Commodities

October 2015

# COMMODITIES BULLETIN





## Welcome to the October edition of our Commodities Bulletin.

In our first article, Associate Owen Webb from our Melbourne office reports on the recent decision *Sang Stone Hamoon Jonoub Co Limited v Baouyue Shipping Company Limited* (2015) EWHC 2288 (Com) and considers this decision from the cargo owner's perspective.

Next, Partner Judith Prior and Associate Eleanor Midwinter report on a recent important judgment in relation to REACH. The European Court of Justice has clarified the meaning of "article" under REACH Regulation 2006 (EC No. 1907/2006). Judith and Eleanor assess its significance in the second article.

Finally, Partner Robert Finney provides the latest in his series of regular regulatory updates for the commodities sector. This month he looks in particular at inadequate market abuse controls in the commodities sector, an Ofgem warning on market abuse in power and gas markets, restrictions pending registration in relation to trading into the EU and final draft rules for commodities firms under MiFID II – which are stricter than expected.

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.

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# The consequences of failing to take delivery of cargo

**Commodities traders will be interested in a recent decision of the English High Court in *Sang Stone Hamoon Jonoub Co Ltd v Baoyue Shipping Co Ltd "Bao Yue"*[1] which considered a vessel owner's entitlement to discharge cargo into storage, pending presentation of an original bill of lading, on terms that created a lien in the storage provider's favour in the event of non-payment of storage charges.**

## Background

Sang Stone Hamoon Janoub Co Ltd (the shipper) was the shipper and bill of lading holder in respect of a cargo of iron ore from Bandar Abbas, Iran, to Tianjin, China, on board Baoyue Shipping Co Ltd's (the owner) vessel in 2012.

A dispute arose between the shipper and the end buyer of the goods under the sale contract and the shipper would not release the original bill of lading. Since the bill was not available on the vessel's arrival, the cargo was discharged by the owner into a warehouse under letters of indemnity and in reliance on the bill of lading, which incorporated the following clause of the charterparty (clause 12):

*"... In case original Bs/L would not be ready upon vessel's arrival discharge port, owners allow to discharge cargo upon arrival to custom bonded warehouse area against Charterer's single LOI with owners P&I Club wording signed by Chrs.*

*Release cgo against original bill of lading. In the event cargo being kept in the warehouse in lieu of waiting for OBL to arrive at the discharge port, the expense of warehouse and all relevant costs to be for Chrtrs' account..."*

...the creation of a lien was a reasonable and foreseeable incident of the storage contract which the owner was authorised to conclude.

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Under the contract between the owner and the warehouse operator, the owner agreed to pay storage charges and failure to pay entitled the warehouse operator to refuse to release the cargo. The cargo remained in storage for several years and the warehouse operator refused to release it without payment of the hefty storage charges.

## The claim

Although it was common ground that the owner was entitled to discharge the cargo into storage, the shipper commenced proceedings against the owner in the English High Court in tort, claiming alleged conversion of the cargo on two grounds:

1. A lien for storage charges was created in favour of the storage provider without the shipper's express or implied authority.
2. The shipper was denied access to the cargo regardless of whether it presented the bill lading.

The owner counterclaimed for reasonable storage charges incurred under the storage agreement.

## Conversion

In order to establish the tort of conversion, a claimant must show that the defendant's conduct was:

1. Inconsistent with the rights of the owner (or other person entitled to possession).
2. Deliberate and not accidental.
3. So extensive an encroachment on the rights of the owner *"as to exclude him from use and possession of the goods"*.

## The decision

The court dismissed the shipper's claim and accepted the owner's counterclaim.

The court began by noting the accepted principle that a shipowner, as a bailee of cargo, is under a duty not to convert it. It also accepted that goods may be converted by a person who creates a lien on them without the authority of their owner.

However, the court held that an owner who authorises a bailee to deliver goods into storage *"must be taken to authorise the creation of a lien where that is a reasonable and foreseeable incident of the storage contract which the bailee is authorised to conclude"*.

