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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 141 – LANDSBANKI FREEZING ORDER 2008

*Legal assessment of the impact on the financial markets of
the Landsbanki Freezing Order 2008*

The logo for the Financial Markets Law Committee is a light blue, three-dimensional rectangular block. The text "Financial Markets Law Committee" is printed on the front face of the block in a dark blue, sans-serif font. The text is arranged in four lines: "Financial", "Markets", "Law", and "Committee". The block is tilted slightly to the right, giving it a perspective effect.

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CONTENTS

1.	INTRODUCTION AND EXECUTIVE SUMMARY	4
2.	BACKGROUND INFORMATION	8
3.	DAY TO DAY IMPACT AND UNINTENDED CONSEQUENCES OF THE ORDER	11
4.	CONCLUSIONS	25

1. INTRODUCTION AND EXECUTIVE SUMMARY

A. Introduction

- 1.1 The role of the Financial Markets Law Committee (“FMLC”) is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.
- 1.2 On 7 October 2008, the Icelandic Government passed an emergency law (the "Emergency Law") which resulted in the Icelandic Financial Services Authority (the FME) taking control over Landsbanki Islands hf ("Landsbanki") by the appointment of a receivership committee in respect of it.¹
- 1.3 On 8 October 2008, HM Treasury responded by making an order (the “Order”) under the UK Anti-terrorism, Crime and Security Act 2001 to freeze all the funds in relation to Landsbanki including those owned, held or controlled in relation to it by the relevant Icelandic authorities or the Government of Iceland.²
- 1.4 There were a number of unintended consequences of the Order for the financial markets and a number of questions and issues were raised by its implementation.
- 1.5 The FMLC considered this to be an important issue and decided to identify the relevant points in writing and to propose recommendations for how any similar process might be handled better in the future to ensure that an asset freezing order achieves its effect without unnecessary disruption to the financial markets. To that end, the FMLC presents this paper.

¹ Act No.125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc.

² The Landsbanki Freezing Order 2008 (SI 2008/2668)

B. Executive Summary

- 1.6 HM Government was forced to act quickly in difficult circumstances when issuing the Order. The purpose of this paper is not to express a judgment on the Order or any action taken by HM Government in relation to the Order. It is merely to draw lessons from the experience of market participants when faced with the Order, in order to ensure that a future asset freezing order in the financial sector achieves its purpose effectively without introducing legal uncertainty into the markets or increasing credit, legal or operational risk of financial market participants. The FMLC notes the report of the House of Commons Treasury Committee³, and in particular the Treasury Committee's concern, expressed at paragraph 51 of its report, that the use of anti-terrorism legislation may be inappropriate in such circumstances, as well as its recommendation that HM Treasury consider the need for appropriate legislation. This report is intended to assist HM Treasury in considering those issues.
- 1.7 As discussed in more detail below, the general approach taken by HM Government in relation to the Order was to issue a very wide prohibitive Order with the intention of dealing with any specific issues by general or specific licence. It is respectfully suggested that this approach created unnecessary difficulties and increased risk for the financial markets, not only because of the legal uncertainty created by the breadth and vagueness of some of the prohibitions and restrictions in the Order, but also because some of the negative consequences of the Order could not be completely undone *ex post facto* by the issue of a general or specific licence. Examples of this are given below.
- 1.8 Accordingly, the FMLC's principal recommendations are as follows:
- a) An asset freezing order should be as narrow and precise as possible, consistent with its objectives, particularly in regard to

3

"Banking Crisis: The impact of the failure of the Icelandic banks", 4 April 2009.

- i) the assets covered by the order ("frozen funds"): it should clarify as far as possible the nature of "frozen funds";
 - ii) the scope of persons specified in the order (any "Specified Person"), i.e. those to whom frozen funds may not be transferred without a specific consent of HM Treasury;
 - iii) the scope of persons who must observe the restrictions in the order;
 - iv) the activities prohibited by the order (in this regard the term "dealing", as it refers to commercial activities relating to frozen funds, is vague, with a wide penumbra of uncertainty and, potentially, a very long reach into activities which are incidental to, or unaccompanied by, any transfer of frozen funds);
and
 - v) the geographic scope of the order.
- b) A freezing order is a draconian remedy which is widely considered to be suitable for use only as a last resort or in the case of an emergency. Because market disruption is the foreseeable consequence of a freezing order, it seems evident that such a measure should be as limited as possible whilst still capable of achieving its objective. In particular, a freezing order should be a short-term measure, ideally with an in-built "sunset" and/or review clause. Careful thought should be given to the impact of such an order and alternatives should be used where possible. Meticulous attention should be paid both to the objective which it is sought to achieve and the realistic likelihood that assets or funds frozen under the order will ultimately be able to be diverted to this objective.
- c) An asset freezing order which is directed towards some particular mischief or threat contemplated by the legislation under which it is made should *not* prevent a party unconnected to that threat or mischief from acting in a commercially prudent manner by exercising its ordinary contractual rights to terminate financial transactions early under a master agreement or other contract entitling it to do so. Nor should it prevent the party from setting off or otherwise netting the values of the terminated transactions or enforcing any related collateral arrangement. (The order may, of course, prevent the net amount so determined

from being paid to any persons specified in the order (a "Specified Person") and prevent any excess collateral being returned to a Specified Person.)

