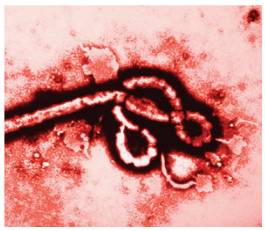
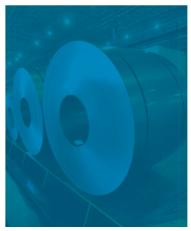
Commodities

October 2014

COMMODITIES BULLETIN





Welcome to the October edition of our Commodities Bulletin.

In our April 2014 Bulletin, Partner Sarah Taylor commented on the decision in *R (on the application of United Company Rusal Plc) v The London Metal Exchange (*27 March 2014*)* which prevented the LME from implementing changes to its warehousing rules in an attempt to minimise the effect of delays in obtaining metals from storage. The Court of Appeal's decision in this case was published earlier this month and Sarah considers its implications in our first article.

Next, Partner Robert Finney provides a regulatory update on issues affecting commodity traders, in particular MiFID II and REMIT.

We are receiving enquiries from trading clients about the impact of the Ebola crisis on their business. In our third article, Lee Forsyth and Sarah Hunt identify some of the issues to consider.

Lastly, in light of developments in the region since her article in our August 2014 Commodities Bulletin, Sarah Hunt provides an update on what banks and traders need to know in relation to oil traded in the region affected by the Kurdish crude dispute and the impact of the rise of ISIS.

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Appeal decision on LME's proposed queuing rule

In the April edition of this Bulletin (http://www.hfw.com/Commodities-Bulletin-April-2014) Partner Sarah Taylor reflected on the decision of the Administrative Court in *R (on the application of United Company Rusal Plc) v The London Metal Exchange (*27 March 2014*)*. Rusal had challenged 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, was put on hold.

The LME subsequently appealed and on 8 October 2014, the Court of Appeal allowed the LME's appeal, concluding that the court below had been wrong to decide that the consultation was unlawful.

The case concerns the new rule proposed by the LME in a consultation notice to all members, warehouse companies and London agents on 1 July 2013. The LME had started the consultation process to try to mitigate a problem, which had begun during 2008, of long queues for physical delivery of metals stored in LME warehouses.

The proposed new rule (known as a linked load-in, load-out or "LILO" rule) effectively required that any LME warehouse with queues longer than 50 days (which was reduced by the LME in November 2013 from the 100 days originally stipulated in its consultation notice, to which the Court of Appeal referred in its judgment) must load-out more metal than was loaded in.

Rusal has been denied leave to appeal the Court of Appeal's ruling, but has already indicated that it intends to seek the permission of the Supreme Court to appeal the decision there.

SARAH TAYLOR, PARTNER

On 7 November 2013, the LME announced that it would adopt the LILO rule as of 1 April 2014. Rusal sought judicial review of the consultation process, claiming that the rule would result in a short-term fall in the global market price of aluminium which would potentially cause hardship to producers.

The court at first instance found in Rusal's favour, deciding that the LME's consultation was procedurally unfair and unlawful for two main reasons:

- Firstly, the LME had not explained or expanded on a second principal option and potential solution to the queuing issue, namely a ban or cap on rents at warehouses with long queues. Consultees had not only been deprived of the opportunity to consider less damaging options than the LILO rule, but were unable to properly consider the LILO rule itself.
- Secondly, the LME had not investigated the rent ban option adequately before starting the consultation process. Consultees who subsequently proposed this option as an alternative or additional option to the LILO rule could not know the reasons why the rent ban option had not been put forward.

The LME had received 33 written responses to its consultation notice proposing the LILO rule. Of those 33, 10 participants proposed a rent ban either in addition to or instead of the rule. Rusal was not one of them, although it did file a written response objecting to the LILO rule.

In her analysis of English public law, the appeal judge examined the established principles of lawful and fair consultation, as set down in the case of *R. v North & East Devon Health Authority Ex p. Coughlan*[1]. She concluded that in order for a court to find unfairness in a consultation notice, something material must have been left out or misstated. The first instance judge had *"extended the principles beyond the limit to which they can properly be stretched"*.

