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CR Sugar Trading Ltd v China National Sugar & Alcohol Group Corp

Jason Chuah

School of Law

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ANALYSIS AND COMMENT

COMMODITY FORWARD CONTRACT AND REGULATED INVESTMENT BUSINESS – TRADING HOUSES BEWARE

CR Sugar Trading Ltd v China National Sugar & Alcohol Group Corp
[2003] EWHC 79 (Comm), English Commercial Court

Facts

This was an appeal by CR against an arbitral award made against them by the Sugar Association of London. CR also made an application for relief under section 5, Financial Services Act 1986.

CR was a physical sugar trader. CSW, the respondents, was a Chinese Government-owned company which imported raw sugar to be refined for subsequent export. CSW granted CR a series of put options whereby CR purchased the right to sell quantities of raw sugar to CSW at a very low strike price. CR paid very substantial premiums for these 'put' options. When market prices fell significantly, CR exercised their put options but CSW refused to take physical delivery (by refusing to establish the relevant letters of credit). CSW argued that the contracts were unenforceable for being in breach of the Financial Services Act 1986. That defence succeeded at arbitration.

The arbitration tribunal held that the contracts were contracts for 'investment business' and because CR was a company carrying on business in the United Kingdom without being authorised under the Financial Services Act 1986 to conduct 'investment business', the contracts were unenforceable.

Decision

David Steel J dismissed the application. The main question was whether the put options were in fact contracts for an investment purpose or commercial purpose – the former would fall within the remit of the Financial Services Act 1986. The latter are unregulated and would be exempt from the Act.

The relevant parts of the 1986 Act define 'investment business' as engaging in the business of buying, selling, subscribing for or underwriting investments or offering or agreeing to do so either as principal or agent. The critical term 'investments' includes:

- options to acquire or dispose of any investment falling within any other paragraph of Schedule I to the Act;
- rights under a contract for the sale of a commodity or the property of any other description under which delivery is to be made at a future date and at a price agreed upon when the contract is made.

It thus followed that both commodity contracts for the future delivery and options to acquire or dispose of commodities for future delivery are generally within the scope of 'investments'. Under the Statutory Guidance to that Act, a contract is regarded as made for investment purposes if it is made or traded on a recognised investment exchange or made otherwise than on a recognised investment exchange but expressed to be as traded on such an exchange or on the same terms as those on which an equivalent contract would be made on such an exchange. A contract not falling within the above shall be regarded as made for commercial purposes if under the terms of the contract, delivery is to be made within seven days. Where a commodity contract does not easily fit into these criteria, the following shall be treated as *indications* that the contract was for a commercial purpose:

(a) either or each of the parties is a producer for the commodity or other property or uses it in his business;
(b) the seller delivers or intends to deliver the property or the purchaser takes or intends to take delivery of it.

The court held that both parties were engaged in the business of purchase and sale of sugar and did not 'use' sugar in their business. As to whether the seller had intention to deliver the sugar and the buyer (CSW) had intention to take delivery of it, the court held that at the material time (when the contract was made) there was no intention to deliver or to take delivery of the sugar.

The contracts were therefore caught by the Financial Services Act 1986 and could not be enforced.

Comment

Although this case was decided on the basis of the Financial Services Act 1986 which has now been replaced largely by the Financial Services and Markets Act 2000, the lessons which might be drawn are nonetheless relevant as the new Act had not made significant changes in this context (see the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001).

It is obvious that the ruling in the present case could seriously affect trading houses – David Steel J effectively held that trading houses who merely buy and sell commodities do not 'use' the commodities they trade in. The practical implication here is that trading houses could no longer justify their commodity forward contracts as having been made for commercial purposes simply because they relied on the physical commodities for the success of their business. The effect of the financial services regime is very severe. The contract is struck down and there is also the risk of potential criminal liability. This is thus no light matter for trading houses – they really must re-examine their contractual relationships with their financing banks and customers based around forward contracts. Traders who deal in physical goods should not think they are exempt from financial services law; while it is clearly open to them to avoid risks by protective measures such as forward contracts and options, they must be careful that these measures could very well be caught by financial services legislation.

This case is also the first reported decision on how the distinction between 'commercial' and 'investment' purposes in the context of international trade should be made. The key issue, as far as David Steel J was concerned, was whether one or more of the parties is a producer or uses it in his business. The issue is not one of law, according to the judge. It is one of fact or construction. The judge said:

> 'In its ordinary meaning, the verb "to use" connoted the process of putting into service or consuming material . . . Those who simply buy and sell material are more likely to be indulging in market speculation than those who produce or consume material.'

All this is without controversy generally. However, as to whether the fact that CSW had in the past imported sugar for refining and resale (known as tolling operations) could support the argument that CSW 'used' the commodity in its business, the court held that it was not relevant because at the time the options were granted, CSW had ceased its tolling operations and in any event, the refining processes were carried out by third parties. This raises a few interesting points. Whilst it is clear that CR's submission should fail, it is at least open to discussion as to whether tolling operations, had they not ceased, would have made an impact on the finding. The court referred to 'putting into service or consuming material'. Does that connote end-use? Additionally, it might be concluded that the court's outright dismissal of the argument on the basis that the sugar was, in any event, to be refined by a third party seems to confine the term 'use' to own or personal use, not 'the process of putting into service or consuming material' involving the agency of a third party. All in all, we are no closer to what 'use' entails, especially in respect of traders seeking to take advantage of the inward (or outward) processing relief schemes available in the United Kingdom and elsewhere. Naturally the court's approach must largely be dictated by the term 'use' in the Statutory Guidance but perhaps, as far as the legislator is concerned, a matter of some consideration should be to place greater emphasis on whether the object of the arrangements was to profit from market speculation.

The second principle to emerge from this case is that in determining whether the parties had intention to deliver or to take delivery of the goods, the operative time is when the option is granted and not when it is exercised. This part of David Steel J's judgment confirms Guidance Release No3/88 of the Securities and Investment Board which states:

> 'In determining a person's intentions, regard will certainly be had to any expression of those intentions, for example, in the contract itself, or which relate to a course of dealings between the parties. This does not mean that the parties can contract out of regulation under the Act; merely that an expression of their intentions is strong evidence of what those intentions are. *In this context it is worth mentioning that the test of intention applies at the time the contract is made*. A subsequent change of intention does not affect the status of the contract so long as it does not lead to a near agreement or doubts about the original basis of the original agreement . . .' (*emphasis added*).

It must however be submitted that this too is not an entirely satisfactory test. As in the present case, the fact was that it was not a simple open and shut case of no intention. The element of intention could be characterised in this way: the intention was to effect physical delivery if the strike price is met and the put option is exercised. The parties' intention was thus conditional (on market conditions). On this issue there was little guidance from the court – the position was that as the tribunal had concluded on the facts that 'the parties had persistently left out the possibility of delivery' and as this was a fact-sensitive issue, the tribunal's findings should not be overturned.

As far as principles are concerned, this case regrettably, though understandably, offers little. It does, however, highlight quite compellingly the perils of mixing commercial transactions with market speculative actions for trading houses.

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