Commodities

December
2015

Welcome to the December edition of our Commodities Bulletin.

First, in light of a number of recent 'fat finger' trading incidents, Partners Brian Perrott and Robert Finney consider some of the risks and regulations associated with error trades on commodity exchanges, in what is an increasingly demanding regulatory environment.

Next, Partner Anthony Woolich, together with Associate Eleanor Midwinter, review a recent EU Court of Justice case, *AC-Treuhand v European Commission* (C-194/14 P), looking at the likely implications of the decision for trade associations.

Letter of credit fraud is becoming increasingly common and ever more sophisticated. In our third article this month, Senior Associate Andrew Williams looks at the position under English law of the various parties to a letter of credit transaction in the event of fraud.

Lastly, Partner Robert Finney provides his regulatory update, highlighting developments in MiFID II, market abuse, the EMIR derivatives regime and new Swiss regulation.

Should you require any further information or assistance with any of the issues dealt with here, please do not hesitate to contact any of the contributors to this bulletin, or your usual contact at HFW.

Sarah Taylor, Partner, sarah.taylor@hfw.com
Amanda Rathbone, Professional Support Lawyer, amanda.rathbone@hfw.com

'Fat Finger' incidents highlight need for effective pre-trade controls

This article considers some of the risks and regulations associated with error trades on commodity exchanges in an increasingly demanding regulatory environment.

In June 2015, a Deutsche Bank trader mistakenly sent a client US$6 billion. The 'fat finger' error occurred when a junior trader processed a trade using the gross rather than the net figure, resulting in a trade with 'too many zeroes'. Deutsche Bank was swift to resolve the issue and reported the incident to various regulators in the US and Europe.

In September 2015, it was speculated that a 'fat finger' trade was responsible for a fall on the London Stock Exchange (LSE) so sharp that it suspended trading in several energy and mining stocks for several minutes.

Industry standards

Having systems in place to avoid mistakes occurring is the ideal. Deutsche Bank operates a "four eyes" policy, which requires every trade to be reviewed by a second person before being processed. It is not clear why the trader's error was not identified through application of this policy.

Commodity exchanges and the Futures Industry Association (FIA) encourage members to establish controls to prevent 'fat finger' errors.

ICE Futures Europe (ICE) considers that both members and the exchange should have controls to prevent entry of erroneous orders. While acknowledging that trades substantially different from market price may damage users' confidence in the market, ICE considers that market integrity demands that transactions should not be adjusted or cancelled arbitrarily. To this end, ICE sets a No Cancellation Range (NCR): any trades within the price range will not normally be altered, even if executed in error. ICE has, however, established procedures to prevent 'fat finger' trades, by also setting price reasonability limits outside which its platform will not execute orders.

Having systems in place to avoid mistakes occurring is the ideal.

BRIAN PERROTT, PARTNER

The London Metal Exchange (LME) recently reminded members to take "proper care and attention...when submitting orders" and to have appropriate procedures to prevent error trades. The LME warns that those who fail to do so or create a disorderly market are liable to disciplinary action, as they are on other exchanges.

In 2012 FIA Europe published guidance on systems and controls for electronic trading environments to establish an industry standard for venues and firms, including examples of pre-trade risk limits such as maximum order values.

Regulatory landscape

In the UK, the Financial Conduct Authority's (FCA) Principles for Business require each regulated firm to "take reasonable care to organise and control its affairs responsibly and effectively with adequate risk systems" and to have "adequate, sound and appropriate risk management processes and internal control mechanisms". In this context the FCA endorses the guidelines on systems and controls in an automated trading environment issued in 2012 under the Markets in Financial Instruments Directive (MiFID) by the European Securities and Markets Authority (ESMA). But the FIA's guidance is relevant too, given the FCA does not prescribe detailed rules for every area in which systems and controls standards apply.

From 2017-18, these regulatory requirements will be further strengthened under MiFID II. Detailed requirements will apply not only to high frequency and "algorithmic trading", defined as involving "limited or no human intervention", but also to trading venues and to firms that provide direct electronic access to them. ESMA draft regulations under MiFID II, sent to the

European Commission in September 2015, set out a range of pre-trade risk controls to be implemented by both investment firms and trading venues.