The appeal judge could find nothing in the consultation notice that would have prevented Rusal from responding

1 [2001] QB 213

on the rent ban issue for want of information. She commented that it would *"considerably increase the burden"* if public bodies had to consult on all options, including those that they had decided not to pursue.

Rusal has been denied leave to appeal the Court of Appeal's ruling, but has already indicated that it intends to seek the permission of the Supreme Court to appeal the decision there.

Meanwhile, the LME has announced that it intends to implement the LILO rule with a start date of 1 February 2015. Its two-week consultation with listed warehouse companies in respect of some minor amendments to the rule began as soon as the Court of Appeal decision was made public. The LME has also promised to discuss with the market and publish further information on the reforms, including on rent caps and bans.

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For further information, please contact Sarah Taylor, Partner, on +44 (0)20 7264 8102 or sarah.taylor@hfw.com, or Clare Chyb, Associate, on +44 (0)20 7264 8348, or clare.chyb@hfw.com, or your usual contact at HFW.

Regulatory update for commodities: MiFID and REMIT

MiFID

A package of reforms to replace the EU's Markets in Financial Instruments Directive (MiFID) was formally adopted last spring. Work is now in progress to develop delegated "Level 2" regulations that must be adopted by the European Commission in order to flesh out and implement the requirements. The European Securities and Markets Authority (ESMA) is currently digesting responses to its consultations on a range of technical issues. In December 2014, it will consult on the resulting draft regulations.

The package of reforms, commonly referred to as "MiFID II" but comprising a replacement Directive (MiFID II), a new Regulation (MiFIR), and the Level 2 regulations once they are adopted, will apply to authorised (licensed) firms and market participants from 3 January 2017, subject to limited transitional provisions.

The broader scope of the new regime will impact commodity market participants in particular, by covering more commodities and derivatives transactions (including physically-settled transactions), by allowing fewer and narrower exemptions from authorisation and by imposing new requirements on both authorised and non-authorised firms.

Specifically, MiFID II:

- Removes the commodity traders exemption and narrows the exemption for ancillary business.
- Defines a new category of trading venue, the organised trading facility (OTF), which allows execution on a discretionary basis and might include (for example) various electronic and voice-broking services.
- Extends the category of financial instruments comprising commodity derivatives that can be physically settled (Section C(6) of Annex I) so as to include such derivatives traded on an OTF except for wholesale gas and power derivatives that must be physically-settled.
- Adds emissions allowances to the list of financial instruments covered by the regime.
- Introduces position limits to be set by the regulator for contracts traded on trading venues (regulated markets, multilateral trading facilities and OTFs) and "economically equivalent" OTC contracts, as well as position management powers, daily position reporting (to include positions of clients, clients of clients, etc.), and weekly publication by venues of aggregate positions by categories of holder.
- Establishes a framework to require that trading of certain classes of sufficiently liquid derivatives which are subject to mandatory clearing under EMIR be executed on an EU or equivalent non-EU venue.
- Introduces transparency requirements for commodity and other non-equity instruments traded on trading venues. These are also extended to cover circumstances when there is a liquid market or an order is large in scale.

Firms trading commodity derivatives should consider whether they must restructure to maintain their exempt or other regulatory status under MiFID and how to comply with the other changes, many of which affect non-authorised firms, too.

The extension to emissions allowances and a broader range of commodity derivatives also broadens the scope of EMIR and the market abuse regime.

In the context of EMIR, uncertainty as to the scope of commodity derivatives under C(6) and C(7) of the existing MiFID has prompted a new ESMA consultation with a view to issuing guidelines to ensure pan-EU consistency. The interpretation affects not only whether trades are covered by MiFID but also reporting, risk management and potentially clearing obligations under EMIR. It also determines whether a gas or power trade falls under the market abuse regime or REMIT (see below).

REMIT

There have been several significant steps towards introducing the much delayed transaction reporting under the EU Regulation on wholesale Energy Market Integrity and Transparency (REMIT). Adopted in October 2011, REMIT prohibits insider dealing and market manipulation in wholesale energy markets and establishes a monitoring regime for wholesale energy trades.

