# REGULATING THE COMMODITY TRADING INDUSTRY:

# COMPARING FIRM RESPONSES IN BRUSSELS AND BERNE

Jakob Engel - PhD Candidate in Economic Geography, University of Oxford
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# Outline

1. Introduction, context and motivation
2. Theoretical framework and research questions
3. Case study: payment disclosure regulation
4. Initial findings

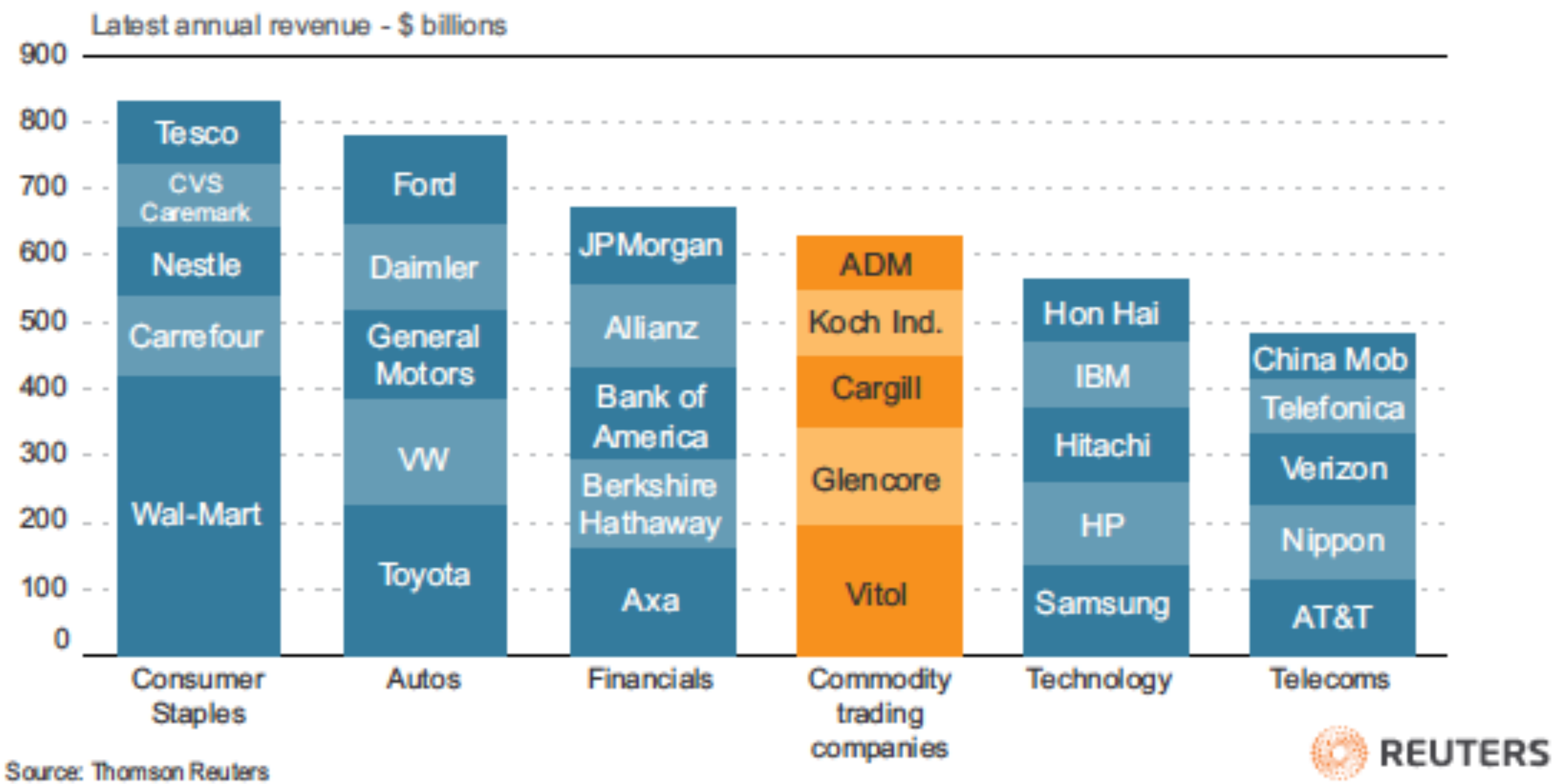
# The growth of the *modern* commodity trading industry: A very short economic history

- Commodity trading has existed for centuries to bring energy, metals and grains from production areas (especially colonies) to port cities and capitals.