Europe is not alone in formalising requirements in this area in both commodity derivatives and/or securities. For example, in 2013 the US Securities and Exchange Commission (SEC) replaced its previous circuit breaker rule with a "limit up, limit down" regulation designed to prevent trades in individual stocks from occurring outside specified price bands and which could respond more sensitively to erroneous trades as well as dealing with major price moves.

Conclusion

The practical implications of both exchange restrictions on unwinding erroneous trades and the increasing level of regulation highlight the importance of regulated firms, other market participants and venues themselves seeking practical legal advice to establish procedures to guard against 'fat finger' errors, to ensure compliance with all the relevant regulatory requirements and to resolve claims and regulatory enforcement issues when errors do occur.

For more information, please contact Brian Perrott, Partner, on +44 (0)20 7264 8184 or brian.perrot@hfw.com, or Robert Finney, Partner, on +44 (0)20 7264 8343 or robert.finney@hfw.com, or your usual contact at HFW. Research conducted by Michael Burgess, Trainee Solicitor.

hfw Risk of cartel facilitation under Article 101 TFEU

The Court of Justice of the European Union (CJEU) has upheld a fine of €348,000 against AC Treuhand AG, a consultancy specialising in market data analysis, for its involvement in the 'Heat Stabilisers' cartel. In a decision[1] with potentially wide-ranging implications, including for commodity trade associations, the CJEU held that a consulting firm can be liable for an infringement of EU competition law even though it is not a participant in the relevant market itself, if it provides commercial services which "facilitate" the anti-competitive activities of cartel members.

On 22 October 2015, the CJEU rejected AC Treuhand's appeal that it had not participated in an agreement or concerted practice. It held that the provision of consultancy services can constitute anti-competitive behaviour where the purpose of the services is directly linked to the objectives of a cartel, regardless of whether the consultancy operated on the same market as the cartel.

Background

AC Treuhand brought the appeal in the CJEU against a fine of €348,000 imposed by the European Commission on 11 November 2009, arguing that its services to members of the 'Heat Stabilisers'[2] cartel did not constitute participation in an agreement or concerted practice and that it was not active on the market in question. The appeal was supported by the opinion of Advocate-General Wahl. However, ultimately the CJEU rejected these arguments, holding that AC Treuhand did not provide "mere peripheral services" but that rather, the purpose of the services was to contribute to the anti-competitive objectives of the cartel. Moreover, the CJEU held that the terms "agreement" and "concerted practice" in article 101 do not mean that an undertaking can only be liable if it is active in the same market as the cartel.

Key points

The basis of the CJEU's finding against AC Treuhand was that it was found to have:

- Intended to contribute to the common objectives of the cartel.
- Been aware of the actual conduct planned or undertaken by the cartel *or* that it could reasonably have foreseen it and that it was prepared to take the risk.
- Collected and supplied to the cartelists data on sales on the relevant markets.
- Contributed to the objectives of the cartel by acting as a moderator and mediator between the parties.
- Been present at meetings at which anti-competitive agreements were concluded, without clearly opposing them.

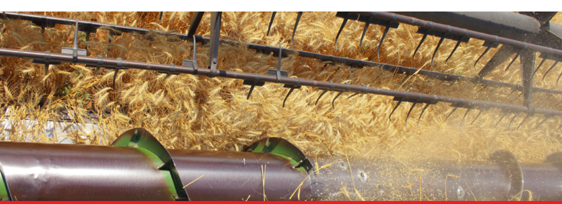
However, the CJEU was clear that an undertaking would not be liable if it only provided *"mere peripheral services"* that were unconnected with the obligations assumed by the cartelists and the anti-competitive results of their actions.

Implications

This judgment is a warning for consultants or other third parties

1 Case C-194/14 P

2 Case COMP/38589 - Heat Stabilisers



providing commercial data to a number of market participants in the same market, particularly where they are actively involved in providing the forum for meetings and in the exchange of sensitive commercial information. AC Treuhand was active and present during the process of customer allocation and price fixing in this case. The CJEU was clear that in such circumstances it does not matter whether the consultancy is itself a participant in the market in question and upheld a fine that was independent of turnover in the relevant market – the usual basis for penalties arising from cartel involvement.

