SEPTEMBER 2008

FINANCIAL MARKETS LAW COMMITTEE

ISSUE 133 – BANKING REFORM, DEPOSITOR PROTECTION – THE SPECIAL RESOLUTION REGIME

Response to the July 2008 Tripartite Consultation Document on a Special Resolution Regime

c/o Bank of England
Threadneedle Street
London EC2R 8AH
www.fmlc.org

FINANCIAL MARKETS LAW COMMITTEE

ISSUE 133 WORKING GROUP

Peter Beales	LIBA
Simon Gleeson	Clifford Chance LLP
Matthew Jolly	UBS
Dorothy Livingston	Herbert Smith
Michael McKee	DLA Piper
Ed Murray	Allen & Overy LLP
Bob Penn	Allen & Overy LLP
Bill Tudor John	Lehman Brothers
Christina Turton	Barclays
Joanna Perkins	Secretary, FMLC
Saima Hanif	Legal Assistant, FMLC

CONTENTS

1. Introduction and Summary

a) Introduction

1.1 In July 2008, the Financial Markets Law Committee ("FMLC") produced its response to the April 2008 'Financial Stability and Depositor Protection" Tripartite consultation paper. That response focused exclusively on the proposal for a special resolutions regime ('SRR'), and in particular, the safeguards that were necessary to prevent, as far as possible, any negative repercussions for the markets.

1.2 Shortly before the publication of that paper, the Tripartite Authorities produced a third consultation document which dealt specifically with the SRR and included draft legislation.[1] This paper is a response to that third consultation document. It builds upon the views of the FMLC expressed in the response of July 2008.

b) Background and Summary

1.3 Of particular concern to the FMLC, is the proposal to vest certain "stabilisation" powers in the Authorities, allowing them to effect property and share transfers, pursuant to a strategy which may involve transferring the bank which is subject to a resolution to a new owner, creating a bridge bank or effecting a partial transfer of the bank's assets to the new entity. The powers, which are set out in clauses 14 to 23 of the draft legislation, include the power to draw up a property transfer instrument which will provide for the property (in the UK and overseas), rights and/or liabilities of the bank subject to the resolution to be transferred either in whole or in part. Clause 19 provides that the effect of a property transfer instrument may be, inter alia, to avoid any contractual termination clause or similar which specifies the resolution itself, and consequent property transfer, as a default event. Clause 17 provides that a property transfer instrument may make any one of a number of provisions to substitute a transferee ("Newco") for the struggling bank in relation to its contractual undertakings and provides, in sub-paragraph (6) that enforceable

1 "Financial stability and depositor protection: special resolution regime", July 2008, Cm 7459.

rights and liabilities in respect of any asset may be apportioned between Newco and the struggling bank (presumably, with the intention that rights may be transferred and liabilities retained by the bank). Collectively these powers are referred to below as "the contractual override powers".

1.4 It is against the market risks inherent in these very wide powers that the FMLC seeks safeguards. If these inherent risks arise at all, they are likely to begin to materialise as soon as the provisions establishing the powers come into force, and not at the time when the SRR is established in respect of a particular bank. This is because the existence and potential use of the statutory powers will have to taken into account when a creditor enters into a commercial transaction with any bank that could conceivably be subject to the regime at a later date.

1.5 When the Authorities' possible use of the powers has been taken into account, it may be seen that it has a negative regulatory or commercial impact on the transaction in question affecting its feasibility. In particular, legal opinions relating to the transaction will be "qualified" rather than "clean", to the extent that lawyers must allow for the legal possibility that their client's counterparty may be subject to a special resolution. This could ultimately affect the regulatory capital that their client would have to assign to the putative exposure, making the deal much less attractive. Cumulatively, the effect of establishing the statutory powers, even if they are never actually used, could be damaging to the interests of the deposit-taking banks that are within the regime and potentially subject to an exercise of the proposed stabilisation powers.

1.6 It is against these risks that the FMLC seeks protective safeguards.

1.7 Whilst it is acknowledged that some of the safeguards thought by the FMLC to be necessary have been included in the July Consultation Document, there remain significant legal uncertainties in relation to the contractual override powers and the protection of netting arrangements in particular:

- The proposal to safeguard some netting arrangements would only apply to individual netting agreements and not to master netting agreements. As explained in more detail below, this ignores the considerable importance for banks' risk mitigation models of being

able to rely on the legal robustness of global netting arrangements and on insolvency set off;

- The limitation of the netting safeguard to "Qualifying Financial Contracts" also restricts the efficacy of netting and set off and could stifle innovation of new products.

