Commodities

November 2013

COMMODITIES BULLETIN

New LME warehousing rules

On 7 November 2013, the London Metal Exchange (LME) announced significant changes to its warehousing rules in an attempt to quell a rising tide of objection from metal users and politicians.

Changes to the rules were first proposed in July 2013, following complaints by metal users (notably beer and soft drinks manufacturers) about long delays in taking physical deliveries of metal from certain LME warehouses (principally in Detroit, US and Vlissingen, Netherlands). It was claimed that these delays were artificially inflating prices, prompting the US Department of Justice and the Commodity Futures Trading Commission to investigate the industry.

A three-month consultation period prompted impassioned responses, with aluminium consumers and US politicians either supporting the changes or saying they did not go far enough, whilst some producers, traders and warehousing firms raised concerns.

The LME has since acknowledged that, *"... the increased premium that excessive queues cause creates significant difficulties for the metals community in respect of both discovery of the "all-in" price* [being the free market price of metal plus the regional premium for physical delivery from an LME warehouse], *and effective hedging of that price. Accordingly, it is appropriate to take action to address this issue."*[1]

What are the changes?

The existing LME warehouse rules provide that warehouses holding more than 900,000 tonnes of metal in one location must deliver out at least 3,000 tonnes of metal a day, without any limit on the amount taken in each day.

Under the new rules, from 1 April 2014, warehouses with delivery backlogs exceeding 50 days (down from 100 days in the original July proposal) will face extra load-out requirements beyond the existing minimum 3,000 tonnes. The amount of metal to be loaded out will be calculated using a formula based on the total

1 LME Result of Consultation on Changes to LME Policy regarding the Approval of Warehouses in relation to Delivery Out Rates, pg 2 para. 6, 7 November 2013

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amount of metal loaded in and out of that warehouse over a certain period of time (the calculation period). The LME hopes that the introduction of the 50 day threshold will improve its status as a market of last resort for physical metal deliveries.

The changes will be introduced in two phases. The preliminary phase will see warehouses broadly required to load out the same amount of metal as they have loaded in for the nine month period from 1 July 2013 to 31 March 2014 (the preliminary calculation period). The aim of this phase is to stop metal stocks (and queues for delivery of those stocks) from growing any further.

Once the preliminary period has passed, the formula will change, with effect from 1 August 2014, so that every three months warehouses will be required to load out *more* metal than the amount loaded in for the preceding three-month calculation period. The aim of this phase, which is of indefinite duration, is to decrease stocks and queues for metal.

Once a warehouse brings its waiting time below 50 days, these additional load-out requirements will no longer apply.

The LME has outlined other steps it may take to deal with warehouses deemed to be unreasonably incentivising the formation of queues. This could mean even stricter load-out requirements. The LME is also considering the suggestion by some respondents to the consultation that warehouses be prevented from charging rent for metal held in queues, or for warehouse charges to be capped (although rent restrictions could risk violating competition law provisions).

Furthermore, the LME plans to: review the effectiveness of its Warehousing Agreement; undertake a full-scale external logistical review of its warehousing network; introduce new transparency market reports; and create a Physical Market Committee to ensure that the voice of participants in the physical metals market is heard at the LME.

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MARTINA KELLY

The LME has emphasised its intention to review the impact of the changes at regular intervals.

What impact will the changes have?

It is feared that increased availability of physical metal through reductions in queue lengths could put downward pressure on prices.

During the consultation period, critics pointed out that the proposals may incentivise the movement of metal to non-LME warehouses, where reliable inventory data is not widely available, making it more difficult to track global supplies and possibly endangering the LME's status as the world's main aluminium trading hub.

Others have commented that the changes constitute a major market intervention, which goes far beyond the appropriate role of the LME in the market.

The LME is pushing ahead with the rule changes despite the possibility of legal challenges, particularly from aluminium producers and warehouse operators.

On a positive note, the announcement of the rule changes will be welcomed by traders waiting to learn about them before booking new long-term metal deals.

Enough to satisfy the legislators?

A subcommittee of the US Senate Banking Committee has been actively investigating the physical commodities market and, together with some regulators, including the US Federal Reserve, has criticised the role played by financial institutions in commodities markets.[2]

In September 2013, the European Parliament endorsed a political agreement on Market Abuse Regulation (MAR), which is intended to introduce rules to prevent, detect and punish market abuse. It seems likely that these will give a stronger regulatory emphasis to the physical commodity markets. The UK Financial Conduct Authority is reported to have visited a number of physical market participants and infrastructure providers as part of its

2 National Law Review, October 28, 2013, Financial Services Legislative and Regulatory Update - October 28, 2013 , Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, P.C.

preparations, including warehouses in a number of jurisdictions.

With investigations by both US and EU regulators ongoing, it remains to be seen whether the LME's rule changes and other suggestions will head-off regulatory intervention in the physical commodities trading markets, particularly warehousing.

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Is a carrier obliged to ship cargo on board a particular vessel?

The recent English Commercial Court decision in *Univeg Direct Fruit Marketing DFM GMBH and others v MSC Mediterranean Shipping Company S.A.* (4 October 2013), in which the Court considered whether a carrier had a contractual obligation to ship on board a particular vessel, is a helpful illustration for cargo interests.

The claimants were consignees and shippers of a cargo of clementines from Cape Town to Rotterdam. The defendants were the carriers. The fruit cargo had to be harvested, treated, transported and packed before loading. That process could take more than seven days. The voyage usually took 14-18 days.