In the present case, the owner's authority to create a lien under the

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storage contract was implied by the terms of the contract of carriage. The shipper had expressly authorised the storage of the cargo by, among other things, the incorporation of clause 12 into the bill of lading. It also impliedly authorised the storage under the well-established general law that if a bill of lading holder does not claim delivery within a reasonable time, the master may land and warehouse the cargo. In such circumstances, the creation of a lien was a reasonable and foreseeable incident of the storage contract which the owner was authorised to conclude.

The court rejected the shipper's assertion that denial of access to the cargo amounted to conversion. Whilst in some circumstances a denial of access to goods may constitute a conversion, in this case, the shipper failed to establish that it had been deprived of the use and possession of its cargo, which remained available to it on presentation of the bill of lading and payment of the accrued storage charges.

Commodity sale and purchase frequently involves a number of different contracts and parties must take account of the possibility that actions taken in relation to one contract can adversely affect their position in others. In this case, the shipper had refused to supply the original bill of lading because of a dispute with its buyer in the sale contract. The apportionment of liability in the contract of carriage meant that the shipper then found itself unable to recover from the owner the vast storage charges caused by the delay in taking delivery.

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## hfw European ruling increases regulatory burden under REACH[1]

**The decision of the European Court of Justice (ECJ) in *Fédération des entreprises du commerce et de la distribution (FCD), Fédération des magasins de bricolage et de l'aménagement de la maison (FMB) v Ministre de l'Écologie, du Développement durable et de l'Énergie*[2] is likely to affect the interpretation of REACH and in turn impact actors in the supply chain.**

REACH was put in place with a view to protecting human health and the environment by regulating the production, import and trade of chemicals within the European Union and setting out informational requirements regarding those chemicals.

REACH refers to chemicals as "substances", which may be present on their own, in mixtures or in "articles"[3]. Where a chemical substance categorised as being a Substance of Very High Concern (SVHC) for health or environment, particularly because of its carcinogenic, mutagenic or toxic properties, is present in a particular article above a concentration of 0.1% weight by weight (w/w), REACH Article 7 requires the producer or importer to submit a registration/notification for such SVHC to the European Chemicals Agency (ECHA). The producer or importer cannot place such an article on the market unless the specific use has been authorised. The presence of a SVHC at the stipulated concentration also obliges the supplier of the article under REACH Article 33 to provide the recipient with information.

It is not possible to obtain a blanket authorisation – each use must be specifically authorised, failing which such use will be prohibited. The process can be slow, costly, and strict time limits apply. In addition, it can be difficult to obtain required information from non-EU suppliers, or in complex supply chains, relating to each component in an article. Accordingly, it is important for actors in the supply chain to be clear whether they are obliged to seek authorisation and/or to supply information to users and consumers of the article in question.

Until now, there has been uncertainty as to whether, in the case of a complex product made up of several individual articles, these obligations apply where the concentration of the SVHC exceeds 0.1% (w/w) in the completed product, or whether the concentration in each individual component needs to be considered.

Although it is not legally binding, many actors in the supply chain rely upon guidance issued by the ECHA regarding the interpretation of REACH to help them to comply with their obligations, or to assess whether such obligations exist. In April 2011, ECHA guidance on requirements for substances in articles indicated that the duties to notify and provide information applied only if the SVHC concentration exceeded 0.1% w/w in the finished product as a whole.

1 Regulation (EC) No 1907/2006 of the European Parliament and of the Council of 18 December 2006 concerning the Registration, Evaluation, Authorisation and Restriction of Chemicals (REACH).

2 Case C-106/14, (10 September 2015 (FCD/FMB)

3 REACH, Article 3(3), defines an article as an "object which during production is given a special shape, surface or design which determines its function to a greater degree than does its chemical composition".

In a significant departure from the view previously adopted by the ECHA, the ECJ upheld the view taken by the French Minister. According to the ECJ, there was no distinction between an article incorporated as a component of a complex product and an article present in isolation. Each article incorporated as a component of a complex product was covered by the duties to notify and provide information if it contained a SVHC in the relevant concentration.

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Several Member States, including France, adopted a more restrictive interpretation, which was less favourable to industry.

