HFW

COMMODITIES BULLETIN
FEBRUARY 2022

Welcome to the first edition of our Commodities bulletin for 2022.

We are delighted to welcome Barry Vitou and Anne-Marie Ottaway to the team. Barry and Anne-Marie specialise in white collar crime and financial investigations and have provided the first article for this edition. Consistent with our commitment to sustainability, our next piece explores the impact of energy transition on the commodities markets and the potential opportunities it presents. We then offer a perspective on insolvency clauses in proforma trade contracts. Finally, we consider standard form grain contracts as they apply to the current situation in Australia, namely a bumper crop combined with significant weather events including flooding.

Please also see our schedule of upcoming events. There is no doubt that the year ahead presents exceptional challenges and opportunities for the commodities sector. The knock-on effects of COVID-19, including supply chain delays, continue and it will be interesting to see how these affect the prediction of a commodities supercycle, sustainability targets, anti-slavery obligations, insolvencies and price volatility.

We welcome your feedback so please do not hesitate to share comments or suggestions for future content. Kung Hei Fat Choi, Happy New Year and happy reading!

Stephen Thompson and Ranjani Sundar

GLOBAL INVESTIGATIONS AND ENFORCEMENT – DEVELOPMENTS IN 2021 AND THE OUTLOOK FOR 2022

BARRY VITOU
PARTNER, LONDON

ANNE-MARIE OTTAWAY
PARTNER, LONDON

"A key focus for regulators in the US, which we can expect to see replicated in the UK and EU, is commodities price manipulation."

COVID created uncertainty and instability on a scale unprecedented in our lifetime. The impact on global supply chains and the scarcity of commodities are now being felt in lengthy delays in the supply of products and in financial pressure. All the ingredients for financial misconduct are present and the argument for doubling down on compliance is stronger than ever.

Against that backdrop, companies should be on high alert. In our experience, compliance pressure increases when there is scarcity of supply forcing price rise increases.

In this review, we reflect on significant developments in the compliance, investigations, regulatory and white collar crime enforcement space in 2021 and predict what to expect in 2022.

Focus on commodities price manipulation

A key focus for regulators in the US, which we can expect to see replicated in the UK and EU, is commodities price manipulation. Last year the US Department of Justice ("DOJ") secured a guilty plea from a former oil trader to commodities price manipulation. Reports indicate that the DOJ is also investigating the suspected manipulation of energy pricing benchmarks published by S&P Global Platts. They are focussing on a hot market, using knowledge garnered from previous investigations (like LIBOR and FOREX) and harnessing technology. This is risky for non-US businesses.

US investigations frequently focus on non-US entities, which then find themselves dealing with enquiries from their home regulator (which for obvious reasons represents an existential threat) as well as the long arm of US law enforcement.

In addition, continued improvements in the data analysis capabilities of regulators and law enforcement agencies enable them to spot suspicious patterns in the markets which had previously gone undetected.

The fraud unit of the DOJ, the Commodities and Futures Trading Commission ("CFTC") and the UK's Financial Conduct Authority ("FCA") have all emphasised their increasing use of data analytics to identify potential wrongdoing. We expect to see a continued focus on market abuse (including price manipulation and insider dealing) investigations in 2022 but unlike previously, the agencies will not wait for whistle-blowers or self-reports. Rather, they are proactively building their own cases based on data. The chief of the DOJ's fraud section commented in 2020: *"There is just a wealth of information there, which is going to give us years and years of cases to come"*.

Continuing focus on anti-money laundering

Anti-money laundering (AML) efforts remain a key priority across a number of jurisdictions. Of particular note in 2021 was the first prosecution of a bank by the FCA for failing to comply with AML regulations. NatWest Plc pleaded guilty to three offences and was fined £264,772,619.95. This month it was reported that the FCA has 40 active cases focusing on failures in AML controls, at least two of which are being considered for criminal action and six are on a dual track, with a decision yet to be made on whether there should be regulatory or criminal outcomes.

The sentencing remarks in the NatWest case highlight the need to ensure ongoing monitoring of customer relationships. We can expect the FCA and other AML supervisors to have this firmly in mind.