The Commission's expert group on REMIT recently approved a draft regulation implementing the data reporting framework. This regulation may now be finalised by December 2014 or January 2015. Its publication would trigger the six month transitional period for reporting "standard contracts" by "market participants". Anticipating this, the Agency for the Cooperation of Energy Regulators (ACER) has launched a new, more user-friendly notification platform whereby users can notify several national regulatory authorities (and ACER) at the same time and using only one notification form. ACER has also completed a public consultation on its Transaction Reporting User Manual (TRUM) and requirements for the registration of reporting mechanisms (RRMs).

In 2013, the UK government established a civil regime for enforcing REMIT's market abuse prohibitions and the obligation to report suspicious transactions. The Department of Energy and Climate Change (DECC) has just consulted on the introduction of new criminal offences to reflect those prohibitions and close the gap between the financial and energy markets regulatory regimes. The civil enforcement regime for REMIT data collection and registration is still being developed.

For further information, please contact Robert Finney, Partner, on +44 (0)20 7264 8343, or robert.finney@hfw.com, or your usual contact at HFW.

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ROBERT FINNEY, PARTNER

hfw The Ebola virus: impact on commodities

The recent spread of the deadly Ebola virus is currently affecting West Africa, specifically Guinea, Liberia and Sierra Leone. However, there are concerns that the virus will spread further and indications are that it has already reached Europe and the USA.

There has been an impact on some commodity prices, with cocoa prices reaching their highest levels in over three years due to fears that the virus may reach the Ivory Coast and Ghana, which together produce almost 60% of the world's cocoa.

Trade in other commodities in and out of the region, including oil, is likely to be impacted.

Commodities traders should be aware of and make provision for the potential legal issues which may arise as a result of the Ebola outbreak. This article addresses some key points to consider.

Force majeure and frustration

Affected parties may find contractual performance more difficult or financially unappealing because of rising commodity prices and/or costs (including production and shipment costs). The impact on shipping may affect trading parties, for example making it difficult to comply with obligations under sales contracts to supply a vessel to load/deliver goods at West African ports due to quarantine restrictions or closures.

In these circumstances, parties may consider whether they have an excuse for non-performance or an opportunity to terminate the contract.



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Force Majeure: Under English law, force majeure is only available if the contract provides for it and only to the extent that the contract covers the specific circumstances preventing performance. If there is any ambiguity, it will be resolved against the affected party. Further, if the circumstances preventing performance change over time, the force majeure provisions may cease to apply.

The effect of a force majeure clause is often to suspend obligations until the cessation of the force majeure event. A party may be entitled to terminate in certain circumstances, but only if this is specifically provided for in the contract.

Frustration: Under English law, a contract may be discharged where an event occurs after the contract is entered into which is not caused by one of the parties; is not addressed in the contract; and where the event so fundamentally changes the nature of performance that it would be unjust to require it to continue.

English courts have been consistently reluctant to find that there has been a frustrating event. Frustration arguments are only successful where a party can show that a contract has become impossible to perform. If performance has become more time-consuming, more difficult or more expensive, this will not amount to frustration.

Quarantine and demurrage

For traders acting as charterers, there will be a number of shipping related issues to consider.

These include owners and charterers' respective rights and obligations in relation to port safety; the impact of delays on the charterparty (including payment of hire); and the possibility that vessels coming from Ebola affected areas may be refused entry at subsequent ports of call[1].

A particular issue likely to occur in relation to the Ebola outbreak is that of quarantine of vessels and/or ports. As well as the impact of this on payment of hire, traders acting as charterers will need to consider carefully the impact on them in relation to demurrage.

The situation where quarantine relates to the vessel is relatively clearcut. If a voyage chartered vessel is quarantined, she cannot be considered ready because the charterers do not have unrestricted access to the vessel. Therefore, demurrage does not count during quarantine.

In relation to quarantine of ports, a number of charterparties contain clear provisions. Clause 17(a) of the Asbatankvoy form makes clear that the charterers are liable for demurrage where they send the vessel to a port already in quarantine, but not where the port is declared quarantined during the voyage. Other charterparties contain similar wording, including BPVOY4 (Clause 29), ExxonMobil Voy2012 (Clause 23) and Shellvoy6 (Clause 23).

What happens when there are no specific contractual demurrage provisions addressing quarantine?

Charterers may argue that a quarantined vessel is not entitled to be paid demurrage unless she is ready in all respects. If a vessel is quarantined and awaiting free pratique[2], charterers can argue that any Notice of Readiness (NOR) tendered is invalid[3].