It seems possible that new disputes will arise out of this decision, and that the case law on this topic may be clarified further in due course. The difference between "mere peripheral services" and "facilitation" is potentially ambiguous; trade associations, consultancy groups, data-providers, event organisers and others should all be wary of crossing this line.

HFW perspective

Service providers should not be complacent about the possibility of liability under article 101. Those providing a forum where competitors in the same industry can meet should be vigilant and should disseminate appropriate guidelines and protocols to ensure compliance with competition law, and review any existing guidelines to ensure compliance with this new ruling, insofar as is possible.

For more information, please contact Anthony Woolich, Partner on +44 (0)20 7264 8033 or anthony.woolich@hfw.com, or Eleanor Midwinter, Associate on +44 (0)20 7264 8013 or eleanor.midwinter@hfw.com, or your usual contact at HFW. Research conducted by Lois Day, Trainee Solicitor.

Letter of credit fraud: what protection is available?

Letter of credit fraud is becoming increasingly common and ever more sophisticated. Although the Uniform Customs and Practice Rules 600 (UCP 600) is frequently incorporated by express agreement into letters of credit, it makes limited reference to fraud, leaving it to be dealt with by the relevant domestic law(s) of the letter of credit contracts. This article considers the position under English law of the various parties in a letter of credit transaction.

Introduction

A letter of credit is essentially a bank's undertaking to pay against the presentation of documents that comply with the terms and conditions of that undertaking. It is independent from the contract of sale on which it is based. The seller has the bank's undertaking to pay, provided it presents compliant documents, irrespective of any dispute in the underlying contract. The confirming or issuing bank is obliged to pay if the documents presented appear to be in good order. This is known as the autonomy principle and is seen as fundamental to the successful operation of the letter of credit system.

Under English law, there are two significant exceptions to this principle:

- Illegality, where payment under the credit is prohibited by law.
- Fraud.

Once fraud has been committed, there are very few remedies available to a buyer. Payment against documents for goods en route leaves buyers vulnerable. Prevention is therefore the best protection and due diligence on a new trading partner or unfamiliar bank will be vital.

ANDREW WILLIAMS, SENIOR ASSOCIATE

Fraud is an exception to the rule that a bank deals in documents alone and is obliged to pay against documents which are conformant on their face without regard to their accuracy or genuineness[1]. It was established on grounds of public policy, but the English courts remain cautious and require a high standard of proof, both as to the fact of the fraud and as to the bank's knowledge, because they are reluctant to interfere with the autonomy principle.

1 UCP 600, Articles 5, 7, 8, 34.

Protection against fraud for parties in a letter of credit transaction

Buyers

Once fraud has been committed, there are very few remedies available to a buyer. Payment against documents for goods en route leaves buyers vulnerable. Prevention is therefore the best protection and due diligence on a new trading partner or unfamiliar bank will be vital.

A buyer might seek an injunction to prevent the issuing or corresponding bank paying on the basis that the beneficiary has acted fraudulently. However, such injunctions are rarely granted. In one unsuccessful case[2], the Court of Appeal commented:

"If, save in the most exceptional cases, [the applicant] is to be allowed to derogate from the bank's personal and irrevocable undertaking,.....by obtaining an injunction restraining the bank from honouring that undertaking, he will undermine what is the bank's greatest asset,.....namely its reputation for financial and contractual probity. Furthermore, if this happens at all frequently, the value of all irrevocable letters of credit and performance bonds and guarantees will be undermined."

Alternatively, a buyer might seek an injunction preventing the seller from relying on falsified documents. However, the court has held[3] that it was not open to a buyer to seek to prevent his seller from drawing on the letter of credit, noting that the *"integrity and insulation of banking contracts could be overthrown, simply by the device of injuncting the beneficiary rather than the bank"*.

Seller

Fraudulent letters of credit issued or advised by fictitious banks are a risk for sellers. When dealing with a new trading partner or unfamiliar bank, sellers should seek the opinion of their own bank before proceeding.