On 8 June 2011, the French Minister for Ecology, Sustainable Development and Energy (Minister) issued a notice which stated that the concentration limit should be referable to each component part of the finished product, where such component could also be classed as an article under the REACH definition in Article 3(3). In FCD/FMB the French Conseil d'État referred the following question to the ECJ for a preliminary ruling:

*"Where an article within the meaning of REACH is composed of several elements which themselves meet the definition of "article"...are the obligations resulting from Article 7(2) and Article 33 of the regulation to apply only with regard to the assembled article or to each of the elements which meets the definition of article?"*

In a significant departure from the view previously adopted by the ECHA, the ECJ upheld the view taken by the French Minister. According to the ECJ, there was no distinction between an article incorporated as a component of a complex product and an article present in isolation. Each article incorporated as a component of a complex product was covered by the duties to notify and provide information if it contained a SVHC in the relevant concentration. The important factor to consider was whether the component articles ceased to be articles in the making of the new product, for example, by a change to their shape, surface and design. The ECJ also decided that the duty to provide information extended beyond producers and importers to all operators along the supply chain. The ECHA has announced that it will update its guidance to reflect the FCD/FMB decision.

In the meantime, actors in the supply chain should ensure that they are REACH compliant, for example, by revisiting SVHC testing and information in relation to articles to be placed on the market in the EU. It may also be necessary to reconsider counterparty contracts and supply chains. While the ECJ's test may sound straightforward, assessing a finished product in this way can be complex. Many articles likely to be affected by this interpretation may have been sourced from various countries and suppliers. This may lead to changes in the sourcing of such components or in the contractual requirements in the supply chain.

The ECJ commented that, while proportionality must always be considered, the purposes of REACH would not be served by seeking to minimise administration at the expense of limiting the protection afforded to human health and the environment by the provision of information regarding SVHCs. Ultimately, part of the intention of REACH is to encourage viable alternatives to SVHCs, to limit their use and to force the market to provide adequate information regarding their hazardous properties.

The short-term consequence is likely to be a considerable increase in the regulatory and administrative burden in the supply chain. However, the ruling removes the previous uncertainty and may serve to reduce the risk of large quantities of SVHCs being 'lost' in bulk article supplies, as well as stimulating research and development into alternatives.

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# Commodities regulatory update

### FCA finds inadequate market abuse controls in the commodities sector

The Financial Conduct Authority (FCA) has reviewed the compliance frameworks and governance structures of firms trading and broking across the energy, metals, and soft commodities sectors, with particular focus on their market abuse controls. It found poor awareness and widespread complacency around market abuse risks and inadequate arrangements in many firms.

The FCA reports that some front office staff and senior management hold the misguided view that commodity markets are *"too deep, too liquid and there are too many participants"* to be manipulated. Few firms had conducted a market abuse risk assessment or had ever submitted a Suspicious Transaction Report (STR). STR procedures were generally ineffective. Firms with clear and effective governance structures were in better shape, but monitoring and management of risk intra-day and in respect of prudential risks was generally non-existent or poor.

More positively, recognition of market abuse and other front office risks generally correlated with better practices, especially where risk and compliance staff were present on the trading floor and integrated with the front office, and where training was compulsory and relevant.

### Ofgem warning on market abuse in power and gas markets

On 8 September 2015, days after the FCA published the findings of its review, the UK energy regulator Ofgem published an open letter highlighting market manipulation and insider dealing concerns arising from its monitoring of compliance with the EU Regulation on Wholesale Energy Market Integrity and Transparency (REMIT). Ofgem identified various market behaviours it had witnessed as likely to be or potentially manipulative, including:

- Layering.
- Marking the close.
- Pre-arranged trading.
- Submitting small bids ahead of large offers (or vice versa).

Ofgem also raised concerns as to the confidentiality of inside information, especially information regarding the availability of assets, pending required disclosure, the timeliness of such disclosures, and the methodologies used to identify inside information. The letter concludes with a reminder of Ofgem's powers to deal with breaches of REMIT – which include criminal prosecution powers since April 2015.

### Trading into the EU: restrictions pending registration

In anticipation of the application of the new MiFID II regime on 3 January 2017, the European Securities and Markets Authority (ESMA) has published draft regulations on authorisation, passporting and registration of third-country investment firms, namely Singaporean, Swiss, American and other firms from outside the EU. These regulations set out the information such firms must provide when applying to ESMA for registration and how they communicate their regulatory status to their EU clients.