- **Business model:**
  - 'transforming commodities in space (logistics), in time (storage), and in form (processing)'[1]
  - Knowledge of spatial distribution of current and future commodity supply & demand as prime asset of commodity trading firms and their traders.

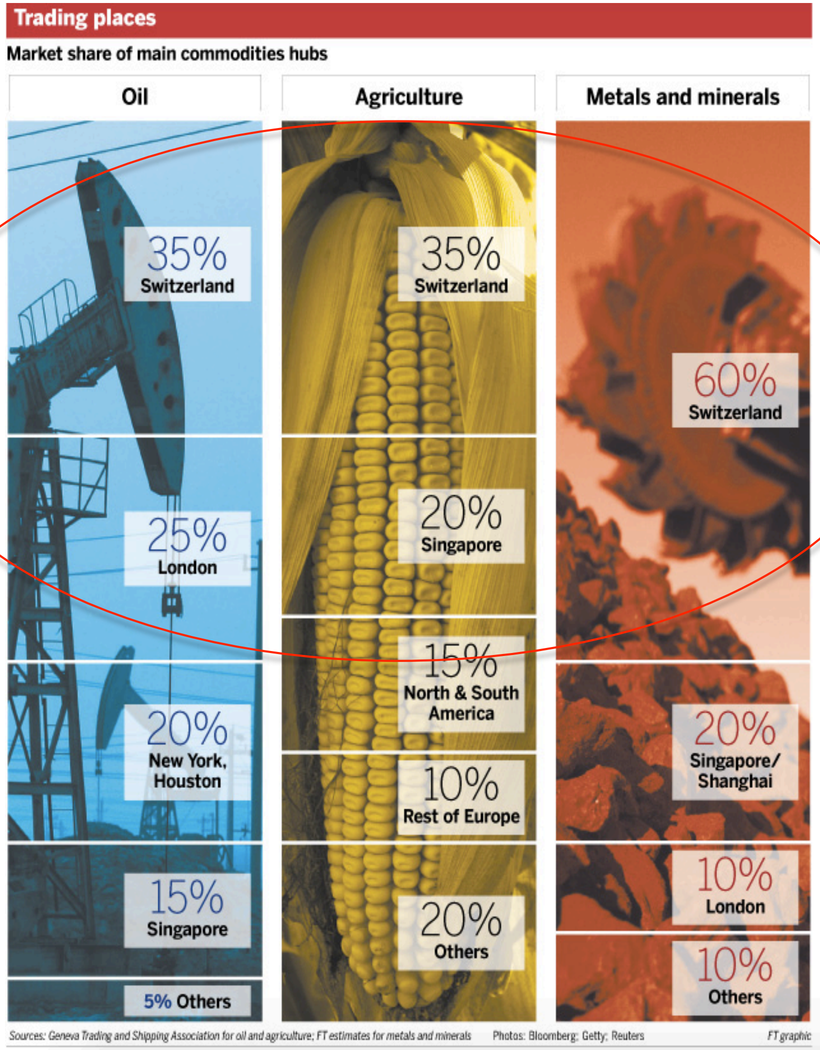
[1] Pirrong 2014, p. 4

# Commodity trading has become a globally significant industry



# The CT industry and its spatial concentration

- Commodity trading has become a globalised industry driven by a few hubs.
- Geography has shifted from Houston, Calgary, London and Rotterdam towards Geneva and Singapore and increasingly Dubai with emerging economies developing SOE trading  firms.
- Heavily concentrated in greater Geneva-Lausanne-Zug region.
  - Growth from appr. 200 firms in 2006 to over 500 in 2012.
  - Makes up over 3.5% of Swiss GDP.
  - Over 9% of output.