Banks

An issuing bank can be induced to open a credit by fraudulent misrepresentation. The Court of Appeal has held[4] that, unless fraud was established, any claim a bank might have against a beneficiary making a fraudulent demand must be pursued separately following payment, and cannot normally be used as a defence or set-off to avoid payment.

In one case, under UCP 500[5], a confirming bank had paid under a letter of credit but it was later discovered that some of the documents presented were fraudulent. The issuing bank refused to pay the confirming bank on the grounds that the confirming bank had no greater rights than the fraudulent beneficiary. The court agreed.

In order to remedy this, article 7(c) of the UCP 600 establishes a definite undertaking by the issuing bank to reimburse the nominated bank when that bank has accepted a draft or incurred a deferred payment obligation. This has been upheld by the English court[6]. It is reiterated by article 12(b) of the UCP 600, which expressly provides an authority from an issuing bank to a nominated bank to discount a draft that has been accepted for deferred payment.

Corresponding banks should act with caution before refusing to pay out, even where they suspect fraud. There must be clear evidence of the fraud at the time of payment. It is insufficient merely to suspect fraud or to prove there was material which would lead a reasonable banker to infer fraud.

Where a corresponding bank is unable to seek reimbursement down the chain, one option is to bring a claim against the seller, either for restitution for mistake, or for damages for the production of deceitful documents.

HFW perspective

The autonomy principle in letters of credit is powerful and leaves parties vulnerable to fraud, particularly in circumstances where frauds are becoming increasingly sophisticated. Prevention is the best defence available and due diligence is a key element of this, especially in relation to new trading partners or unfamiliar banks.

Whilst the UCP 600 offers consistency, it addresses fraud only to a limited extent. Parties should therefore consider which domestic law will govern should an allegation of fraud arise. Although a letter of credit is treated as one transaction, it actually involves multiple parties, multiple individual contracts, and potentially multiple jurisdictions.

For more information, please contact Andrew Williams, Senior Associate, on +44 (0)207264 8364, or andrew.williams@hfw.com, or your usual contact at HFW. Research conducted by Matthew Tozzi, Trainee Solicitor.

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2 *Bolivinter Oil SA v Chase Manhattan Bank* [1984] 1 Lloyd's Rep 251

3 *Czarnikow-Rionda Sugar Trading Inc v Standard Bank* [1999] 2 Lloyd's Rep 187

4 *Solo Industries UK Ltd v Canara Bank* [2001] 2 Lloyd's Rep 578

5 *Banco Santander SA v Banque Paribas* [2000] 1 All ER (Comm) 776

6 *Fortis Bank S.A./N.V., Stemcor UK Limited v Indian Overseas Bank* [2009] EWHC 2303 (Comm)

Commodities regulatory round-up

This article highlights developments in MiFID II, market abuse, the EMIR derivatives regime and new Swiss regulation.

MiFID II delayed and CRR commodity dealers exemption extended

The MiFID II rollercoaster has taken another turn, with implementation likely to be delayed by one year, to January 2018. Publication of regulations setting out details of the new regime seems unlikely until Q1 2016.

The EU's mammoth post-crisis legislation extending and reforming the regulation of investment firms, services and markets in Europe, was originally due to come into effect on 3 January 2017. However, the detailed "Level II" rules are not yet final and there seems insufficient time to complete the logistical steps necessary for implementation, including building the IT and other infrastructure that will give it life.

In mid-November 2015, the European Securities and Markets Authority (ESMA) and the European Commission (the Commission) announced a potential delay to European Parliament (EP) members. Within three weeks, and after initial opposition and scepticism, the EP's MiFID II negotiating team accepted the delay, on condition that the Commission:

1. Reports regularly to the EP on implementation progress.
2. Finalises the Level II legislation as soon as possible, and "taking utmost account of our remarks on their content".

Most of those "remarks" concern commodities. The EP team wants numerous changes to the proposed position limit arrangements and criteria for the ancillary activity exemption whereby certain commodity firms may escape authorisation. We understand that the Commission is seeking to respond, for example by reintroducing the concept of a capital employed criterion to help determine whether a firm's speculative derivatives activity is ancillary.