1.8 The FMLC is further concerned that any drafting to implement the proposed safeguards has not yet been subject to public scrutiny, nor has it been made clear in what instrument they would be set out. This makes a satisfactory review of the overall consequences impossible.

2. Legal Certainty

a) Legal Opinions and Regulatory Risk

2.1 As set out at length in the FMLC's July 2008 paper, the acid test of legal certainty in the financial markets is the legal opinion. In order for any contractual term to be treated as binding for regulatory, capital and risk purposes, the contract must be covered by an appropriate legal opinion.[2]

2.2 The legal opinion must draw two clear conclusions – that the terms of the contract, including any early termination and close-out netting provisions,[3] will be valid between the parties whilst they are solvent, and that as regards each party the contract will be effective in the insolvency of the other party.

2.3 In a situation where a government has a power to act to avoid termination and netting provisions but has given non-binding guidance that it will not do so, the position is identical from a legal certainty perspective to that which would prevail if no such guidance had been given. A law firm giving a legal opinion

2 Although the FSA Handbook does not at any point use the phrase 'legal opinion', it is questionable whether in practice, anything less then a legal opinion will provide confirmation that a contractual term is binding.

3 Subsequently in this paper when we refer to "netting", we mean "close-out netting", that is netting of transaction values under a master agreement following early termination of transactions, mark-to-market valuation, conversion of those values to a single currency and determination of a net amount due. Other types of netting typically occur prior to insolvency, namely, payment or settlement netting and netting-by-novation, and are aimed principally at operational efficiency and reduction of settlement risk rather than directly at post-default credit risk. Similarly, in this paper when we refer to a "collateral arrangement" or "collateral agreement", we normally mean a financial collateral arrangement of the type contemplated by the Financial Collateral Arrangements (No. 2) Regulations 2003 SI 2003/3226.

must draw attention to this power and cannot give an assurance that such power will not be exercised based on a non-binding statement of executive intention.

2.4 The proposed "code" will be no more than a non-binding indication of opinion, in that the various parties will be required to do no more than to "have regard to" its content. The meaning of this term was examined by the court of appeal in *Dunnachie v Kingston-upon-Hull City Council*.[4] The effect of this decision is that the practical effect of the words "must have regard to" in a statute is no more than "may not completely disregard". Clearly an administrative decision could be challenged on this basis if, where a public authority was required to "have regard to" a particular consideration, it could be shown that the authority had reached its decision by completely disregarding that consideration or could have reached it only by doing so. However, in any other circumstance the term has no restricting or limiting effect on the public authority.

2.5 In light of the fact that the proposed legislation seems intended to give the Authorities a broad power to vary the terms of any contract as they see fit, it is virtually impossible for there to be any legal certainty in respect of a contract with a UK institution subject to the regime. In short, the width of the suggested powers severely curtails the ability of a law firm to provide a clean legal opinion.

2.6 As such, unless there is further protection for counterparties in the form of limits on the statutory override powers, law firms would find themselves unable to give such an opinion. The qualified opinion which they would feel able to give would not necessarily satisfy the regulatory requirements for clean opinions that are imposed by the FSA and yet there is no discussion of this anomalous possibility or any suggestion that those requirements will be modified.

2.7 The role of clean legal opinions in regulation, particularly with regard to termination provisions and netting agreements, is discussed further below. However, at this stage it is important to note that specific concerns arise in relation to the contractual override powers in the context of structured finance

4 [2004] EWCA Civ 84.

transactions and securitisations, which must benefit from clean opinions not only for regulatory purposes but also in order to obtain favourable ratings for the issued securities. The SRR proposals could, it seems, result in the "true sale" opinions being called into question. To avoid this, it is essential that the proposed legislation is amended to make it clear that the powers of the Bank of England do not extend, for example, to overturning transactions between the issuer and LLP in a covered bond transaction (and possibly other provisions in programme agreements).

