules on services are relatively undeveloped. Although they cover some derivatives, the position of those physically-settled contracts which the EU treats as derivatives contracts would be uncertain.

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Question 3: I have physical commodities trading contracts with UK and/or other EU counterparties. Is there anything I should do now?

Where one or more parties to an existing physical commodities trading contract are based in the UK or elsewhere in the EU, these contracts should be reviewed, taking into account issues including:

Duration - Spot, short term, long term or master contract?

Brexit is more likely to impact long term or master contracts. Spot and other short term contracts are likely to complete either before the referendum or the end of the transition period (although they may still be affected by currency fluctuations, see below).

Currency

GBP and EUR values have already been affected in the run up to the referendum and are likely to be affected further in the event of Brexit – consider how this may impact your contract (which is likely to be in USD). This is particularly relevant for repurchase contracts.

Between which jurisdictions will the commodities physically move?

Brexit may impact UK import/export and transit procedures – but there should be scope to resolve any contractual issues arising between the parties by negotiation during the transition period. If goods will be in Scotland at any point, consider the possibility of Scotland seeking independence from Britain in the event of Brexit.

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For trades between the EU and the US, bear in mind the EU/US Transatlantic Trade and Investment Partnership (TTIP), which is due to be concluded in the next few years. The UK may be excluded from TTIP if it leaves the EU, depending on the nature of its post-Brexit relationship with the EU.

Relevant EU laws

(See also introduction.) The greatest uncertainty in relation to EU laws in the event of a Brexit relates to EU Regulations because if the UK left the EU, these would no longer have effect in the UK unless the UK government took action to introduce equivalent domestic legislation.

Relevant Regulations could be identified now so that any changes or developments in relation to them can be monitored – for example, does REACH apply?

Termination/Renegotiation of Key Terms

Is Brexit a Material Adverse Change (MAC) or Force Majeure event which would allow the contract to be terminated or key terms renegotiated? You may wish to consider inserting a clause allowing flexibility in the event of a Brexit vote. (See also Questions 5 and 6.)

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hfw Question 4: What clauses in my finance facilities should I consider reviewing in the light of a potential Brexit?

A Brexit would be unlikely to have an immediate impact on loan documents. Outlined below are some key provisions to consider:

- Events of Default/illegality – Breach of a representation and/or warranty often provides grounds for a default under a loan. Usually, the borrower represents and warrants that it has obtained all necessary authorisations and consents to enter into the loan document. If this representation and warranty is made applicable to both parties, then the financial institution (which may be relying on a consent/authorisation granted pursuant to EU level financial services regulation) may no longer be authorised and therefore may potentially be in breach (or claim that its obligations under the facility would now be illegal for it to perform). Given the transition period before any UK departure from the EU, there should be scope to address this by negotiation between the parties. It may be prudent to identify facilities that would be affected now so that prompt action can be taken in the event of a vote for Brexit.
- Material Adverse Change (MAC) – Depending on the date of the agreement, in our view it is unlikely that Brexit would constitute a MAC, as circumstances known to the parties at the time of entry into an agreement very rarely do. Nevertheless, parties may wish to expressly exclude Brexit from any definition of MAC or its equivalent.
- Force majeure – Given the restrictive manner in which this concept is usually interpreted by the English courts, a contractual force majeure clause is unlikely to be triggered unless Brexit is specifically identified as a force majeure event. (See also Question 6.)
- Contractual recognition of bail-in – Under Article 55 of the BRRD[1], any contract which is
  - governed by the law of a non-EU country, and
  - which contains a liability (such as a loan) of an in-scope entity,

  must include a provision whereby the counterparty acknowledges that such liability may be subject to bail-in by the applicable regulator. "Bail-in" was developed after the recent financial crisis to allow the authorities to ensure that shareholders and creditors of a firm bear the costs of its failure, without recourse to public funds. Given the UK's support for the financial regulatory regime changes in Europe, it is unlikely this requirement would be disapplied on a Brexit.

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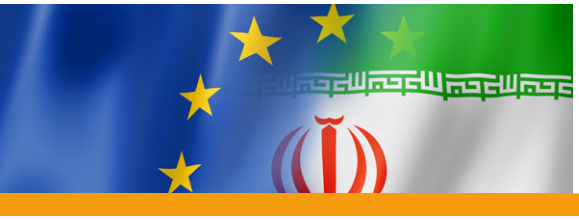
1 Banking Recovery and Resolution Directive (2014/59/EU)



Question 5: I am a UK company. Will EU trade sanctions still apply to me in the event of a Brexit?

The EU imposes trade sanctions in accordance with the EU Common Foreign & Security Policy (CFSP). Leaving the EU would permit the UK to set its own foreign and security policy and to adopt whatever trade sanctions it considered appropriate in light of that policy.

So if the UK decides to leave the EU, would UK businesses be able to trade freely with the likes of Iran, Russia, Syria and North Korea?

The position is not as straightforward as that. Many of the current restrictions are likely to remain in place, for three main reasons.