Under the Markets in Financial Instruments Regulation (MiFIR), third-country firms without an EU branch will be able to provide investment services and perform investment activities, and ancillary activities, to non-retail clients and counterparties only if they are first registered with ESMA.

Registration will be possible only if the European Commission has decided that the third country's prudential and business conduct framework have equivalent effect to the EU's and co-operation arrangements have been established between ESMA and the third-country regulator. Until then, the provision of services by third-country firms in the EU remains subject to member states' national regimes. Where those regimes are restrictive, third-country firms may encounter barriers to solicitation and business unless they fall within MiFID II exemptions: as has been widely publicised, the exemptions available to commodity firms will, controversially, be much more limited than before at the same time as many physical contracts being reclassified as derivatives for regulatory purposes. Many energy and commodity traders based outside the EU do not realise that when dealing with EU counterparties, they may already be relying on the broader exemptions under the existing MiFID regime.

### MiFID II final draft rules for commodities firms – stricter than expected

On 28 September 2015 ESMA published final reports on technical standards it has been preparing under MiFID II along with final drafts of the technical standards themselves, which it has sent to the European Commission for adoption. The regulations are stricter in many respects than anticipated and leave numerous questions unanswered.

When it comes into effect in January 2017, MiFID II will wreak major regulatory changes for commodities firms. For such firms, the two most important regulations address:

- **The ancillary exemption:** this will depend on passing a market share test and a main business test. Surprisingly, the latter now looks


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just at the proportion of derivatives trading activity that is deemed speculative, ignoring trading in physical commodities, non-trading business, and fixed assets.

- **Position limits:** national regulators will set limits for commodity derivatives traded on exchanges and other venues they supervise, which will apply also to "economically equivalent OTC contracts". ESMA has:
  - Reduced the range of possible limits to 5-35% of deliverable supply (for spot months) or open interest (for longer dated contracts).
  - Set definitions, for example for "economically equivalent OTC contracts", that limit the range of positions that can be netted in applying a position limit.
  - Maintained an inflexible approach to the hedging exemption, which will not be available at all to financial entities, including firms that are authorised under MiFID.

MiFID II position limits apply to non-EU entities too, although it remains unclear how. The ancillary exemption, and certain other exemptions, from authorisation are available to both EU firms and non-EU firms, as indicated above. EU firms that are not exempt will require authorisation under MiFID II which will trigger a range of regulatory requirements, including:

- Capital requirements.
- Governance and remuneration requirements.
- Pre- and post-trading transparency rules, execution standards and more trade reporting.
- More obligations under the European Market Infrastructure Regulation.
- Conduct of business rules.

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## Related publications

**New non-financial reporting requirements for businesses**

In our September Dispute Resolution Bulletin, Partner Daniel Martin looked at two new sets of non-financial reporting requirements for businesses. Both are likely to affect commodities businesses. If you would like to read more, Daniel's article can be found here: http://www.hfw.com/Dispute-Resolution-Bulletin-September-2015

# Conferences and events

**C5 Forum on International Trade Disputes**
Brussels, Belgium
20-21 October 2015
Presenting: Folkert Graafsma

**HFW Commodities Breakfast Seminar**
London, UK
20 October 2015

**HFW International Trade and Commodities Seminar**
Hong Kong
28 October 2015
Presenting: Peter Murphy, Andrew Johnstone, Brendan Fyfe and Sian Knight

**Refined Sugar Association and Sugar Association of London Seminar**
London, UK
10 November 2015
Presenting: Judith Prior and Daniel Martin

**IECA Seminar**
Geneva, Switzerland
19 November 2015
Presenting: Robert Finney
Attending: Robert Wilson, Marc Weisberger, William Hold

**HFW Sanctions Seminar**
London, UK
26 November 2015
Presenting: Daniel Martin and Anthony Woolich

**HFW International Trade and Commodities Seminar**
Hong Kong
1 December 2015
Presenting: Peter Murphy, Guy Hardaker, Andrew Johnstone and Sian Knight

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