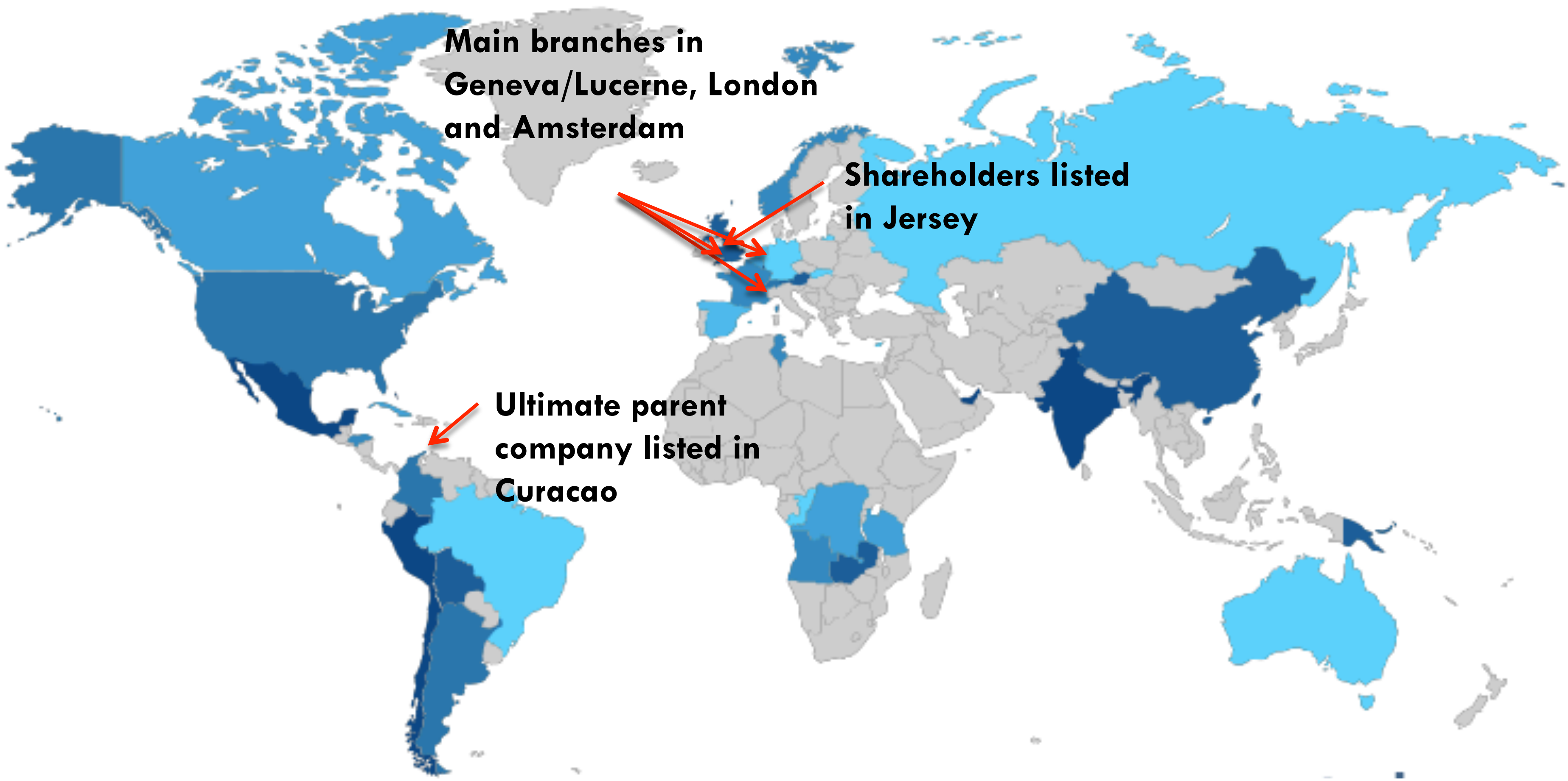


# Taxation and trading hubs

| Hub | | Corporate tax rate | Additional financial 'perks' for CTFs |
|---|---|---|---|
| Current leading hubs | **Switzerland** | 18%, but generally 8-10% for CTFs | Further reductions possible (e.g. financing activities can be taxed at 1%)<br>Availability of binding advance tax rulings<br>Extensive tax treaties and financial rulings |
| | **Singapore** | 17%, but 5-10% for CTFs | "Global Trader Programme" for CTFs<br>Extensive network of tax treaties<br>Low personal tax rates |
| Historical hubs | **UK** | 20% | Wide tax treaty and investment treaty network<br>Leading financial center |
| | **Netherlands** | 25%, but 5-15% effective tax rate | Sophisticated infrastructure |
| | **Hong Kong** | 16.5%, but 0% for trading occurring outside HK | Strong financial services sector |
| | **Houston** | 40% | No local and stat4e personal taxes<br>Sophisticated financial infrastructure |
| | **Calgary** | 26.5% | Foreign affiliate taxation system for tax-free repatriation of income from trading |
| Future hubs | **Dubai** | 0%-55% (negotiable) | No income tax<br>Growing system of international taxation treaties |
| | **Brazil** | 34% | |
| | **Barbados** | 25% | Actively seeking to attract traders, esp. through Barbados International Business Corporations system |

Source: KPMG

# 100+ subsidiaries of Trafigura




Source: Orbis Global Business Database, Berne Declaration 2010

# An industry in flux…
# What has changed in the last 15 years?

- **Vertical integration**: trading firms behave more like **extractive companies.**
  - Asset-heaviness has increased substantially for many firms, most notably through Glencore-Xstrata merger.

- **Financialisation**: trading firms behave more like **financial institutions.**
  - Large CTFs are have internalized increasingly sophisticated financial operations – including firm-internal hedge funds and asset management operations.