2.8 In the context of the current liquidity crisis, this legislation is likely to exacerbate the reluctance of financial institutions to provide funding to (other) deposit-taking institutions; banks that are rumoured to be in difficulty would be even less attractive as business partners if law firms could not give clean legal opinions. This problem is not ameliorated by assurances that the powers will not be exercised 'unreasonably', or that regard will be had to a non-binding statutory code.

b) Netting and Collateral Arrangements

2.9 Banks operate netting and collateral arrangements in order to reduce risk and mitigate regulatory capital requirements. The enforceability of such arrangements is key to their recognition for regulatory capital purposes. The ability to manage risk on a net (rather than gross) basis, taking into account the ability to realise collateral and undertake close-out netting is a key part of management of economic, as well as regulatory, capital.

2.10 Netting and collateral arrangements are, of course, only useful as mitigants of credit risk if they can be enforced on a default or insolvency of the counterparty. Accordingly, they are subject to requirement on enforceability as a result of Basel II, which is implemented into European law via two directives - 2006/48/EEC (the restated Banking Consolidation Directive (**BCD**) and 2006/49/EEC (the revised Capital Adequacy Directive (**CAD**) (together generally referred to as the Capital Requirements Directive (**CRD**)). The regulatory capital requirements applicable to banks are complex: it is out with

the ambit of this paper to explore those requirements in any detail; hence the following is a high-level summary of this area only.

c) Regulatory Requirements

2.11 Netting is recognised in the CRD regime generally as a mitigant of credit risk. The CRD sets out detailed requirements for the recognition of netting and collateral.

Off-balance sheet exposures

2.12 In relation to netting of off balance sheet exposures, Part 7 of Annex III sets out a requirement that netting agreements should be recognised by competent authorities only if there is

> *a written and reasoned legal opinion to the effect that, in the event of a legal challenge the relevant courts and administrative authorities would find that the credit institution's claims and obligations would be limited to the net sum of their transactions and rights under*:
>
> - *the law of the jurisdiction in which the counterparty is incorporated…*
> - *the law that governs the individual transactions included, and*
> - *the law that governs any contract or agreement necessary to effect the contractual netting.* [5]

2.13 Absent satisfaction of this condition netting may not be recognised – resulting in the need to hold capital on the basis of a gross, rather than net, exposure.

On balance sheet netting

2.14 On balance sheet netting is also recognised in respect of reciprocal cash balances between a bank and its counterparty, provided that (inter alia) the on-balance sheet netting agreement is "*legally enforceable and effective in all relevant jurisdictions, including in the event of the insolvency or bankruptcy of a counterparty*" (Annex VIII Part 2 Point 3).

5 Paragraph (b) (ii) of Part 7.

2.15 Again, absent satisfaction of the condition, on-balance sheet netting is not recognised – requiring capital to be held on the basis of a gross, rather than a net, exposure.

Credit risk mitigation

2.16 The BCD includes a specific regime for credit risk mitigation – covering guarantees, credit derivatives, and collateral.[6]

2.17 Article 92(1) requires:

> *The technique used to provide the credit protection together with the actions and steps taken and procedures and policies implemented by the lending credit institution shall be such as to result in credit protection arrangements which are legally effective and enforceable in all relevant jurisdictions.*

2.18 Article 92(4) sets out a high-level requirement in respect of funded credit protection (cash collateralized exposures such as credit-linked notes) as follows:

> *In the case of funded credit protection, the lending credit institution shall have the right to liquidate or retain, in a timely manner, the assets from which the protection derives in the event of the default, insolvency or bankruptcy of the obligor — or other credit event set out in the transaction documentation — and, where applicable, of the custodian holding the collateral. The degree of correlation between the value of the assets relied upon for protection and the credit quality of the obligor shall not be undue.*

2.19 Article 92(5) sets out eligibility requirements for unfunded credit protection (such as credit default swaps and guarantees): this includes that

> *…the party giving the undertaking shall be sufficiently reliable, and the protection agreement legally effective and enforceable in the relevant jurisdictions, to provide appropriate certainty as to the credit protection*

6 Subsection 3, Section 3, Chapter 2, Title V.

achieved having regard to the approach used to calculate risk-weighted exposure amounts and to the degree of recognition allowed.

2.20 Failure to comply with these conditions results in the relevant protection not being recognised. It is clear that doubt as to enforceability will affect the certainty of counterparties to UK banks as to their rights on entry of a UK bank into the SRR.

d) Effect of the SRR

2.21 The uncertainty manifested in legal opinions is also likely to affect firms who seek to do business with institutions which are authorised to take deposits and might potentially be subject to the SRR. Uncertainty as to whether core contractual terms, such as termination and netting provisions, can be enforced as negotiated is likely to make transactions more costly and firms more reluctant to enter into them.