However, owners may challenge this. Lord Denning held in the *Delian Spirit*[4] that where a ship apparently has a clean bill of health such that there is no reason to fear delay, even if she has not been granted free pratique, she is entitled to tender NOR and laytime will begin to run:

"I can understand that, if a ship is known to be infected by a disease such as to prevent her getting her pratique, she would not be ready to load or discharge. But if she has apparently a clean bill of health such that there is no reason to fear delay, then even though she has not been given her pratique, she is entitled to give notice of readiness, and laytime will begin to run."

Default

Beyond anticipating that the current situation will inevitably lead to defaults, it can be difficult to prepare in advance when the future spread of the virus remains unknown. However, a number of steps can be taken to mitigate against potential counterparty default generally, including:

1 In mid-September, Malta refused entry to a vessel en route from Guinea to Ukraine because a crew member was displaying ebola-type symptoms and Malta did not have facilities to treat them. The vessel was diverted to Sicily.

2 Free pratique is permission granted by port medical authorities on a vessel's arrival for her crew to go ashore.

3 Some charterparties include a WIFPON (Whether In Free Pratique or Not) clause so that NOR will not be rendered invalid if free pratique has not yet been granted.

4 [1971]1 Lloyd's Rep. 506


- Evidence contractual terms in writing.
- Keep all correspondence relating to the contract (including notes of any oral communications) as in some circumstances these can be evidence of the agreement.
- Comply strictly with contractual terms (for example, nominations should be on time, shipment periods should not be missed, commodities should comply with the contractual specification). This is to prevent a counterparty using a contractual breach as an excuse for termination.

Conclusion

Commodities traders who may be affected by the Ebola outbreak should review the provisions of their existing contracts so as to establish where potential liabilities may lie. They should also ensure that where possible, new contracts contain clear and express provisions as to liabilities relating to the outbreak.

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LEE FORSYTH, ASSOCIATE

Kurdish crude, SOMO and the organisation known as Islamic State (ISIS): what banks and traders need to know

Background

Kurdish crude is currently the subject of an intense debate.

In the August edition of our Commodities Bulletin, we reported that Iraq's Ministry of Oil, represented by the State Oil Marketing Organisation, SOMO, had threatened to sue any buyer lifting Kurdish crude.

The past five months have seen in excess of 11 million barrels of Kurdish crude exported through the Iraq-Turkey Pipeline (ITP) and delivered to destinations such as Israel, China and Croatia.

The vessel *UNITED KALAVRVATA*, carrying one such cargo, was reported to have 'disappeared' from the Galveston Offshore Lightering Area in the Gulf of Mexico, by turning off its transponder on 28 August 2014. The vessel subsequently reappeared on 1 September in the same location, with coastguard data revealing that none of its cargo had been offloaded.

SOMO initiated proceedings against the *UNITED KALAVRVATA* in respect of its cargo on 28 July 2014 in the US District Court for the Southern District of Texas. An order was initially made in favour of SOMO and US Marshalls were instructed to take possession of the cargo. It was subsequently held that the US court lacked the jurisdiction to seize the cargo as the vessel was located 60 miles offshore, but the US Court will hear arguments as to title. The Kurdish Regional Government (KRG) successfully requested that the order made for the seizure of the oil by the court be vacated. On 5 September 2014, SOMO resubmitted a claim in respect of the cargo, this time including the buyer as a defendant, again urging the court to arrest the cargo.

Most recently, on 15 September 2014, the KRG filed a suit arguing the dispute is *"firmly rooted in Iraq, and it will not and cannot be resolved by application of maritime law."*[1]

Issues for banks and traders

What do banks and traders need to be aware of when buying or financing cargoes of Kurdish crude?

For a discussion on whether Kurdistan is legally entitled to sell its crude as a matter of Iraqi law, see http://www.hfw.com/Commodities-Bulletin-August-2014

Where payment is made by letter of credit, both the issuing and advising banks could be involved in a dispute over payment. This is likely to be a question of timing. If the buyer has already paid against the documents and only finds out later that the seller did not have good title, he would still have the right to reject. In practical terms this right may have limited use if the oil is on board his ship and has already been paid for.