  - Heavy recruitment from financial sector in post-crisis years.
  - Border between “speculation” and “bona fide hedging” is increasingly blurred.

# Financials

March 31, 2014 6:09 pm

## Banks' retreat empowers commodity trading houses

By Neil Hume, Commodities Editor Author alerts


Over the past decade, the world's banks have with little fanfare bec immersed in a business far remo their traditional lending activity: of physical commodities.

Morgan Stanley was one of the la shippers of fuel oil to New York I Deutsche Bank at one point held enough aluminium to build 30,000 jum JPMorgan helped ship Brazilian sugar to buyers around the world.

Commodities headcount


But now the banks are retreating from the s masse. The once-in-a-generation shift is em little regulated and largely privately owned commodities trading houses such as Vitol, T and Louis Dreyfus Commodities to consolic



Commodity trading

## End-to-end game

**Commodity-trading houses are growing—and running more risks**

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BANKS, harried by regulators and short of capital, are fleeing the commodities business. Deutsche Bank, Morgan Stanley and UBS either shuttered or shrank their commodities operations last year; this year Barclays, Credit Suisse and JPMorgan Chase have scaled back. But even as they retreat, commodity-trading houses, most of which began life as simple middlemen, are getting ever more deeply involved in the extraction, shipping and refining of raw materials.

The buyer of JPMorgan Chase's physical commodities unit, for instance, was Mercuria, a ten-year-old firm based in Switzerland that started out trading oil but now owns (or has joint ventures with) oil-exploration companies, oil-terminal and pipeline operators, coal and iron-ore mines and biofuel refineries. Vertical integration of this sort gives trading operations more ft.com > companies >