Elsewhere:

- in the EU, changes are being made to AML legislation to clarify the substantive offences (underlying conduct) that can lead to a money laundering offence.
- in the UAE, steps have been taken to strengthen AML legislation, joint agency guidance issued on AML and counter terrorist finance (CTF) compliance and

a new federal AML/CTF agency established, together with a specialist money laundering court in Dubai.

Renewed focus on anti-corruption

In the UK, the Serious Fraud Office (SFO) had a number of setbacks last year. These included the successful challenge by KBR Inc (represented by the authors of this article) in the Supreme Court of the extraterritorial overreach of the SFO's claimed powers to compel documents from foreign companies[1]. We successfully obtained the closure of the investigation into KBR shortly after this win.

Despite this, the SFO also had a number of successes, including a Deferred Prosecution Agreement with Amec Foster Wheeler Energy Limited, who paid £103 million to settle allegations relating to the use of corrupt agents in the oil and gas sector between 1996 and 2014 (part of a US $177 million global settlement with the UK, US and Brazil). The SFO also secured guilty pleas to bribery and corruption offences from Petrofac and GPT, resulting in financial penalties of £77 million and £30 million respectively.

In the US, President Biden issued a memorandum in June 2021 on "establishing the fight against corruption as a core US national security interest" and in December 2021 published the first US strategy on countering corruption which calls for "aggressive enforcement action" and increased international co-operation.

2021 also saw developments in the UAE aimed at enhancing its reputation in respect of anti-bribery and corruption compliance, including making whistleblowing protections clearer and corruption and compliance reporting easier.

Bribery and corruption investigations are rarely restricted to one jurisdiction and we can expect to see an increase in cross-border investigations, particularly in the UK, US and EU.

Increased scrutiny of ESG initiatives

ESG and sustainability considerations (including environment initiatives, promoting diversity, inclusion, fair taxation and workers' rights) are becoming a prominent area of focus for regulators and investors, as well as the general public. Companies can expect their ESG related credentials to be subject to scrutiny.

The UK's FCA published a "Dear AFM Chair" letter in July 2021, aimed at improving the quality and clarity of ESG and sustainable investments and a new strategy in November 2021, focused on ESG issues. In response to concerns over the integrity of some of the 'green' claims made by companies and financial firms, it has also introduced new rules and guidance on climate-related disclosures for listed companies and asset managers.

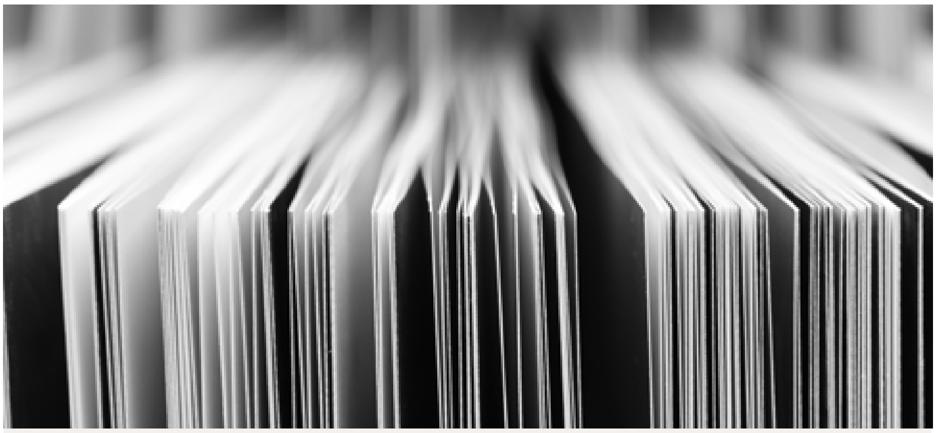
In addition, the EU Directive on the protection of persons who report breaches of Union law (the EU Whistleblowing Directive) includes the protection of the environment and financial services and is likely to increase the chances of any misrepresentations being reported.

We have already seen an uptick in requests from clients to assist them with internal investigations relating to these areas and we expect that trend to continue.