Most FOB and CIF sale contracts provide for payment after the bill of lading date and the issuing bank must pay if conforming documents are presented at the loadport where delivery takes place.

1 Graeber, Daniel. Kurds challenge latest Iraqi oil claims. *UPI.* 16.9.2014. http://www.upi.com/Business_News/Energy-Resources/2014/09/16/Kurds-challenge-latest-Iraqi-oil-claims/1811410870599/#ixzz3ELBxuqge

Both banks and traders should exercise extreme caution in relation to oil originating from this region.

SARAH HUNT, SENIOR ASSOCIATE

If a vessel is arrested, a CIF/FOB buyer could find that it has paid for cargo that it cannot physically discharge. Where payment has not taken place, a buyer may be able to argue that the seller was in breach of contract because it did not have good title in order to avoid payment.

Under a delivered contract, payment will often occur after tender of Notice of Readiness at the discharge port. If a vessel were arrested prior to arrival, a DES buyer could refuse to pay due to failure to deliver.

International sanctions may also have an impact on banks' decisions about making payment under letters of credit. HFW Partner Damian Honey will consider this issue in more detail in the next edition of our Commodities Bulletin.

The situation has been complicated still further because Iraqi crude has reportedly been illegally sold by ISIS since it began to take over parts of northern Iraq and north eastern Syria. Currently, ISIS controls some of Iraq's refineries: its occupied territory includes 11 oil fields. At its peak in August 2014, the Iraq Energy Institute estimated ISIS oil production to amount to 50,000 barrels a day in Syria and 30,000 barrels a day in Iraq. Following US airstrikes, ISIS production has significantly declined. A 14 October 2014 report by the International Energy Agency estimated that daily production has fallen to 20,000 barrels.

United Nations Security Council Resolution (UNSCR) 2170 was adopted unanimously by the 15-member Security Council on 15 August 2014. It forbids:

"nationals or any persons and entities within their territories from making any funds, financial assets or economic resources or financial or other related services available, directly or indirectly, for the benefit of persons who commit or attempt to commit or facilitate or participate in the commission of terrorist acts."

This makes it illegal to trade with ISIS.

As a matter of law, ISIS does not hold title to Iraqi/Syrian crude. When it purports to sell that crude on, no subsequent buyer in the chain ever holds good title. Under English law, a seller must have good title in order to sell[2].

Both banks and traders should exercise extreme caution in relation to oil originating from this region.

For further information, please contact Sarah Hunt, Senior Associate, on +41 (0)22 322 4816, or sarah.hunt@hfw.com, or your usual contact at HFW. Research conducted by Conor Cahill, Trainee.

2 Note that if 'ISIS' oil is mixed with legally obtained oil (to which the buyer has good title) the mixture is held in common and the owner is entitled to receive out of it a quantity equal to that of his goods which went into the mixture, any doubt about that quantity being resolved in favour of the owner; see *Indian Oil Corp Ltd v Greenstone Shipping SA (Panama) [1998] QB 345*.


Conferences and events

HFW Commodities Breakfast Seminar
London
28 October 2014

Commodities Week
Geneva
3–5 November 2014

HFW Commodities Breakfast Seminar
Dubai
11 November 2014

Lugano/Zug Commodity Trading Association's Certificate of Advanced Studies in International Trade
Lugano
13–15 November 2014
Presenting: Sarah Hunt, Sarah Taylor and Alistair Feeney

Collateral Management Agreement Course
Lugano
16 November 2014
Presenting: William Hold

2nd Iron Ore & Coal Shipping Summit ASIA 2014 Conference
Hong Kong
17 November 2014
Presenting: Peter Murphy

HFW Commodities Breakfast Seminar
Singapore
24 November 2014

Joint HFW/HKIAC Trade and Commodities Seminar
Hong Kong
25 November 2014

RSA and SAOL Seminar
London
27 November 2014
Presenting: Judith Prior

Global Energy 2014
Geneva
2–4 December 2014
Attending: Brian Perrott and Damian Honey

HFW Commodities Seminar
Hong Kong
3 December 2014

18th Middle East Iron and Steel Conference
Dubai
8–10 December 2014
Presenting: Simon Cartwright
Attending: Daniel Martin

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