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# WALL STREET BANK INVOLVEMENT WITH PHYSICAL COMMODITIES

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## UNITED STATES SENATE

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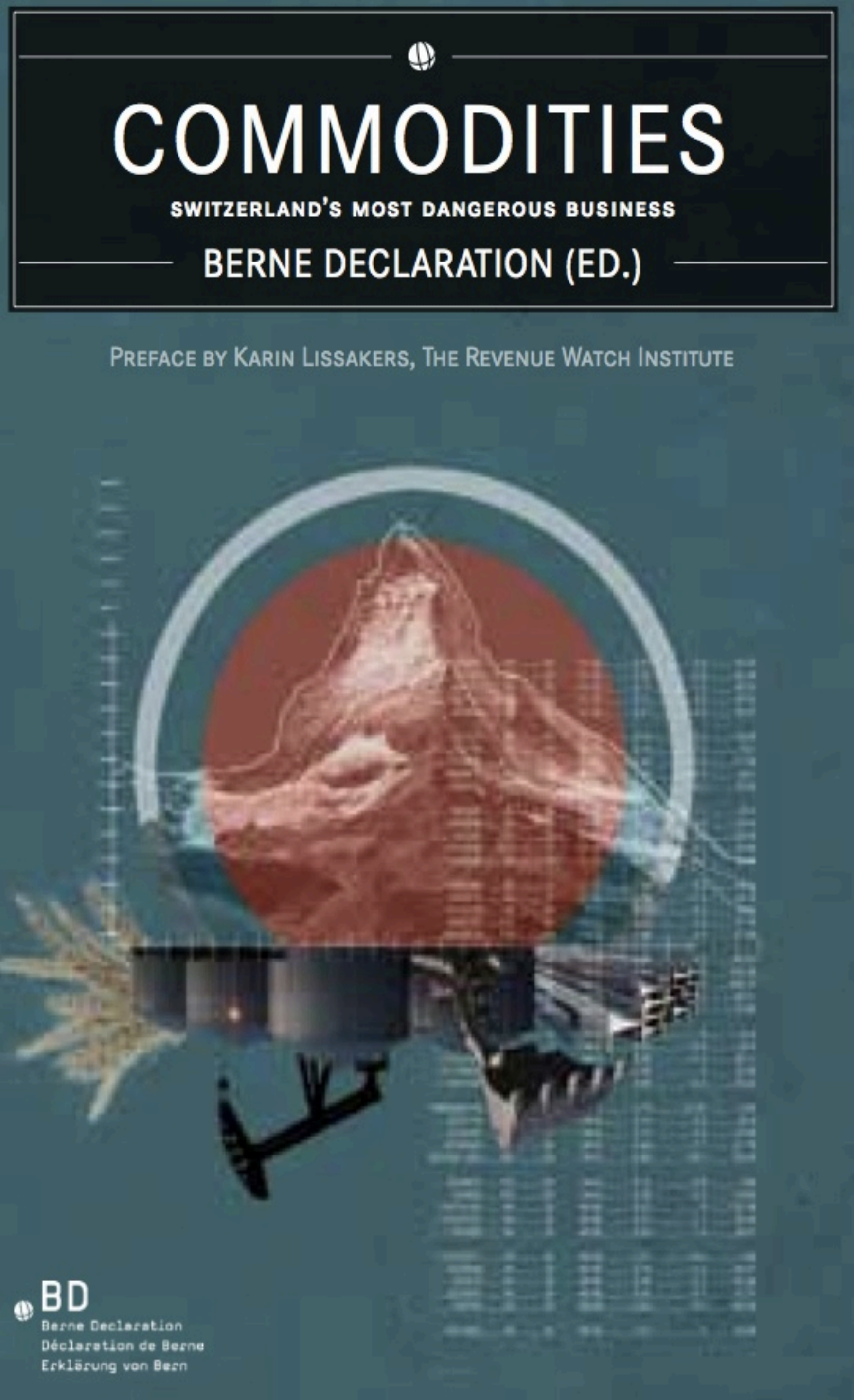
- **Corporate social responsibility:** trading firms have been targeted by numerous civil society organisations concerned about their corporate behaviour and impact on commodity-exporting countries.



