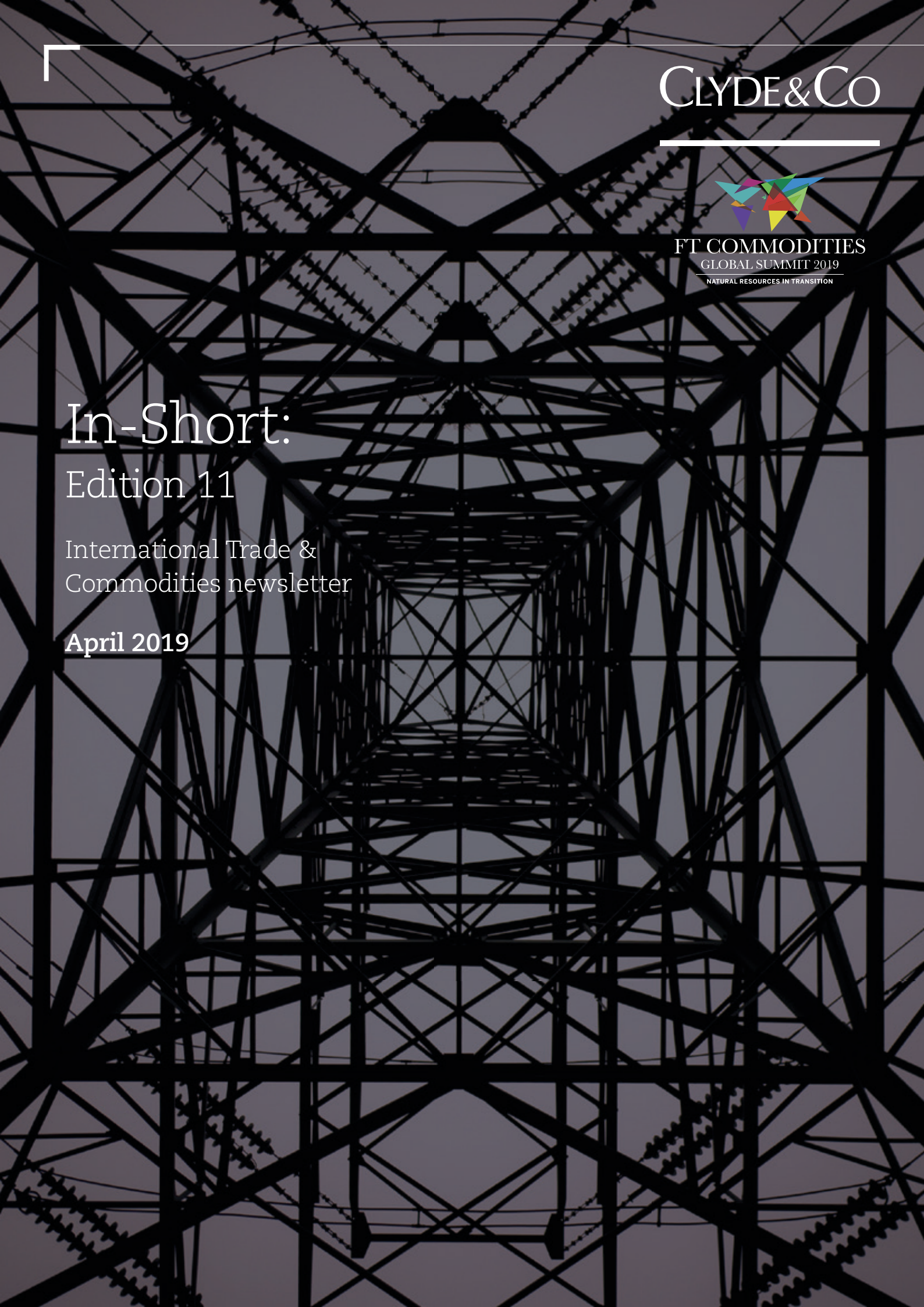

CLYDE&CO

FT COMMODITIES
GLOBAL SUMMIT 2019
NATURAL RESOURCES IN TRANSITION

In-Short:

Edition 11

International Trade &
Commodities newsletter

April 2019

Contents

Introduction

Since our last edition of In-Short, geopolitics have continued to generate uncertainty in the commodities markets: important differences between China and the USA in relation to trade remain unresolved, the BREXIT process is mired in parliamentary deadlock and uncertainty of outcome is now acute and, in the meantime, Norway has announced potentially far reaching changes to the investment strategy for its sovereign wealth fund in relation to oil & gas assets.