2.22 If a firm suspects that a deposit-taking institution is in financial difficulty it will be more likely to feel uncomfortable about acquiring new exposure to that institution and there may be a general reluctance to act as a counterparty to the institution in question. This could have the effect of restricting liquidity and funding at a time when the institution is already experiencing financial difficulties and could exacerbate those difficulties.

2.23 To the extent that the SRR undermines legal certainty such that a bank cannot satisfy itself as to the conditions above, then it will seriously affect the regulatory capital requirements associated with the recognition of netting and collateral for counterparties to UK banks. This in turn will risk adversely affecting the ability of UK banks to deal with regulated institutions.

e) Illustration

2.24 The consequences of the loss of legal certainty may be readily illustrated: UK bank A has a derivatives book. Among its counterparties is French bank B. A and B are party to an ISDA master agreement and a foreign

exchange master agreement. The parties have also entered into a master netting agreement and collateral support agreement, which is used to post collateral from A to B (or vice versa) to the extent that the net mark-to-market position between the two exceeds £1 million. The gross value of the transactions under the arrangements exceeds £500 million. The mark to market value of the transactions under the ISDA is £10 million in favour of A, and of the transactions under the foreign exchange master agreement is £15 million in favour of B, leaving a net balance of £5 million in favour of B. A has posted £4 million (plus a haircut) of high quality securities by way of collateral to B.

2.25 Presently, B will account for its exposure to A on the basis of the net position under the master netting agreement and regard the collateral balance as further reducing that net balance.

2.26 If the SRR regime does not preserve the enforceability of netting under the ISDA agreement and the repurchase agreement, then the exposure of B will be required be held on a gross basis for regulatory capital. This would result in a massive increase in the capital requirements associated with those exposures – sufficiently large to render the relationship uneconomical for B. It would also be likely to result in a breach of B's large exposures requirements.

2.27 If the SRR preserves the enforceability of the ISDA and foreign exchange master agreement, but not the master netting agreement, then B will not longer have the benefit of being able to net the balance of the two together – resulting in a capital charge in respect of the exposure of £15 million (less the £4 million of collateral, assuming collateral is recognised). This could affect the economic viability of the relationship, and would be likely to result in B asking for collateral to mitigate the additional exposure or a higher risk premium in respect of the relationship – a cost which would fall on A.

2.28 Similarly, if the SRR preserves the enforceability of all of the netting arrangements, but not the collateral arrangement under the master netting

arrangement (assuming that it is not covered by the EU Directive on Financial Collateral Arrangements (2002/47/EC) ("FCAD")), then B's capital requirements will have to be based on the £5 million exposure, rather than £1 million.

2.29 Banks exist in a competitive market – both in relation to the sale of financial services and the raising of funding. Increased capital requirements for bank counterparties will reduce the attractiveness of credit relationships with UK banks, and accordingly raise the cost of relationships whose enforceability is affected by the SRR.

3. Safeguards - The Concept Of A "Qualified Financial Contract"

a) Some markets rely on bespoke contracts and master netting arrangements

3.1 There is a risk that those parts of the financial services industry that rely on non-standard netting arrangements may view commercial arrangements with banks subject to the regime as more risky and/or costly once this legislation is in force.

3.2 A good example of an industry sector that could be affected is prime brokerage. UK hedge fund prime brokerage is a substantial industry. Its documentation is typically bespoke, rather than standardised in the way that OTC derivatives are. Both parties to master netting arrangements manage credit risk arising under a wide variety of transactions. For a hedge fund manager, any suggestion that netting under a prime brokerage agreement will not be enforceable in accordance with its terms will be unacceptable (particularly in the current environment, given rumours around the solvency of some of market participants). Contracting with prime brokers who are not UK incorporated, or with institutions which are not authorised to take deposits, is likely not to be subject to this problem. The relationship will simply be moved to a jurisdiction, or entity type, which respects master netting arrangements

b) Objections to the partial transfer tool

3.3 The concerns of the FMLC could be greatly alleviated if the Authorities were prepared to forego the adoption of the partial transfer tool and restrict the statutory powers to those needed to create the other three tools listed in Chapter 3 of the Consultation Paper. If no partial transfer of the struggling bank's assets or business were contemplated, there would be no need to provide for a power to apportion contractual rights and liabilities between two institutions. It would still be necessary to provide that termination clauses were not triggered by the (whole business) transfer instrument and that the transferee could be substituted in any agreement or relationship for the struggling bank, in order to ensure the continued viability of the transferred undertakings. However, any global netting arrangement would be unaffected and remain in place against the possibility of a default by the transferee.

c) The need for an "entire relationship" safeguard

3.4 If the proposal to allow the transfer of some but not all of a counterparty's financial contracts under a partial transfer to a bridge bank is to be taken forward, it needs to be considered in more detail, particularly in relation to the disruption that could be caused to set-off, netting, collateral and structured finance arrangements between the parties.