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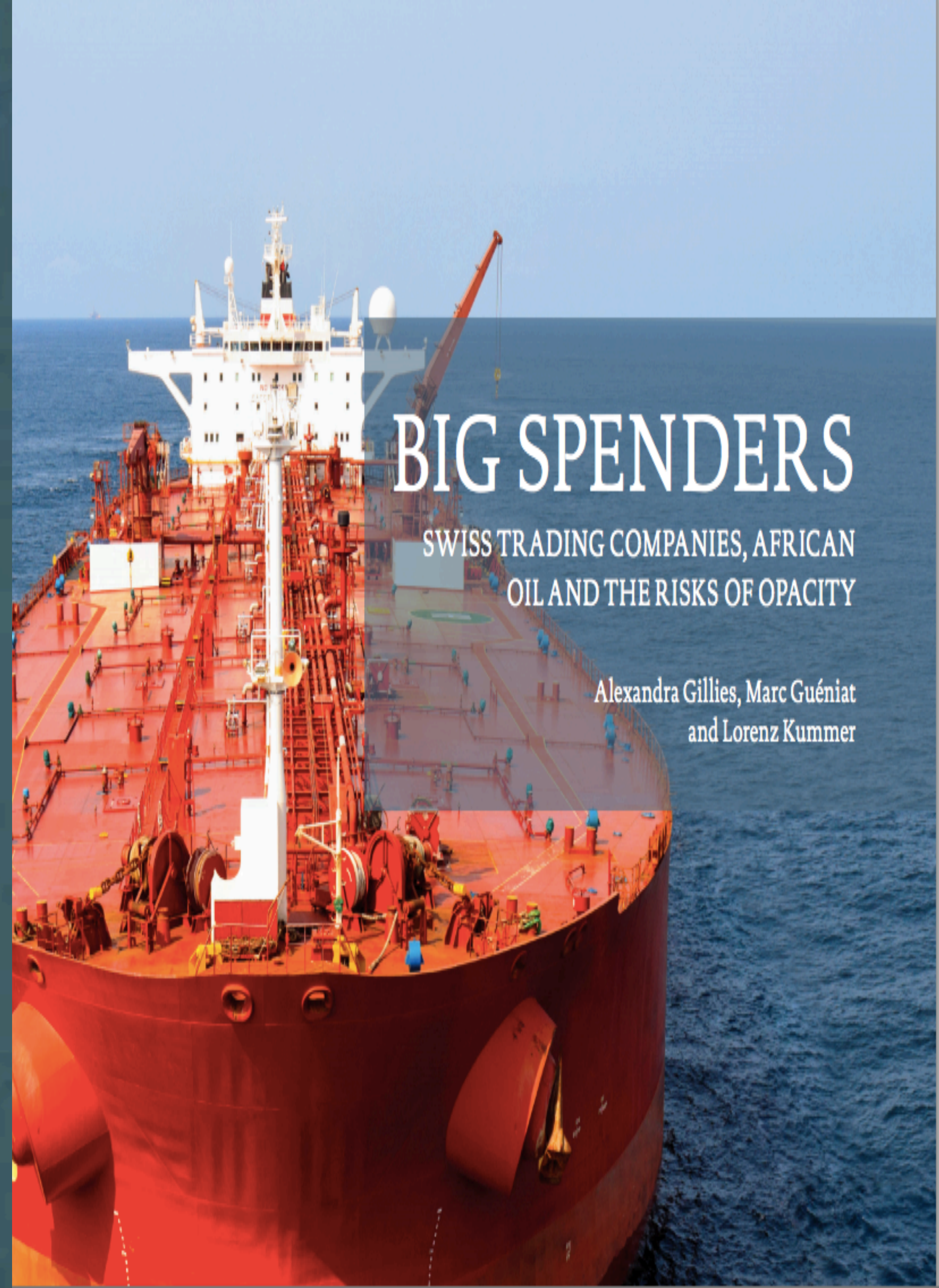

BIG SPENDERS
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Alexandra Gillies, Marc Guéniat and Lorenz Kummer


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# A changing regulatory landscape for the commodity trading industry

| Domain | Legal/regulatory framework | Potential implication for CTFs |
|---|---|---|
| Access to **trade finance** and **capital requirements** | FSB shadow-banking review of SINFIs (Global) – meanwhile abandoned | Higher lending rates and reduced liquidity for trade finance |
| | Basel III (Global) | Trade finance glut, especially for higher-risk counterparties |
| **Derivatives (esp OTC trade)**<br>• Increased reporting requirements of trades<br>• Depending on size of firm, central clearing obligations for trades<br>• Position limits, except if held by hedgers | Dodd-Frank (US)<br>REMIT/EMIR/MAD (EU)<br>MiFID II (EU)<br>FinfraG (Switzerland) | • Upgrades and increased compliance costs for reporting requirements<br>• Restrictions in size of positions<br>• Larger working-capital needs<br>• Need for long-term planning of trades (30 days) to satisfy hedging exemption |
| **Transparency, taxation, corporate responsibility** | *Grundlagenbericht Rohstoffe* (Switzerland) | Recommendations relating particularly to the application of multilateral standards and greater cooperation with Swiss Gov. |
| **Taxation** and **transfer pricing/ profit shifting** | Guidelines on “Transfer Pricing Aspects of Cross-Border Commodity Transactions” (OECD) | Move towards comparable uncontrolled price (CUP) method |

# Research questions

***Research questions***

1. How has the commodity trading industry responded to the risk of more stringent regulation ?
2. How has the the prospect of regulation impacted this very lightly regulated industry…
   - At the industry level?
   - Within individual commodity trading firms?