We are, once again sponsoring the FT Commodities Summit which takes place in Lausanne on 25 – 27 March, with our Corporate Partner, Simon Vere Nicoll, taking part in a panel discussion focusing on M&A activity in the commodities space. Others from Clyde & Co that will be attending the summit include our Trade Finance practice group leader, Robert Parson, regulatory expert, Clare Hatcher, commodity dispute specialists Michael Swangard and Grace Asemota as well as our Mexico office founding Partner, Enrique Garza. If you are attending the summit, you can contact each of them via the event app.

We are also sponsoring the ICCA General Counsel Conclave that takes place in Goa in April, where another Clyde & Co disputes specialist, Eurof Lloyd-Lewis, will be speaking on arbitration and litigation of commodities disputes.

In this issue we cover:

- Block-buster: how TradeTech could change the world
- How will the commodities industry react to geopolitical tensions and technological innovations?
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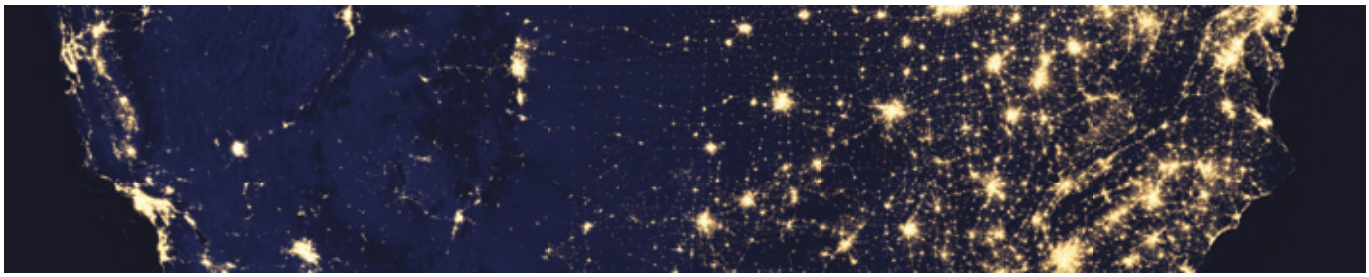

Block-buster: How TradeTech could change the world

By Patrick Murphy (Partner, Dubai)

The possibilities opened up by technologies such as blockchain could revolutionise international trade; but there are legal challenges that remain to be confronted.

The promises of the so called "blockchain revolution" are almost boundless. Claims that it will change how economic rights are licensed, empower inanimate objects to communicate and interact with each, or even change the way government is carried out, could just be the tip of the iceberg. In the same way that in the early days of the internet no-one predicted the rise of the tech giants of today, it is quite possible that its second or third order effects cannot yet be comprehended. Conversely, it is just as possible that it will fall short of its more evangelical proponents' predictions.

But whatever your views on its likely consequences, what is interesting from an international trade practitioners' perspective is how many technical experts from outside the traditional trade community have concluded that, of all industries, the way in which goods are bought, sold and transported around the world is the area that is ripest for disruption.

Blockchain, or more accurately, "distributed ledger technology" (DLT) is famously the technology that underpins, and to many is synonymous with, Bitcoin. It is based on a relatively simple proposition: distributing amongst participants of a network the role traditionally played by a central administrative authority in recording transactions on a ledger. The cryptographic technology underpinning the technology means that the record of the distributed ledger is secure, immutable and – to the extent necessary – public.

But it has applications well beyond just cryptocurrencies. The ledger in question could be – as in the Bitcoin blockchain – a record of the ownership of a digital asset. But in principle a record of the economic rights relating to any asset or even just information, can be stored on a distributed ledger in a secure and immutable manner and made available to appropriate persons as required.

Which is why it could change the international sale of goods.

A 21st Century industry built on 19th Century fundamentals

The 20th Century saw many technological advances in how goods are bought and sold; from navigational and safety improvements at sea that reduced the risk of loss of life and property, through the containerisation revolution, to increasingly sophisticated means of trading and financing commodities.