We have extensive experience of helping clients to prevent compliance failures, in addition to fixing problems if they happen. If you would like to learn more, please get in touch.

BARRY VITOU
Partner, London
T +44 (0)20 7264 8050
E barry.vitou@hfw.com

ANNE-MARIE OTTAWAY
Partner, London
T +44 (0)20 7264 8054
E anne-marie.ottaway@hfw.com



What can companies do? Practical tips

In our experience, the vaccine to potential misconduct is compliance and the passport is ensuring a record of compliance is kept. Our top three tips for companies in 2022 are:

1. **Training**
   Conduct a training refresh, ensuring that all staff (and where necessary third parties such as agents) have had compliance training and that policies are firmly embedded in your organisation's culture. Make sure clear records are kept.

2. **Health check**
   Conduct a compliance health check to ensure that your policies and procedures, training and record-keeping are fit for purpose. An effective compliance programme is critical to protecting your company.

3. **Focus on third parties**
   Third parties remain the biggest risk to a business, wherever they exist in the supply chain. Conduct due diligence on business partners and customers, not only at the outset of a relationship but on an ongoing basis. Monitor transactions to identify anything unusual. Keep records of steps taken.

1 https://www.supremecourt.uk/cases/uksc-2018-0215.html

ENERGY TRANSITION AND COMMODITY MARKETS: ACCELERATING SUPPLY OF CRITICAL MINERALS

JO GARLAND
PARTNER, PERTH

KATE FISHER
SENIOR ASSOCIATE, MELBOURNE

"There is potential for Australia to develop both a competitive advantage and a significant source of income from the export market for critical minerals, subject to the prompt development of sustainable, domestic value chains."

COP26 has brought a renewed international focus on the crucial role of energy transition in meeting net zero emissions targets by the middle of this century. As governments, policy makers and companies navigate the transition to renewable energy and invest in energy generation and storage technologies, supply chains for the critical minerals required to manufacture these technologies are being pushed to the limit. Front of mind is how supply will meet the extraordinary, unprecedented demand. This is, quite literally, a trillion dollar question and one that Australia will play a large role in answering.

Global demand for critical minerals required for the development, construction and operation of renewable energy technologies is set to increase significantly. Lithium, graphite, cobalt, nickel, titanium and rare earth elements are among the most essential minerals required. The International Energy Association (IEA) considers that demand for critical minerals will increase by up to 6 times by 2040"[1] and has provided the following explanation:

> *"Solar photovoltaic plants, wind farms and electric vehicles generally require more minerals to build than their fossil fuel-based counterparts. A typical electric car requires six times the mineral inputs of a conventional car and an onshore wind plant requires nine times more mineral resources than a gas-fired plant. Since 2010 the average amount of minerals needed for a new unit of power generation capacity has increased by 50% as the share of renewables in new investment has risen."* [2]

The IEA also predicts that while revenue from coal production is currently ten times larger than that from critical minerals, that position would be reversed well before 2040 in climate-driven scenarios.[3]

Ensuring the sustainable and reliable supply of these commodities will underpin the success or otherwise of energy transition on a global scale. In particular, there exists obvious potential for geopolitics to cause disruption, a risk magnified by the comparative concentration of their production in relatively few countries. It is estimated that 75% of the most in-demand critical minerals is produced by just three countries, including China and The Democratic Republic of Congo.[4]

To mitigate against the risks of mineral security posed by potential trade sanctions and future world events, it will be necessary to increase geodiversity in the value chains of these commodities. The significant challenge posed by the lead times involved in production from new sites cannot be understated; the front end project development and construction involved in mining critical energy minerals takes, on average, 16.5 years to complete before extraction can begin[5]. For the many countries now seeking to reduce emissions significantly by 2030, these lead times pose a substantial obstacle.

There is potential for Australia to develop both a competitive advantage and a significant source of income from the export market for critical minerals, subject to the prompt development of sustainable, domestic value chains. With its abundance of critical mineral stores and comparatively high compliance with ESG regulations, Australia is uniquely placed to harness the opportunities within these growth markets, notwithstanding the higher costs often associated with sustainably sourced commodities.