3.5 Certainly if the partial transfer tool is included in the legislation, the onus of justifying any partial transfer, particularly one which breaches the entirety and mutuality of business relationships, should be on the Bank of England and Treasury in the administration of an SRR.

3.6 In fact, the FMLC strongly believes that an "entire relationship" safeguard should be built into the SRR. The consultation paper itself outlines many of the reasons why disruption to set-off and netting arrangements would be disastrous in the case of Qualifying Financial Contracts ("QFCs") but provides absolutely no reassurance that such contracts can be adequately and definitively carved out of the partial transfer.

3.7 Of course, if no "entire relationship" safeguard is put in place, then key financial contracts should be exempted from the provisions under discussion.

However, the FMLC does not believe that a list of "qualified financial contracts" is the right approach in this case.

d) Proposals for the protection of "Qualifying Financial Contracts"

3.8 Having a list of specific qualifying contracts will not create legal certainty, but will only give rise to further doubts about how the list applies as new financial products are developed. One need only look to the US jurisdiction as an example of where implementing such a concept has not enhanced market stability. Ireland has in fact opted for a more generic concept. The Irish approach is one that should be followed.

3.9 If a definition of QFCs were to be included we would suggest inclusive wording along the following lines:

> QFC means any financial agreement, contract or transaction, including any terms and conditions incorporated by reference in any such financial agreement, contract or transaction, pursuant to which payment or delivery obligations are due to be performed at a certain time or within a certain period of time and whether or not subject to any condition or contingency.

4. Other Issues – Response to the Consultation Paper

a) Why this response is not more detailed…

4.1 The draft clauses attached to this third consultation paper are cast very broadly. Furthermore, it appears that much of the detail relating to the substance and operation of the SRR will be contained within a code, which has yet to be published. In short, despite the publication of the third consultation document, there is still insufficient detail about the proposed regime to enable the FMLC to put forward a more detailed response.

b) The definition of "bank"

4.2 It is noted that the draft legislation could, presumably unintentionally, cover certain insurers, which are sometimes authorised to accept deposits, as well as

banks. The FMLC assumes this is unintended. As such, the definition should be narrowed bearing in mind the different needs of the two sectors and the fact that the SRR regime is clearly intended to be focused upon banks. The FMLC would suggest that the definition is amended by adding the following text to draft section 2(2):

"(c) an insurance company within the meaning of [cite relevant section that defines insurance company]."

c) The appointment of officers by the Bank of England

4.3 The third consultation paper makes it clear that the powers to act to stabilise a failing bank which are to be taken by the Tripartite Authorities will be exercised by the Bank of England. However, the consultation paper does not specify how, and by which officers, they are to be exercised at the executive day-to-day level. The FMLC is concerned that the Bank will view the appointment of an insolvency practitioner as the correct approach and that this appointment will give rise to an undue emphasis on restructuring rather than merely stabilising the failing bank. Insolvency practitioners are expert in distilling a company's operations to extract value but the range of tools that they have at their disposal, on insolvency, is very wide indeed. Where the law allows, insolvency practitioners tend to regard it as their responsibility to cherry pick assets and reject liabilities and to hive off ("restructure") viable business lines at the expense of the institution or group as a whole.

4.4 The proposed banking reform provisions contained in this consultation paper already set out very broad powers for the Bank of England in the event of an SRR and the FMLC believes that the breadth of these powers will create market uncertainty from the date of their coming into force, through the mechanism of legal opinions. The question of whether they will be exercised responsibly, however, is one on which the Tripartite Authorities have been keen to provide reassurance, which is the purport of the intended Code of Practice. That reassurance is far less likely to be felt by the markets if the expectation is that insolvency experts trained in restructuring are invited to exercise these very broad powers.

d) Conflict of Laws

4.5 The proposal also creates some complex issues as regards the conflict of laws, which do not seem to have been fully worked out. For this purpose, we assume that a UK bank has entered into a contract with a US counterparty governed by New York law, and an order is made pursuant to the SRR which purports to vary the terms of that contract.