But in some crucial respects the industry is still stuck in the 19th Century. In particular, the industry is still heavily reliant on paper documentation, with the attendant costs and inefficiencies that this brings. Whilst that documentation is often "digitised" in the limited sense that paper documents are turned into PDFs, many of the underlying documents are inefficient duplications of existing data: think of the proliferation of paper documents required to record the weight, origin, and specification of goods for customs purposes as they are moved from jurisdiction to jurisdiction. There is no great efficiency realised in this "digitisation" of information. But even more fundamentally, the industry requires certain crucial documentation, such as documents of title, to be produced in original paper form. The transactional inefficiencies associated with that are significant.

Take the venerable bill of lading as an example: a shipowner has an obligation to deliver a cargo to the lawful holder of the original paper bill of lading representing that cargo. If the original bill of lading (which is often being physically passed through a chain of financing banks as it is endorsed from one to another) is not present at the discharge port, the shipowner takes a risk in delivering the cargo to the charterer's order, potentially exposing itself to a significant misdelivery claim. This requires a letter of indemnity from the charterer – and often back to back LOIs from other parties in the chain of sale contracts. This paper edifice collapses if a party in the chain of contracts defaults on payment obligations, often causing an unpaid holder of the bill of lading to arrest the vessel and bring a misdelivery claim against the shipowner, potentially causing multi-party litigation in a number of jurisdictions as

demands are made for security and indemnities under the cascade of LOIs.

DLT's promise that it can operate as an immutable digital record of economic rights, enabling their transfer in a cryptographically secure manner, is an obvious potential solution to the difficulties associated with the continued reliance on original paper documentation.

Indeed, it opens up the prospect of truly digitising all manner of data associated with the international sale of goods, storing that data securely and making it available as and when required to (and only to) the necessary persons.

Pioneering developments

The industry has already responded to the opportunity, with traditional shipping and trading companies developing their own tech driven solutions. Maersk has teamed up with IBM to create TradeLens, a DLT based platform that records and shares information and tracks physical assets and documents. A consortium including APL, Keuhne + Nagel and Accenture have cooperated to develop a DLT solution that, in trials, removed the need for up to 20 different printed shipping documents which contained data that was replicated in each of them.

In the commodity trading and financing sphere, two consortia of financial institutions, oil majors, traders and survey companies have developed two related DLT start ups aiming to revolutionise oil trading: Vakt, a platform that digitises the paper backed processing of physical commodity deals; and komgo, an open financing platform where traders – including the Vakt participants - can elicit finance for the oil trades in question from financial institutions with letters of credit issued over the platform in a cryptographically secure environment.

What the various proof of concept trials and early commercial ventures show, by and large, is that innovation is being driven by individual DLT solutions rather than one global all-encompassing distributed ledger. If that is understandable in context of early commercial trials of new technology, it brings with it some commercial limitations too: for example, IBM admitted last year that it is struggling to add competing carriers to the TradeLens platform given IBM and Maersk's ownership of the IP involved. To a certain extent the long term viability of the technology is dependent upon its "network effects" and ability to reach the maximum of participants. In that regard, the Vakt and komgo platforms are particularly interesting because of the number and variety of stakeholders involved and the fact that two DLT based platforms were designed at the outset to interoperate.

Legal Challenges

But if there are commercial challenges to reap the true network effects DLT in the international trade sphere, the legal challenges are at least as significant. In particular, replicating the legal effect of paper documents presents a challenge. As a recent report by Clyde & Co on Electronic Bills of Lading for the ICC Banking Commission shows, whilst data contained in documents such as bills of lading can be securely transferred and shared on DLT based systems, replicating in electronic form the transferable nature of a negotiable instrument such as paper bill of lading is technically and legally much more complex.

Few jurisdictions legislate to provide for the effective transfer of the rights enjoyed by a lawful holder of a bill of lading when an electronic bill of lading (e-bill) is transferred. There have historically been attempted work arounds. Organisations such as essDOCS and Bolero have, for many years now, attempted to replicate the functional equivalence of a paper bill of lading with e-bills, but this requires agreement by pre-determined participants to a single set of contractual rules within what is sometimes referred to as a "club system". When a party who is not a part of the club is involved in a transaction, it requires the conversion of the e-bill bill into a paper document. The development of DLT solutions has not changed the fundamental difficulty that very few jurisdictions place e-bills on the same legislative footing with regard to the transfer of right as original paper bills of lading.