The Commonwealth Scientific and Industrial Research Organisation (CSIRO) has released the Critical Energy Minerals Roadmap (the "Roadmap"),[6] which provides a scientific basis for investment. It estimates that the metal value of the energy transition's top technologies

will exceed AUD$5 trillion dollars globally by 2050.[7]

Some of the greatest potential opportunity lies in the scope for Australia to produce nickel, copper, aluminium, lithium, manganese and magnesium. Australia has the world's largest resources of titanium and ranks in the top 5 for resources of cobalt, lithium, manganese. It is also the world's second largest producer of rare earth elements. The Department of Industry, Science, Energy and Resources has highlighted that further potential exists to discover more minerals in Australia, noting that established mining regions cover just 20% of the country, leaving 80% largely "under-explored".[8] The Roadmap sets out the importance of investment in domestic production and manufacturing to maximise local profit, whilst also recommending the prompt formation of multi-disciplinary, international partnerships to create efficient, geographically diverse and timely critical mineral projects.

The creation of a circular economy for critical minerals will be integral to meeting projected demand by reducing the amount of primary supply required. Optimising scope for recycling of renewable energy components, including batteries and wind turbines, is an additional link in the critical mineral chain with significant commercial opportunity, particularly as the number of EV batteries predicted to reach the end of their first life is expected to rise steeply from 2030. The IEA estimates that by 2040, recycled elements could reduce primary supply needs for critical minerals by approximately 10%.[9]

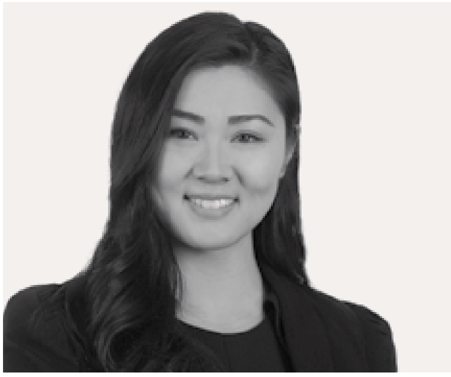
The supply of critical minerals will be a driving force in energy transition. The challenges posed by security of value chains and long lead times to new project delivery are real, but not insurmountable, and provide genuine opportunity to engage with and capitalise on the critical mineral growth markets.

JO GARLAND
Partner, Perth
T +44 (0)20 7264 8049
E jo.garland@hfw.com

KATE FISHER
Senior Associate, Melbourne
T +41 (0)20 7264 8461
E kate.fisher@hfw.com

1 https://www.iea.org/news/clean-energy-demand-for-critical-minerals-set-to-soar-as-the-world-pursues-net-zero-goals
2 Executive summary – The Role of Critical Minerals in Clean Energy Transitions – Analysis - IEA
3 Executive summary – The Role of Critical Minerals in Clean Energy Transitions – Analysis - IEA
4 The state of play – The Role of Critical Minerals in Clean Energy Transitions – Analysis - IEA
5 Executive summary – The Role of Critical Minerals in Clean Energy Transitions – Analysis - IEA
6 https://www.csiro.au/en/news/news-releases/2021/csiro-research-highlights-australias-minerals-key-to-its-renewable-energy-powerhouse-potential
7 https://www.csiro.au/en/news/news-releases/2021/csiro-research-highlights-australias-minerals-key-to-its-renewable-energy-powerhouse-potential
8 https://www.industry.gov.au/policies-and-initiatives/critical-minerals-facilitation-office/investing-in-critical-minerals-in-australia
9 https://www.iea.org/reports/the-role-of-critical-minerals-in-clean-energy-transitions/executive-summary

RANJANI SUNDAR
PARTNER, SYDNEY



LUCY HEE
ASSOCIATE, SYDNEY

> **"The purpose of the laws governing insolvency is to promote business turnaround and to ensure that all company creditors are treated 'pari passu' that is, they are to share equally the assets available to them."**

"(UN)FAIR MARKET PRICE" INSOLVENCY CLAUSES

In the context of grains contracts, the entry by one party into insolvency can be perplexing for the solvent counterparty who may have yet to perform its contractual obligations. This is particularly so where the parties have entered into a proforma trade contract containing a "fair market price" insolvency clause. That is, under certain trade association rules, an insolvent party may (notwithstanding the insolvency) receive a windfall payment from the solvent counterparty depending on the market conditions at the time, despite the fact that the insolvent party is technically in breach of the contract for failure to fulfil its contractual obligations.