Firstly, the UK has a commitment to maintain national legislation to give effect to UN sanctions. If EU sanctions no longer applied, the UK would need to adopt national legislation which included those restrictions mandated by the UN. This means that the UK company would continue to be under some restrictions (albeit these would be less severe than the current EU measures).

Secondly, even if the UK was outside the EU, many UK businesses would find that EU restrictions (as well as those imposed by other states which impose sanctions, such as the US, Switzerland and Canada) would continue to apply to them, because of the nature of their business (see box below). This means that the UK company would continue to be under non-UK restrictions.

Thirdly, current UK foreign policy is broadly aligned with EU policy, and the UK has driven the debate in respect of many of the sanctions which have been imposed. That suggests that even if the UK were to leave the EU, the UK would adopt restrictions in line with those adopted by the EU. Norway currently has a similar model, whereby they adopt national restrictions which are in line with those adopted by the EU.

That said, with or without a Brexit, it is possible that in the future UK foreign policy might diverge from EU policy in relation to a particular sanctioned regime. This has arisen in the past, in the context of sanctions against Russia, where there were apparently real challenges in agreeing a common package of restrictions, because of the difficulty in aligning different EU member states' divergent national interests.

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So if the UK decides to leave the EU, would UK businesses be able to trade freely with the likes of Iran, Russia, Syria and North Korea?

DANIEL MARTIN, PARTNER

Take the hypothetical example of a UK subsidiary of a Singaporean company, which employs French, Canadian and Australian nationals in its London office, ships goods on Maltese flagged vessels, relies on finance from a German bank, has insurance cover in place from a Swiss insurer and trades in US Dollars.

If the entity currently wants to trade with Iran, it needs to consider Singapore sanctions (if its parent company is involved in the trades), EU sanctions (by reason of its UK incorporation and physical presence, French employees, German bank and Maltese flag state), Canadian and Australian sanctions (because of those nationals), Swiss sanctions (because of its insurer) and both US primary sanctions (because of the US Dollars) and US secondary sanctions (because those apply even where there is no US nexus).

In the event that the UK were to leave the EU, sanctions imposed by the EU would no longer apply to the business directly (i.e. by reason of the UK incorporation and physical presence), but they would continue to apply indirectly, because of the French employees, German bank and Maltese flag state. The US, Swiss, and other sanctions will continue to apply whether or not the UK is in the EU.

hfw Question 6: I am negotiating long term contracts with EU (or UK) counterparties. Should I include a Brexit Force Majeure clause?

A Force Majeure (FM) clause is one by which one or more of the parties to a contract is entitled to cancel it or declare FM, with the consequence that the contract is suspended or extended until a specified event beyond the parties' control has passed.

English law interprets FM clauses restrictively, and a party seeking to trigger a clause will have to show:

- The FM event falls within the clause and the injured party has been prevented or delayed from performing the contract by reason of that event. (Without express reference to Brexit in the FM clause, it is hard to see how any party to a current contract could get past this first hurdle.)
- The delay or non-performance was due to circumstances beyond the party's control.
- The FM event was not reasonably foreseeable at the time the contract was concluded. (This will affect contracts entered into as of April 2016 when the referendum was announced.)
- There were no reasonable steps which could have been taken to avoid or mitigate the event or its consequences.

Parties currently negotiating long term contracts should consider which particular impacts of a Brexit might affect their agreement sufficiently to merit including a FM clause and identify these clearly in the clause. For example, Brexit might result in significant changes to the current customs/excise system. Parties may decide that they require the right to terminate the contract if in consequence of Brexit, customs duties, taxes or excise payable under the contract should exceed a particular specified percentage of their current rate. Careful drafting will be required to make the clause effective in the right circumstances.

Before entering into such a clause, parties should also anticipate and provide for the related consequences of termination in the clause. For example, many sanctions clauses provide for no penalty to either party in the event of the imposition of sanctions and entitle either party to terminate with notice, save that the obligation to pay the price remains where the product is already delivered.

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hfw Question 7: I am a metals trader. How would Brexit affect the current warehousing issues in the metals market?

Anyone familiar with the global metals market will be aware of the LME's attempts to force warehouse operators to reduce load out waiting times – with new rules to come into effect in May 2016 penalising any operator with queues in excess of 30 days. The LME is facing the serious consequence that the metal leaving LME storage is not being on-sold for processing, but is heading to other, cheaper, non-LME warehouses. This further distorts the differential between LME prices and the underlying market price for the metal.

At present, the LME cannot determine the level of storage costs in its own warehouses. Under EU competition rules, warehouses cannot know in advance what the others will charge – they must second guess their competitors.

From the regulators' perspective, the spread of storage costs indicates a free flowing market, notwithstanding that the LME and non-LME storage markets are at odds. Were the LME to impose a flat storage rate on its warehouse operators, this could easily be seen as anti-competitive under EU rules.

Does Brexit pose an opportunity for the LME?