MLETR

One potential solution is the Uncitral Model Law on Electronic Transferable Records (MLETR), which is a specimen text that can be adopted by states wishing to legislate to recognise the transfer of rights in electronic documents that are functionally equivalent to transferable documents of title such as bills of lading.

It provides for the recognition of electronic records where the record contains all the information required of, say, a bill of lading and where a reliable method is used to maintain the integrity of the record and subject it to control from its creation until it ceases to have effect. "Control" is crucial in this context because it represents the functional equivalent of the possession of a physical transferable document. The MLETR is neutral as to the technology concerned, meaning that it can accommodate a variety of different technologies, including distributed ledgers, and it supports the principle of non-discrimination against the foreign origin of an

electronic transferable record, to foster the cross border use of electronic records.

The MLETR has no effect until it is adopted into national legislation. It is, for the time being, an aspiration for many jurisdictions. If adopted, however, it has the potential to fulfil some of the more exciting predictions about the direction of international trade.

The future?

That is because, once DLT based platforms can transfer economic rights to negotiable documents in a legally enforceable manner, it opens up possibilities brought by other technologies. For example, data recorded by the "Internet of Things" - interconnected inanimate objects - can be stored on distributed ledgers and used as a data oracle to verify anything from the time of the arrival of a container to the specification of a cargo. So called "smart contracts" – computer codes that execute instructions upon pre-defined events – could then execute payment instructions upon the verification of the necessary facts; and title to assets or other economic rights can then be transferred automatically and with full legal recognition, on a distributed ledger.

Many of the frictional disputes and costs involved in international trade could be removed entirely by the application of such technologies. That is, for the moment, still an aspiration and there are commercial and legal challenges to be surmounted. But it is a tantalising vision of the future.

How will the commodities industry react to geopolitical tensions and technological innovations?

By Simon Vere Nicoll (Partner, Guildford)

The commodities industry faces a difficult year ahead with an ever changing political landscape, a US - China trade war and the introduction of innovative technology: this will present new challenges, but also opportunities, for traders.

Is consolidation between the industry's leading players inevitable?

US - China Trade War

Despite a temporary ceasefire between the US and China, the reality is that many of the trade tariffs remain in place. Most notably, the US-imposed tariffs target steel and aluminium imported from China, and the China-imposed tariffs target US agricultural and consumer products.

The US/China trade deficit hit a 10 year high in December 2018, when the import/export deficit increased to $491 billion. Given the unpredictability of the Trump administration, it is not clear what this will mean for the commodities industry in the short, medium or long term.

Soya bean markets have been hit hard by Chinese tariffs, pricing the US out of the market, along with many of its other bulk crops. Soya beans were the US top agricultural export to China in 2017, worth about $12.7 billion. With an oversupply in the US due to the trade war, prices are likely to fall, and the US Department of Agriculture expects world soya bean stores to grow 9% on the year to 106.72 million tonnes in autumn 2019. Traders are looking to fill the supply hole left by the US, with the likely winner being Brazil.

US oil exports are also in the midst of a drought. Before the tariffs, China accounted for 20% of all US oil exports: this is now almost down to 0%. Russia has benefited the most from China's ever growing demand for crude oil.

Amongst the unrest and uncertainty, China and the US will each be looking for suppliers in different markets; and traders will need to be agile and responsive in order to capitalise in this volatile market.

Development of Technology

The development of technology such as the use of block chain is leading to a more secure and integrated supply chain, revolutionising the way products are tracked and approved, leading to a faster, cheaper and more secure way of settling transactions in all commodities, whether soft or hard.

The technology behind block chain has the ability to cover many aspects of the supply chain, from financing to execution and logistics. The hope of moving away from the exchange of contracts and letters of credit by fax may soon become a reality.

The traditional model whereby traders financed farmers, bought their crops, stored them and sold them is ceasing to exist. Farmers have become much more sophisticated in a technology advanced world. Farmers have access to market data, yield and weather reports, and as technology develops, farmers will gain greater control.

Traditional commodity traders will be looking at forming closer ties with suppliers and investing in new technology, creating a more integrated and consolidated supply chain.

Mergers & Acquisitions

Prices across the crops sector remain relatively low, as a result of record output of coffee beans from Brazil driving down prices, increased foreign competition from the likes of Argentina, Brazil and Russia, and ever thinning margins. Soft commodity traders are likely to be forced to consolidate as they look to acquire market share amid an ever consolidated customer base.