Initial booking confirmations to the claimants referred to the cargo being shipped on board the MSC Lesotho at Cape Town. However, due to industrial action at Cape Town and other South African ports, the defendants later informed the claimants that they would not be able to ship on board the MSC Lesotho. Instead, the cargo was shipped on the MSC Stella.

The MSC Lesotho was the first vessel to leave Cape Town and arrived in Rotterdam five days before the MSC Stella. When the MSC Stella arrived, the cargo was in a damaged state.

The claimants argued that the failure to load on board the MSC Lesotho caused the damage to their cargo. In their view, had it been delivered five days earlier, it would not have been damaged. They also argued that the defendants were contractually obliged to ship on board the MSC Lesotho. By shipping on board the MSC Stella, the claimants contended that the defendants were in breach of contract and claimed compensation for their losses.

The claim failed. The Court found that there was no basis for the argument that the defendant carriers had a contractual obligation to ship on board a particular vessel. The booking confirmations were stated to be subject to the terms of the defendants' bill of lading and the seaway bill.

The Court found that there was no basis for the argument that the defendant carriers had a contractual obligation to ship on board a particular vessel.

LUKE ZADKOVICH

Those bills expressly provided for the defendants to substitute any vessel.

The Court also considered the cause of the deterioration of the cargo. On the balance of probabilities, it was not satisfied that the cargo suffered material further deterioration in the five days between the arrival of the two vessels'. The claimants did not satisfy the test that but for the five day delay, the damage would not have occurred.

Although in the event, the additional delay was not found to have caused the damage to the cargo, nevertheless, this case is useful for encouraging cargo interests to consider local conditions and likely delay events at the time of drafting appropriate rider clauses to bills and incorporated charterparties, and to be aware of how the risks are allocated between the parties. In this case for example, the claimants might have considered insisting on a clause to the effect that once a vessel is notified to the shipper, the carrier cannot substitute another vessel without liability for any losses, especially when delivery of perishable cargo can be so time critical. However, cargo interests should bear in mind our experience that large carriers can be resistant to amending their standard terms.

Although addressing the issue at the drafting stage is the best option, even once performance is under way, there may be scope to identify a legal solution for cargo interests who find themselves in similar circumstances to the claimants in this case. However, in circumstances where the carrier wishes to maintain the contractual freedom of vessel substitution, it will always be much harder to achieve this once the contract is alive.

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HFW commodities teams in court:

Three HFW commodities teams have been in action in the English Commercial Court in the last month.

Partner Chris Swart, Senior Associate John Rollason and their team acted for US commodities giant Archer Daniels Midland Company (ADM) in the successful application to the English High Court for a worldwide freezing order (WFO) against top Syrian businessman Mr Tarif Akhras, in relation to a claim for outstanding payment of US$26 million. Mr Akhras has extensive business interests in Syria, in grain and sugar as well as other soft commodities. The circumstances for granting a WFO were unusual because Mr Akhras is already the subject of EU, Canadian and Swiss sanctions. HFW regulatory Partner Anthony Woolich assisted in relation to the sanctions issues. http://www.hfw.com/HFW-Advises-ADM-on-WFO-Syria-Oct-2013

Partner Katie Pritchard and her team achieved success on behalf of clients, Transition Feeds LLP (a partly-owned subsidiary of ED&F Man) in High Court appeals under sections 68 and 69 of the Arbitration Act 1996 against three related FOSFA Arbitration Appeal Awards. The matters involved successive deliveries of palm oil from Itochu Europe plc to Transition Feeds and the resulting unusability of one of the cargoes as an ingredient for animal feed following the hijacking of the carrying vessel by pirates. In a judgment dated 15 November 2013, Field J found that the FOSFA Board of Appeal was guilty of serious irregularity in that it had failed to deal with two of the claimants' arguments concerning the proper measure of damages. Field J also held that the FOSFA Appeal Boards in the two related matters had made errors of law in interpreting and applying the 'costs follow the event' rule. The matters will now be remitted to FOSFA for further decision.

Meanwhile, Senior Associate Sarah Hunt and her team from the Geneva office were in action on behalf of clients Taurus Petroleum Limited. The judgment included some significant elements likely to be of interest to commodity traders, including the Court's decision that Iraq's State Oil Marketing Organisation does not have sovereign immunity and the question of whether the debt due under a letter of credit can be attached by a Third Party Debt Order. The judgment has gone on appeal. For a more detailed analysis, please go to http://www.hfw.com/English-Commercial-Court-decision-erodes-State-immunity-defence-November-2013.

Conferences and Events

Key issues in trading contracts
Lugano Commodity Trading Assocation
Lugano
12 November 2013
Presenting: Luke Zadkovich

Bridging cultures in International Arbitration
Tokyo
14 November 2013
Panellist: Chanaka Kumuarasinghe

EBOTA/REACH Centre Training
HFW London
19-20 November 2013
Hosting: Judith Prior/Eleanor Midwinter

The Sugar Association of London Newcomers Seminar
22 November 2013
Presenting: Judith Prior

Singapore Commodities Breakfast Seminar
HFW Singapore
27 November 2013
Presenting: Paul Aston, Christopher Swart, Max Wieliczko, Suzanne Meiklejohn and Adam Richardson

IECA Winter Conference
Hotel Beau Rivage Geneva
28 November 2013
Presenting: Robert Finney, Robert Wilson and William Hold

EBOTA/ISCC Workshop
Hotel Métropole Geneva
12 December 2013
Attending: Judith Prior

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