It might not be that straightforward. Competition law is enshrined in the UK by the Competition Act 1998 (the Act). Under the current terms of that legislation the Competition and Markets Authority and the UK



Post-Brexit, for goods stored in an EU location, the cost of storing those goods will still be susceptible to an EU investigation even where the storage contract is subject to English law.

courts have power to apply Articles 101 (prohibition of anti-competitive agreements) and 102 (prohibition of abuse of dominance) of the Treaty on the Functioning of the EU (TFEU) as well as the equivalent provisions under national law. In addition, the Act requires consistency with judgments of the EU Court of Justice. Brexit would not of itself automatically lead to a repeal of this legislation and the UK's access to European markets is likely to depend on compliance with standards equivalent to EU regulation in any event.

There is a final issue – the LME has warehouse operators all over Europe. Whilst its contracts may be subject to English law, the metal will still be stored in jurisdictions which are covered by EU regulation. Post-Brexit, for goods stored in an EU location, the cost of storing those goods will still be susceptible to an EU investigation even where the storage contract is subject to English law.

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Question 8: I am a UK based oil trader. I am currently affected by directly applicable EU legislation, including environmental regulation through REACH. Will Brexit change this? I am also affected by EU directives like the Ship Source Pollution Directive or Waste Framework Directive. Will Brexit change this?

EU Regulations, including REACH, currently have direct effect in the UK. They will not continue to have effect post-Brexit unless the UK government acts to introduce new equivalent legislation, or, for those Regulations which have been incorporated into the EEA Agreement (including REACH), if the UK remains part of the EEA. In either case, the UK would lose its lobbying power in relation to such regulations in the future, which could be problematic for many industries. On a practical level, if Brexit takes place, regulations such as REACH would continue to affect trade into the EU because compliance would be necessary to compete and trade with EU companies, meaning that many of the relevant obligations would be built into contractual terms. For example, informational requirements for REACH are already applied to non-EU companies under commonly used oil trading GTCs.

EU Directives which have already been implemented into UK law would continue to apply post-Brexit. However, these may be amended by the UK government, or interpreted differently by the English courts. This would include the interpretation of the Ship Source Pollution (SSP) Directive, which has been transposed into UK law. Where the European Court of Justice (ECJ) has given a particular ruling as to the interpretation of relevant directives, that ruling is unlikely to be binding and may not be persuasive to an English court following an exit from the EU. For example, the interpretation of "waste" under the Waste Framework Directive may change. The English Supreme Court will, we assume, be the court of last instance in the event of Brexit.

On a more practical level, it is possible that the UK would find it more difficult to receive information from and share research and guidance with the EU Commission, and from bodies such as the European Chemicals Agency post-Brexit.

In the event of a pollution incident, environmental obligations and potential liabilities of operators of land-based storage facilities, and the owners of products in those storage facilities, may be affected by Brexit (depending on the nature of the post-Brexit regime). Some aspects of environmental law would be unaffected however. The environmental obligations and potential liabilities placed on owners, charterers and cargo-owners in the event of a pollution incident in UK territorial waters are governed by a number of international conventions ratified by the UK, which set out where claims should first be directed. Exit from the EU should not affect the application of the international regime to vessel pollution in UK waters.

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Question 9: How will a Brexit affect UK employees working in the EU and EU employees working in the UK?

Whilst there has been a great deal of political commentary on the possible outcome of the upcoming referendum, very little has been said as to Britain's future relationship with the EU in the event of a vote to leave. It is the nature of this relationship that will determine the impact for employers of a Brexit on their workforce both in the UK and EU.

In the event of a Brexit, at the end of the transition period both European workers in the UK and British workers in the EU could lose their automatic rights to work freely in the UK and EU respectively. However, it is in no-one's interest for there to be forced repatriations and in our view, it is likely that there will instead be transition arrangements. Eligible workers could apply for permanent residence in the country in which they work or possibly, where appropriate, apply for citizenship.

It is likely that there will instead be transition arrangements.

NEIL ADAMS, PARTNER

At this stage, employers should review their workforce to identify both UK nationals working in the EU and EU nationals working in the UK so that they can plan for the impact any changes to the scope of the current freedom of movement and freedom to work may have on their business in the event of a vote to leave.

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What impact will Brexit have on disputes?

For a perspective on how a Brexit might affect disputes, please see the article by Damian Honey, Partner and Nicola Gare, Disputes Professional Support Lawyer, in the April edition of our Disputes Resolution bulletin, at http://www.hfw.com/Dispute-Resolution-Bulletin-April-2016.

Conferences and events

2nd Annual Qatar International Arbitration Summit
Qatar
18 May 2016
Presenting on energy disputes: Damian Honey

Commodities trading law seminar
HFW Sao Paolo
19 May 2016
Presenting: Brian Perrott, Richard Merrylees and Geoffrey Conlin
Attending: Simeon Newman

SIAC Conference
Singapore
27 May 2016
Presenting: Chanaka Kumarasinghe

Ethanol training
HFW Geneva
6 June 2016
Presenting: Sarah Hunt, Kathryn Martin

HFW International Trade & Commodities Seminar
Bankers Club, Hong Kong
8 June 2016
Presenting: Peter Murphy, Andrew Johnstone, Guy Hardaker, Brendan Fyfe, Sian Knight

IECA Annual Conference
Lisbon
19-21 June 2016
Presenting: Marc Weisberger, Daniel Martin
Attending: Robert Wilson, Philip Prowse

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