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SEISMIC SHIFT IN OVERSIGHT OF COMMODITY TRADERS OFFERS OPPORTUNITY FOR THE INDUSTRY

Commodity traders and the energy markets have got the world's attention.

The Russian invasion of Ukraine has sparked the beginning of what is likely to be a seismic shift in the oversight, regulation and enforcement of the commodity trading industry. This offers a unique opportunity for commodity traders to help shape that shift and to ready their businesses for what is coming, in turn increasing their competitive advantage.

In the UK, we have seen a Bank of England liquidity fund of £40 billion for energy suppliers and a package of £100 billion to deal with surging energy prices. Top of the EU's agenda is an attempt to reach consensus on what to do about intervention in the energy market. In the meantime, hikes in energy prices have created raging inflation in Europe, foreshadowing a European - if not global - recession.

Energy market price increases have been likened to a "Lehman moment" for the energy sector and have sparked a UK government review described as being intended to *"undertake fundamental reforms to the structure and regulation of energy market through recommendations from a new review of the UK energy regulation.*"

The UK review mirrors a global concern and review of the energy and other commodity markets.

The Financial Stability Board, an international body that monitors and makes recommendations about the global financial system, is looking at three areas in relation to commodity markets under the umbrella of its snappily titled "non bank intermediation sector" work. First, it is looking into "*linkages between commodity markets and the rest of the financial system. … second, … commodity market volatility [which] has led to large margin calls for commodities derivatives, that seem to have placed strains on a number of market participants. Third, [gaining]…. a more comprehensive picture of leverage in the financial system and possible amplifiers in the event of market stress, including through banks' prime brokerage businesses.*". A report is due next month.

When explaining the problem in the aftermath of Lehman, Mary Schapiro, then SEC Chairwoman, referred to "*the proliferation of complex financial products, including derivatives, with illiquidity and other risk characteristics that were not fully transparent or understood.*"

The comparison to the Lehman moment is likely a good one. Commodity traders have long been under the radar and their business not well understood. Central banks have this year spoken of the opacity of commodity trading. For example, physically settled transactions that are not reportable create potentially huge unknown exposures. The LME nickel market meltdown earlier this year is a stark reminder of and wake-up call to the problems which can ensue.

While the catalysts for Lehman and the global financial crisis may be different, governments have identified the importance of commodity traders to global financial stability.

Against that backdrop, more government oversight, scrutiny and enforcement is inevitable. Indeed, enforcement in the commodity sector had been gaining momentum even without the energy crisis.

Glencore recently pleaded guilty in the US and UK and agreed to pay over US$1.1 billion in respect of bribery and market manipulation violations relating to the Platts oil benchmark. (The UK sentencing is slated for later this year). Just over a year and a half ago, Vitol entered into a US$135 million settlement with the US Department of Justice for bribery violations under the Foreign Corrupt Practices Act, and a related settlement with the US Commodity Futures Trading Commission in respect of manipulation of the Platts oil benchmark. There is reported to be an ongoing investigation into manipulation of the Platts oil benchmark involving a cooperating witness.

Against this backdrop, what should commodity businesses do?

First, in the context of the general review into the industry and global financial stability, we recommend commodity businesses work to ensure that their compliance house is in order and that existing policies and procedures are demonstrably fit for purpose.

HFW has a team of experts helping clients with their compliance programmes using a two-phase approach: first, a series of checks to understand what exactly is actually going on in a business from a compliance perspective and second, to enable change where necessary.

Second, it is likely that commodity business leaders will be called upon to explain the industry and the work they do in it as part of the global reviews of the industry being undertaken.

HFW can help leaders be prepared to be called upon and answer the questions of those reviewing and considering reform of the industry.

This article will form part of our next Commodities Bulletin, in which we will be reflecting on some of the impacts of Russia's invasion of Ukraine on the commodities sector.

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