There are two ways of looking at this significant issue. From the perspective of the insolvent party's creditors, as at the date of the insolvency event these contracts are an asset of the insolvent party and ought to be made available to the company's creditors. From the solvent counterparty's perspective however, such an outcome can be seen as unfair and artificial, particularly where the solvent counterparty is required to make a payment to the insolvent party through no fault of its own.

A number of proforma trade contracts stipulate that an insolvent party is required to provide notice of insolvency to a solvent counterparty within a specified period of an insolvency event ("Insolvency Notice"). Once given, the issuance of the Insolvency Notice has the effect of closing out the contract between both parties at the fair market price on the business day following the issuance of the Insolvency Notice. If the insolvent party fails to issue the Insolvency Notice as required, the solvent counterparty has the option of declaring the contract as closed-out at either the fair market price on the first business day after it became aware of the insolvency event, or at the fair market price on the first business day after the earliest insolvency event known to the solvent party; in either case, the closing out of the contract is linked to the "fair market price".

It is well established in contract and equity that a party cannot benefit from its own breach. However, as a result of the present drafting of insolvency clauses in some trade association rules and contracts, an insolvent party may stand to benefit from the insolvency. In other words, the effect of the relevant provisions may be to close-out the contract at a time when the market has moved in the insolvent party's favour, to the detriment of the solvent counterparty, requiring it to pay the difference between the contract price and the fair market price to the insolvent party's administrators. By way of example, the relevant insolvency event could occur 6 months prior to the contractual delivery period and at a time when the market moves in the insolvent party's favour. Due to market volatility, the conditions at the time of the relevant insolvency event may not truly reflect the price at the time of delivery of the product. The operation of the proforma insolvency clause could mean that a solvent counterparty who was at all times ready, willing and able to perform its contractual obligations may be required to pay a substantial sum to the insolvent party's administrators rather than being paid damages for the insolvent party's contractual default.

The purpose of the laws governing insolvency is to promote business turnaround and to ensure that all company creditors are treated 'pari passu' that is, they are to share equally the assets available to them. Whilst insolvency administrators, who are to act in the best interests of the insolvent party's creditors, may argue that the insolvency clauses in proforma trade contracts are fair and just with a view to increasing the funds available to the insolvent party's creditors, the solvent counterparty is unlikely to agree if it means that it must make a payment to the administrators in circumstances where they did not breach the contract.

For this reason, when entering into contracts, parties may wish to ensure that the applicable insolvency provisions characterise an insolvency event as a contractual default and make clear that it is the defaulting / insolvent party who ought to pay the solvent party any difference in price. For practical purposes, this could be done by expressly contracting out of the proforma trade contract insofar as insolvency is concerned, and including a more appropriate insolvency clause in the contract.

RANJANI SUNDAR
Partner, Sydney
T +61 (0)2 9320 4609
E ranjani.sundar@hfw.com

LUCY HEE
Associate, Sydney
T +61 (0)2 9320 4643
E lucy.hee@hfw.com

OWEN WEBB
SPECIAL COUNSEL, MELBOURNE

CARLITA BLOECKER
ASSOCIATE, MELBOURNE

RAIN, RAIN, GO AWAY – THE IMPACT OF WEATHER ON FORWARD CONTRACTS

Australia has been looking forward to a bumper crop of wheat for 2021/22, with a previously estimated national crop yield of 35-37 million metric tonnes. Of that, approximately 24 million metric tonnes has been flagged for export. Whilst the West coast of Australia is on track to meet expectations, the East coast was pummelled with significant rain and flooding from November 2021. By that time, the East coast was well into its harvest period and many farms suffered considerable crop damage.