The metals industry saw a record year in 2018 for M&A, with a total deal value of $53.4 billion, compared to $28.1 billion in 2017. Deal value in Q4 2018 declined by 70% versus Q3 2018 to $5 billion; announced deals in 2019 suggest that this may be a temporary slowdown.

The remainder of 2019 will be interesting for the commodities industry as a whole as they look to tackle a heated geopolitical climate, ongoing demand for rare metals and increased price competition in the agricultural sector. Consolidation may be the best way to tackle such issues for the bigger players but, as always, there will be opportunities for the more nimble. Vorträge bei der Veranstaltung 2019!

The industry must make the case for supply chain insurance

By Mark Wing (Partner, London). Originally published in Insurance Day.

Businesses can suffer huge losses as result of supply chain disruption – the insurance industry should do more to improve resilience.

For years now, manufacturers and retailers have been outsourcing to cut costs and improve efficiency. A whole industry has grown up to help them drive production, hone their supply chains, minimise lead times and ensure deliveries are just what they need, just in time.

The result is many manufacturers and retailers are no longer competing on their own merits. Their reputation and their ability to do business are almost entirely dependent on the competence of a small number of key suppliers and, in turn, the businesses that supply them, all of which are operating on wafer-thin margins.

Although this state of affairs has created a substantial out-sourced risk, it appears not to be one companies believe they can, or should, insure. In part this may be because the industry has been slow to step up to the mark.

Cover for supply chain risks is a form of business interruption insurance, which historically has been limited to interruption flowing from damage to the insured's own property. This means an event that does not have a physical effect on the insured's property (such as DHL's failure to distribute chicken to KFC's restaurants) would not give rise to an insured business interruption loss under a standard policy, no matter how significant the impact on the insured's business.

Insurers' attempts to increase the relevance of the cover, via contingent business interruption policies or, more recently, bespoke multinational supply chain programmes, appear also to be failing to gain traction.

The 2017 BCI supply chain resilience survey found 51% of businesses said their supply chain-related losses were uninsured. Recent surveys by CNA Hardy have repeatedly shown supply chain is never a risk that rises to the top of the boardroom agenda, irrespective of horror stories in the news.

Why is cover not being bought? There may be a number of reasons for this. Supply chain complexity is a fact of life. It is relatively easy to perform deep vetting on a company's known main suppliers, all of which will be required to meet the appropriate regulatory standards – ISO, employment, health and safety and so on – and all of which are subject to external audit.

Secondary suppliers

The challenge is more for companies to get their arms around the broad network of smaller businesses supporting these main contractors, for which there may be no central procurement process and therefore less data available. Knowledge of the chain is essential if risk is to be managed and cover to be made effective and affordable.

An even more fundamental issue is that businesses are either unaware of the existence of supply chain cover or that nothing is available that fits their needs. Supply chains are bespoke, so there is no "one size fits all", standard product, even at the more developed multinational programme level. With so little traction in the risk-managed corporate market, there is little data available to build insight into losses, making it impossible for more standard covers to trickle down into the mid-market.

With specialist cover hard to access, standard practice appears to be for most businesses to manage their risks through contractual arrangements with their suppliers and, when discounts cannot be negotiated, to litigate. But while a combination of commercial leverage and legal recourse can deal with the everyday failures, it is unlikely to be sufficient to resolve catastrophic failures.

The business interruption cases we have seen in recent weeks are likely to be just the first of many as supply chains become ever more stretched and it takes less to disrupt them. The combination of fewer main suppliers forced to compete largely on price, sourcing more aggressively across a wide range of sub-contractors in a broad range of geographic markets represents both a unique concentration of risk among a few businesses, but also exposure to a much wider range of perils including natural catastrophes power failures, cyber risk, strikes, political unrest as so on.

Paradigm change

So is it time to change the paradigm? As businesses struggle to respond to the increasingly complex and interconnected environment in which they operate, this would seem to be a good time for the insurance industry to respond to the evolving supply chain threat and help improve resilience. But how?

For risk to be managed it has to be understood. Could supply chain be yet another example of where technology may provide the answer? If more supply chains could be run on blockchain, we would generate transparency and insight – paving the way for better risk management and more tailored covers at competitive prices.

As every sector reaches the point of maximum efficiency, so a new paradigm opens up. Maybe we have reached that point with supply chain insurance. Or maybe we just need to head down to Burger King.

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J456626 - March 2019