Meanwhile the European Banking Authority (EBA) and ESMA have provided initial advice on capital regimes for non-systemic, non "bank-like" investment firms, recommending that a specific regime be developed and implemented by 2020 and that until then, the current exemption from the large exposures and capital adequacy provisions of the Capital Requirements Regulation (CRR) be extended.

Full collateralisation of bank guarantees for wholesale energy derivatives

EMIR generally requires non-financial counterparties, which includes most commodity traders, whose collateral requirements at an EU central counterparty (CCP) are met by a commercial bank guarantee to collateralise that guarantee fully. From 15 March 2016, that requirement will be extended to cover cleared gas and power derivatives.

Market Abuse Regulation

The UK legislation, rules and guidance governing market abuse will look very different if HM Treasury and the Financial Conduct Authority (FCA) adopt the changes they have proposed in order to implement the EU's 2014 Market Abuse Regulation (MAR), which will apply from 3 July 2016.

MAR will replace the 2003 Market Abuse Directive, extending and strengthening the rules against insider dealing and market manipulation. More products, namely financial instruments, will be covered, including commodity derivatives, whether traded on exchange, through broker platforms or multilateral trading facilities, or OTC.

The range of OTC commodity derivatives captured will be further extended on 3 January 2017, the current date for MiFID II to become effective, though that is likely to be delayed as mentioned above. However, certain conduct in or impacting spot commodity markets will be caught from July 2016.

Note that MAR applies to market participants whether or not authorised under MiFID or MiFID II. This includes non-EU parties dealing in financial instruments traded on an EU venue, even if the dealing takes place OTC or outside the EU.

As an EU regulation, MAR applies directly and imposes requirements on member states in respect of administrative, investigatory and enforcement powers, and the types and scale of sanctions. In addition, a number of current UK provisions will become redundant and HM Treasury is consulting on regulations that will repeal the substantive offences in the civil market abuse regime and the FCA's power to issue the Code of Market Conduct. It also proposes changes to other legislation, including the money laundering disclosure provisions.

The Code of Market Conduct, relied upon heavily by market participants in interpreting the current regime, will transform into a much slimmer chapter containing non-binding guidance on the MAR regime. The FCA will provide pointers to relevant provisions

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ROBERT FINNEY, PARTNER

of MAR and retain non-exhaustive examples of market abuse and lists of factors relevant to determining whether behaviour may constitute market abuse - to the extent that such examples or factors remain compatible with MAR. Some further guidance in the form of FAQs is expected from ESMA before MAR takes effect in July 2016.

Next steps in Swiss regulation of derivatives

The Swiss Financial Market Infrastructure Act (FMIA) adopted in June 2015 will come into force on 1 January 2016, although the reforms in respect of derivatives, broadly similar to those found in EMIR and MiFID II, will not take effect until later. Detailed ordinances must be finalised on matters such as derivatives reporting, clearing, and the application of risk mitigation techniques. The position limits and obligation to trade certain derivatives on regulated venues will not apply until later, at least until the EU and other jurisdictions adopt equivalent requirements.

For more information, please contact Robert Finney, Partner, on +44 (0)20 7264 8343, or robert.finney@hfw.com, or Taïs Jost, Associate, on +44 (0)20 7264 8351, or tais.jost@hfw.com, or your usual contact at HFW.

Related publications

Commodities Regulatory Bulletin

In January 2016, HFW will launch a new Commodities Regulatory bulletin. This will be a monthly bulletin concentrating on key international regulatory developments which are of particular interest to commodity and emissions trading clients. If you would like to receive this bulletin, please contact mailings@hfw.com.

HFW extends Season's Greetings to all of our readers with our best wishes for 2016.

Conferences and events

Commodities Supper Club
HFW London
18 December 2015
Presenting: Brian Perrott, Simon Rainey QC and Robert Bright QC

Trading in Troubled Markets Seminar
British Embassy, Tokyo
21 January 2016
Presenting: Brian Perrott, Chris Swart and Andrew Johnstone

Kluwer 4th International Arbitration Summit
Dubai
27 January 2016
Presenting: Damian Honey and Simon Cartwright

Dubai Sugar Conference 2016
Dubai
30 January – 2 February 2016
Presenting/Attending:
Simon Cartwright, Judith Prior and Brian Perrott

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