# Rapid overview of relevant literature

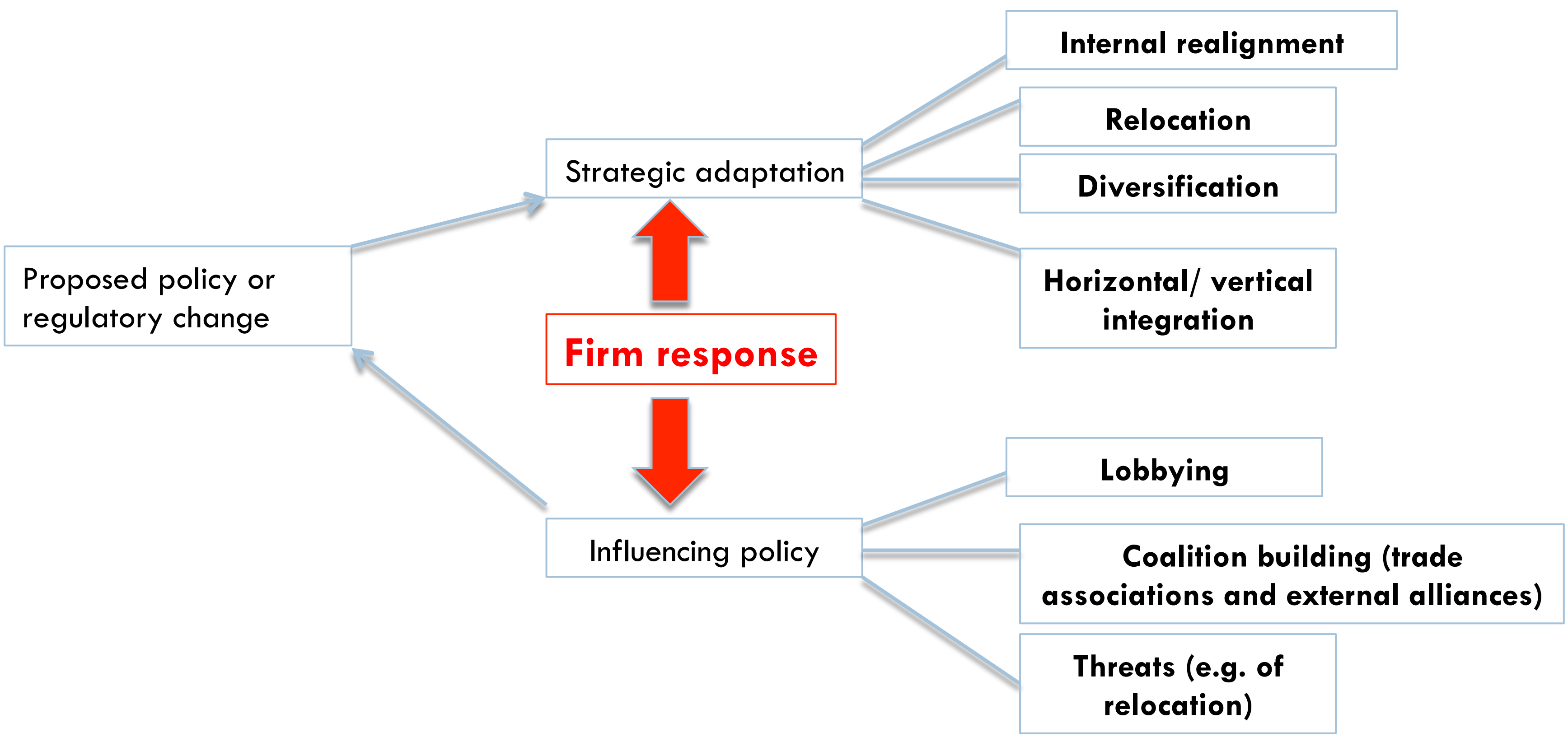
- **Theories of firm behaviour in the context of regulation**
  - Business/management studies lit on firm responses to regulation : Leone 1986, Porter 1980, Schaffer 1995 – provides framework for firm behaviour
  - Resource dependence theory – government regulations as a key aspect of a resource-dependent firm's ability to control its environment: Pfeffer and Salancik 1978.