4.6 The first question is how an English court would view the contract if it were litigated before it. The second question is, if a US court were to disregard the SRR in reaching a decision on the contract, what would be the response of the English court to an attempt to enforce the US judgment against property in England through that court? The third is how the question would play out if the judgment were a judgment of an EU member state court?

4.7 We know that an English court would take the view that a foreign statute is ineffective to change the terms of a contract governed by English law.[7] It is not clear, however, whether an English court would also refuse recognition to English legislation that changed the terms of a foreign law contract. The Rome Convention (and, in the not too distant future, Rome I) requires the English courts to apply the parties' choice of law, which governs the interpretation, performance and extinction of the contractual obligations. However, there are exceptions for rules of law the application of which is manifestly contrary to the public policy of the forum (i.e. England) and for the mandatory rules (in the case of Rome I, overriding mandatory rules) of the forum.

4.8 Faced with a foreign law contract and English legislation, the first question for the court would be as to the extent of the geographical and legal application of the legislation. Ideally, this would be set out expressly in the legislation but, if not, the court would have to decide whether the statute applied to foreign law contracts with foreigners. If the legislation does, as a matter of construction, apply to foreign law and foreigners in this way, the court would then have to

7 National Bank of Greece v Metliss [1958] AC 509.

decide whether the legislation represented public policy or overriding mandatory laws in England.[8] Again, this could be set out expressly.

4.9 If, through its express provisions or as a matter of interpretation, the legislation does represent public policy or (overriding) mandatory provisions, then the English courts will ignore the law chosen by the parties. The Convention and Rome I both speak in terms of refusing to apply a rule of a foreign law that is contrary to public policy rather than applying the forum's own rules. However, both also say that nothing restricts the application of the (overriding) mandatory rules of the forum, which presumably does allow the application of the forum's laws rather than just the non-application of a foreign law. In practice, it probably makes no difference.

4.10 This might not technically mean that the English courts accept that English legislation can change foreign law contracts, or that foreign law accepts that English legislation can change foreign law contracts, but it makes no difference in practice.

4.11 If a US court gave a judgment that ignored the SRR, and the judgment creditor then sought to enforce the judgment in England, the English courts could refuse enforcement on grounds of public policy, as set out in the SRR. This would be clearer if the legislation were to state expressly that a judgment that did not recognise the SRR could not be enforced in England - an example of this may be found in the disapplication of overseas insolvency judgements to market contracts in s.183 of the Companies Act 1989. However, the FMLC notes that any provision promoting the non-recognition of foreign judgments or foreign law will of necessity have significantly negative effects on legal certainty in the London market, and it does not seem to be desirable to include such a provision in the legislation.

4.12 Potentially more interesting is the position of a judgment from another EU member state that ignored the SRR.[9] This judgment would be entitled to

8 Overriding mandatory laws are defined in Rome I as being "provisions the respect for which is regarded as crucial by a country for safeguarding its public interests, such as its political, social or economic organisation, to such an extent that they are applicable to any situation falling within their scope, irrespective of the law other applicable to the contract under this Regulation". In the current climate, it is easy to see the SRR falling within that description.

9 The FMLC has not had the opportunity to consider the interaction of the SRR proposals with the requirements of the Winding Up Directive (2001/24/EC)

recognition and enforcement in England under the Brussels Regulation unless it was manifestly contrary to public policy. Though public policy is national, the ECJ reserves the right to determine whether something is or is not capable of being manifestly contrary to public policy (public policy for the purposes of the Brussels Regulation might, therefore, not be the same as when concerned with enforcing a US judgment; it is possible also that it is not the same as under Rome I, since Rome is concerned with the public policy around rules of foreign law whereas Brussels is concerned with the public policy around enforcing foreign judgments, but there is probably no difference in practice). If legislation provided that judgments contrary to the SRR are manifestly contrary to public policy, there could potentially be a judgment of the ECJ saying that the legislation was not entitled to take that view. (There is then a question of whether that would entitle the judgment creditor to enforcement or whether it would give the judgment creditor a claim against the UK for breach of its EU treaty obligations).