While the effect of La Niña and the devastating rains across the East coast have not diminished hopes for a bumper crop for Australia as a whole, buyers wishing to receive high-protein wheat may be disappointed. S&P Global Platts reported in December 2021 that milling grade wheat is forecast to fall to approximately 35 - 45% of the overall crop in 2021/22, down from 65%-70% in 2020/21.

For sellers impacted by the rain and floods on the East coast of Australia, it is a good reminder to revisit the risks associated with forward contracts. The most widely used standard term contracts do not typically provide the seller with any relief where they are unable to source high quality wheat to fulfil their delivery obligations. In particular, force majeure (FM) clauses rarely protect the seller against crop failure resulting in a deficiency in the quantity or quality of wheat available.

Grain Trade Australia (GTA) Rules

Where the GTA Rules are incorporated into a sale contract, both "production risks" and "crop failure" are expressly excluded from the list of FM events. ("Production risks" include adverse seasonal conditions such as frost, drought and rainfall.)

Further, while the FM clause in the GTA Rules can apply in the event of flooding, such as has occurred across large areas on the East coast of Australia, this may not ultimately assist the affected seller. This is because the effect of the FM clause under the GTA Rules is to extend the time for delivery. It does not relieve the seller of its obligation to deliver once the FM event has ceased, or from liability for any deficiencies in the quality of wheat. If, at the end of any extensions granted by reason of the FM event, delivery has still not been made in full, the seller will be in default.

GAFTA contract terms

For sellers using the standard GAFTA Form 18 (Goods from Australia in Bulk on FOB terms), the position in respect of FM is slightly different in that there is no express exclusion of 'production risks' and 'crop failure' from the list of FM events. However, the only FM event potentially available for sellers whose crops have been damaged by the rains and floods is likely to be that of "Act of God'. A seller seeking to rely on this clause would have to prove an extraordinary weather condition and its application will vary depending on the nature and extremity of the circumstances.

Once the rain stops and the floods recede, there will no longer be a FM event on foot for the purposes of GAFTA Form 18 and a seller will likely only be able to take advantage of an extension of time in which to make delivery of the wheat, rather than being excused from the obligation to deliver. As with the GTA Rules, the probable outcome under GAFTA Form 18 is that a seller who fails to deliver in full will be held in default.

Conclusions

Two key conclusions emerge:

- While forward contracts have the benefit of offering the parties certainty of price and quantity, in circumstances where extreme weather events are expected to become more common as a result of climate change, they also involve some considerable risk.
- Contracting parties should have in mind their likely requirements from and the potential risks to the transaction when considering the scope of a FM clause. For example, the FM clauses in the GTA Rules

and GAFTA Form 18 have different areas of focus, with the GTA clause focussing much more on weather and localised events, while the GAFTA clause is more focussed on what could happen between countries and at ports.

OWEN WEBB
Special Counsel, Melbourne
T +61 (0)2 9320 4646
E owen.webb@hfw.com

CARLITA BLOECKER
Associate, Melbourne
T +61 (0)3 8601 4522
E carlita.bloecker@hfw.com