- **IPE/socio-legal studies on global business regulation and shift from national, public regulation to global, semi-private institutions**
  - CF. Braithwaite & Drahos 2000, 2002; Stiglitz 2007, Levi-Faur 2011, Büthe and Mattli 2011
  - Substantial post-crisis literature on re-regulation of financial sector - points particularly to the importance of legitimacy and alliance formation in regulatory outcomes (Porter 2013, Helleiner 2014, Pagliari and Young 2015, Williams 2015)

- **GVCs/GPNs and their political & economic relationship to host regions**
  - Significance of state actors and regulations in determining processes of 'strategic coupling' – Henderson et al. 2002, Smith 2014, Ponte and Sturgeon 2014, Coe and Yeung 2015)
  - But very limited analysis of services industries and of financialisation in corporations (though this is emerging in Seabrooke and Wigan 2015, Coe, Lai & Wojcik 2015.

# How do businesses respond to new regulations?

***"The indirect and unintended competitive consequences of regulation are an important and poorly understood part of the regulatory process."*** Roberta Leone 1981, p. 117




Source: Adapted from Schaffer 1995

# Methodological approach & challenges

***Methodological approach***

**Comparative analysis** of commodity trading industry in 2 areas of regulation:

1. **Disclosure of payments** to foreign governments (Swiss *Grundlagenbericht*).
2. **Position limits** under new **commodity derivatives regulation** in EU (MiFID II) and US (Dodd-Frank).

**Process-tracing** – *based on:*

- *Semi-structured interviews with trading executives and regulators in multiple jurisdictions,*
- *Review of regulatory texts, EC/ESMA, CFTC & Swiss consultation documents and hearing transcripts, CTF financial records and annual report*
- *Review of media and particularly trade publications (e.g. risk.net, FOW, etc.)*

***Challenges***

1. **Demonstrating causality** between regulatory change and firm/industry behaviour.
2. **Comparability** between two different regulatory processes at very different levels of jurisdiction.
3. **Tracking a moving target** (i.e. both regulatory processes are ongoing and firm-responses are likely to have longer lags).

# Context

- Pressure on extractive companies to improve transparency of transactions – development of numerous codes of conduct (e.g. EITI).
- Mobilization of Swiss NGOs, MPs & media questioning behaviour of domestic commodities industry.
- Swiss government comes under pressure to incorporate greater transparency into legislation – extensive cross-government consultation process for White Paper (*Grundlagenbericht*).
- Report has numerous recommendations on improving corporate behaviour but commodities trading industry – unlike extractive companies – remains exempt from new requirements to report payments to foreign governments.

# Industry response

- Policy influencing
  - Threats to relocate to emerging commodity hubs in Asia (especially Singapore) due to "competitive distortions".
  - Creation of Swiss Trading and Shipping Association with large paid staff ("*I think he's in Berne almost every day*").
  - Strong support in consultations from sub-national governments (especially in Lake Geneva region), as well as from Franco-Swiss financial and business service sector.

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  - Strong support in consultations from sub-national governments (especially in Lake Geneva region), as well as from Franco-Swiss financial and business services sector.
- Strategic adaptation
  - Massive increase in *publication* of CSR and sustainability activities by CTFs.
  - Sustainability advisors/VPs integrated into all major firms.
  - Trafigura is first to exceed requirements and adopt EITI standards.

# Initial findings

- By advertising significance to domestic economy (3.6% Swiss GDP) and through strategic alliances, the CTI has succeeded in averting large changes to the status quo (for now) → the competiveness argument has been central here.

- Level of regulatory oversight (ie. national vs. trans-national) impacts how regulation is combated in terms of approach used, allies sought and effectiveness of regulatory arbitrage threats.
  - The different role of the financial industry as both an ally and rival has been notable.

- Regulatory dynamics are becoming drivers for changes to firms' internal organisation.
  - Firm level: investments in compliance, corporate affairs & CSR departments are changing organisational culture → Trafigura as paradigmatic case study.
  - Industrial structure – first signs that we are seeing stronger concentration and collaboration given increased compliance and transaction costs