4.13 There is also a comparable question as to whether an English judgment giving effect to the SRR would be entitled to recognition under the Brussels Regulation in other EU member states. Other member states could similarly refuse recognition on grounds of public policy. If the SRR brought about expropriation without any or adequate compensation, that might be considered to be contrary to human rights by local courts and thus contrary to public policy.

d) Comparison with US FIDC regime[10]

4.14 Reference is made at several points in the Consultation Paper to the United States regime for dealing with struggling or failing banks, set out largely in the Federal Deposit Insurance Act. The proposals are said to draw on the experience in the United States. However, the FMLC is of the view that a close examination of the situation in the United States would reveal: i) that many of the provisions of that regime are less invasive than those proposed here; ii) that the safeguards contained in the relevant US legislation are drafted more broadly and are more comprehensive than the safeguards proposed here; and iii) that, in

10 The FMLC is grateful to the CLLS Financial Law Committee, and David Ereira of Linklaters in particular for providing the information for this section.

any event, the US model has been designed for a banking industry with a different structure and nature.

4.15 In the view of the FMLC, incorporating an "entire relationship" safeguard into the proposals, as suggested above, would better reflect the position in the United States. There, for example, the regime provides that any transfer of contractual rights must extend to all contracts with that counterparty (or its affiliates).

4.16 Equally, the FMLC is convinced that, to mirror the US regime, any safeguard for Qualifying Financial Contracts should be drafted as widely as possible. Under the US regime the saving provisions for QFCs are sufficiently widely drafted so as to prevent cherry picking in virtually all commercially arrangements which are subject to set off and netting on close out under a master netting agreement (see section 1821(e)(9)(a) of the US Federal Deposit Insurance Act).

4.17 However, the FMLC would caution against a simple replication of the US regime, as the two banking markets are entirely different, and therefore have very different concerns. For example, in the US, *until recently*, the legacy of the Glass-Stegall Act was the separation of deposit-taking commercial banks from the investment banks that focused on dealing and broking and were the dominant players in the most sophisticated financial markets. The special US regime, which is similar to these proposals, is intended only to apply to deposit-taking commercial banks and that is where the experience of a special regime has been gained. In the UK, however, a clean separation of this sort has not been observed, which means that the investment banking arms or subsidiaries of UK deposit-taking banks may be potentially subject to the regime. Given that structured finance and capital markets activities, along with related services such as prime brokerage, stand to be deleteriously affected by the uncertainty caused by the existence of the contractual override powers, this essential difference between the US experience and the structure of the UK banking industry should be considered in greater depth.

Formatted: Bullets and Numbering

5. Parties

5.1 It should also be noted that the proposed arrangements will involve very significant complexity in respect of the analysis of such transactions. For any given transaction with a UK bank it will be necessary for lawyers considering legal certainty to analyse what the position will be if the contract under consideration:

a. is transferred to a "bridge bank";

b. is subjected to the special bank administration regime;

c. is subject to the special bank liquidation regime;

d. is transferred to the bridge bank but is subsequently retransferred to the rump entity and is subject to either the special bank administration regime or the special bank insolvency regime; and/or

e. is partially allocated to one or more entities subject to one or more of these regimes.

5.2 At the very least, these arrangements seem to breach the principle of Occam's razor.[11] In particular, the express provisions in the consultation paper permitting assets to be transferred and retransferred between the various different entities create immense complexity without appearing to confer any immediate benefit.

11 "Entia non sunt multiplicanda praeter necessitatem", roughly translated as "entities must not be multiplied beyond necessity".

FINANCIAL MARKETS LAW COMMITTEE MEMBERS

Lord Woolf (Chairman)

Bill Tudor John, Lehman Brothers (Deputy-Chairman)

Peter Beales, LIBA

Sir William Blair

Michael Brindle QC, Fountain Court

Keith Clark, Morgan Stanley International Limited

Simon Dodds, Deutsche Bank

Sir Terence Etherton, The Law Commission

Ruth Fox, Slaughter and May

Ed Greene, Citigroup

David Greenwald, Goldman Sachs International

Mark Harding, Barclays

Sally James, UBS Investment Bank

Clive Maxwell, HM Treasury[12]

Gabriel Moss QC, 3-4 South Square

Habib Motani, Clifford Chance LLP

Ed Murray, Allen & Overy LLP

Steve Smart, AIG Europe (UK) Ltd

Paul Tucker, Bank of England

Secretary: Joanna Perkins, Bank of England

12 Clive Maxwell abstained from discussions surrounding FMLC Issue 133 and involvement in the preparation of this paper in recognition of his prior official responsibilities.