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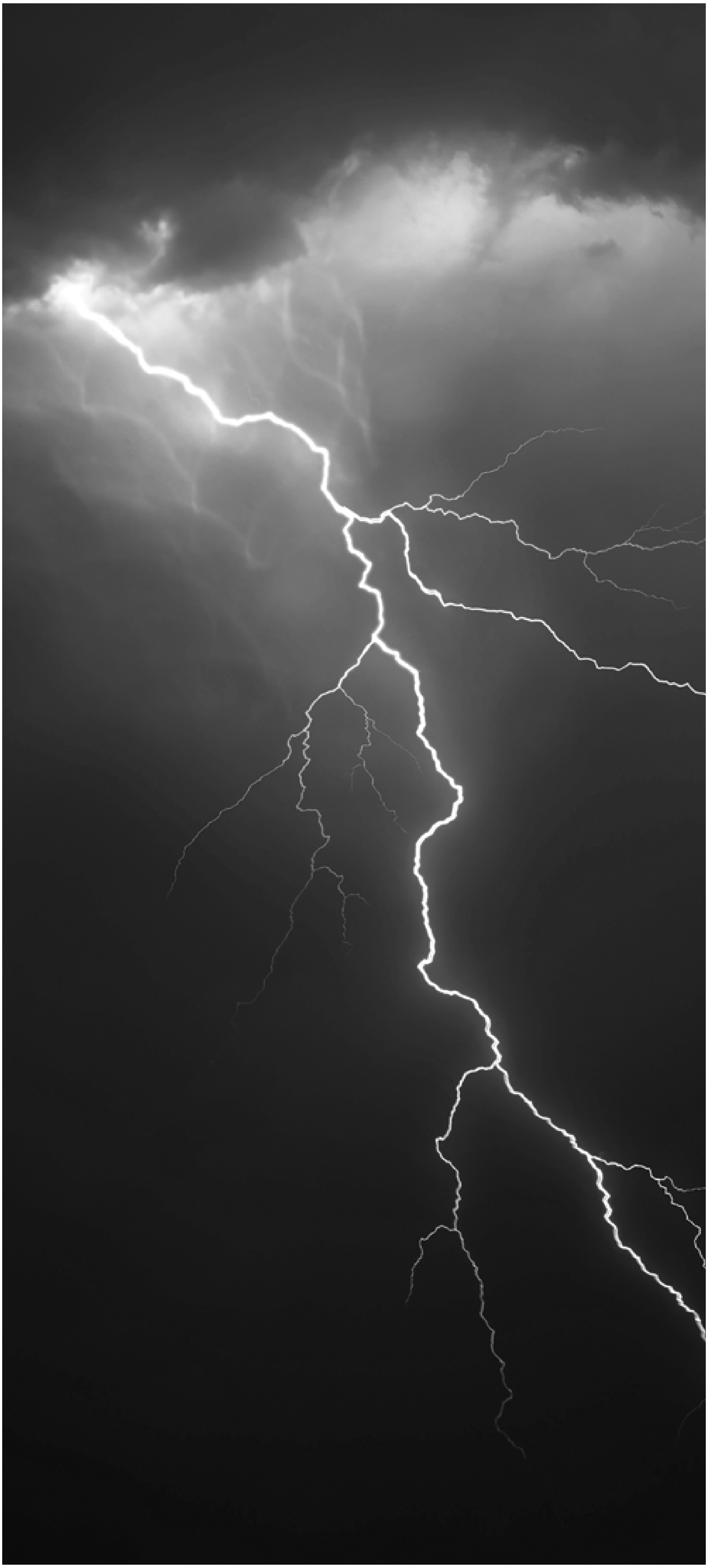

Where you can meet the team next

Commodities Breakfast Webinar – Second session
3 February 2022

Co-hosted by Brian Perrott, Daniel Martin and Nigel Wick. They will be discussing recent judgments in the UK Supreme Court; managing sanctions risks in commodity contracts; and legal issues relating to trade credit insurance.

HFW Global compliance enforcement: Predictions for 2022 and the top 5 developments of 2021
10 February 2022

Co-hosted by our Global Investigations and Enforcement team, Anne-Marie Ottaway and Barry Vitou, who will give their predictions relating to risk and compliance for businesses in 2022, as well as a roundup of the top 5 developments of 2021.

Other team news

Our London office is pleased to welcome the Global Investigations and Enforcement team to HFW, who joined us in October.

Anne-Marie Ottaway

Barry Vitou

Anne-Marie Ottaway and **Barry Vitou** have a formidable track record in ending criminal and regulatory investigations without prosecution or any action against clients. They have successfully handled many of the largest and most complex investigations, including multi-jurisdictional criminal investigations and internal investigations dealing with alleged ethical, ESG and other violations.

HFW has over 600 lawyers working in offices across the Americas, Europe, the Middle East and Asia Pacific. For further information about our commodities capabilities, please visit hfw.com/Commodities

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