- d) However, if a freezing order does include restrictions on a party's right to exercise early termination, close-out netting, set-off, collateral enforcement or other rights, then for the sake of legal certainty and to ensure that the order has a proportionate effect, it should provide as follows:
- i) A breach of the provision prohibiting termination should not give rise to criminal liability but only to civil sanctions (albeit this may require a change to the primary legislation under which the order is made). The defence that a party "did not know and had no reason to suppose" that the exercise of such rights was an offence does not provide sufficient certainty due to the difficulty of determining when culpability would arise, especially where an order is made and comes into effect before becoming available to the market generally through official announcement, website publication, media report or general circulation of the order in the market.
 - ii) The order should specifically confirm that the exercise of any such rights is not invalidated by the order as against any Specified Person.
- e) Consideration should be given to implementing a more effective notification procedure for an asset freezing order.
- f) An asset freezing order in relation to a Specified Person that is a bank should clarify that debits and credits to a nostro or vostro account with the Specified Person are excluded from the scope of the order.
- g) An asset freezing order in relation to a Specified Person should not prevent settlement of securities trades in any system where the Specified Person is a settlement participant.
- h) Any disclosure obligations imposed on market participants by an asset freezing order should be proportionate and limited to where the firm holds frozen funds. The disclosure obligation should be limited to a firm's confirmation that it holds frozen funds, and the order should stipulate that firms are protected against self-

incrimination.

2. BACKGROUND INFORMATION

A. The Initial Difficulties faced by HM Government

- 2.1 HM Government faced a great deal of uncertainty when it implemented the Order. At that time, there was a severe lack of clarity about what action would be taken in Iceland in relation to the Icelandic banks. It was rumoured that Icelandic legislation would create a new Landsbanki bank (“New Bank”) and would allow the transfer of depositors’ accounts along with deposits from the old bank in Iceland to the New Bank. It was thought that depositors in branches outside Iceland (including the UK), on the other hand, would be left holding accounts in old Landsbanki which, as a result of the legislation, would be left with few or no assets or capital from which to meet its liabilities to depositors.
- 2.2 HM Government faced two specific difficulties which were that:
- a) Landsbanki had a UK branch (the trading name of which is Icesave) not a UK subsidiary; and
 - b) the branch had been passported in from an EEA country.
- 2.3 The fact that Icesave was a branch meant that two alternative courses of action were not available to HM Government. Firstly, if it had been a subsidiary, it would have been authorised by the FSA to carry out banking activities. This would have allowed the FSA to remove its permission for Icesave to carry out regulated activities. And secondly, if it had been a subsidiary, a winding up order could have been obtained.
- 2.4 It was also important that Icesave was a branch that had been passported in from an EEA country. Having been passported, it was voluntarily included in the UK Financial Services Compensation Scheme (“FSCS”). At the time the Order was made, the expectation was that UK deposit holders would be left in need of compensation because Landsbanki might not have had sufficient assets to meet its obligations. Because of the membership of the compensation scheme, any

compensation would have had to be met by the FSCS and so, ultimately, by other UK banks.

B. Action taken by HM Government

- 2.5 In the face of all of this, HM Government took action by making the Order to freeze all funds “owned, held or controlled by” Landsbanki or “relating” to Landsbanki and owned, held or controlled by the Government of Iceland, the Icelandic Central Bank, the FME or the Landsbanki receivership committee. This action was taken, therefore, in order to prevent assets being transferred to a New Bank to protect the FSCS and the other banks that would have been levied and because other options, including protective administration, were not available.
- 2.6 The approach taken by HM Government was to issue a wide prohibitive order and then to issue a licence to exempt certain activities. The intention was that the initial licence would be as general and broad as possible to catch most situations and then additional licences would be issued subsequently to address any specific problems that became apparent. These additional licences would then be drafted to assist both those who had approached HM Government and the broader market as well.
- 2.7 Unfortunately, as noted above, some difficulties created by the overly wide initial Order could not be cured by the subsequent issue of a licence, as discussed below in relation to the exercise of close-out rights. Even today, markets still languish under uncertainty caused by both the piecemeal manner in which the problems were addressed and by unresolved questions about the terms of the original order. A clear account of why the order was issued, or issued in these terms, has not yet been given to the satisfaction of market participants and an indication of when it is expected to lapse would be welcomed. So, too, would an explanation of the objective which the order is sought to achieve (and how the frozen funds will be diverted to achieve this objective).

2.8 The first licence⁴ (“Licence L1”), which came into effect at 2.30 pm on 9 October 2008, appeared to be intended to address two main areas of concern, namely:

- a) To enable Landsbanki to continue commercial finance activities to ensure that the Order did not have unintended consequences such as inadvertently causing entities to become insolvent in the short term; and
- b) To establish a framework which allowed banking activity by Landsbanki’s London branch to continue whilst not allowing removal of retail depositors’ money from the United Kingdom.

It also, however, included some protections for participants in the wider market, notably (in paragraph 11) stating that “[a]ny person may exercise any of the following rights: set-off; rights of termination; closing out; netting; reimbursement or indemnity.”

2.9 The second licence⁵ (“Licence L2”), which superseded the first licence and came into effect at 12.40 pm on 13 October 2008 continued to address (in paragraphs 7, 9 and 10 of the licence) the concern of allowing Landsbanki’s London branch to operate while also (in paragraphs 8 and 11) seeking to increase certainty for participants in the wider market in relation to the exercise of their own rights and the performance of their own obligations vis-à-vis Landsbanki.

2.10 After issuing the second licence, HM Government released guidance on 17 October 2008 which explained why licences were not needed for certain matters (for example, UK nationals working abroad).

2.11 The FMLC understands that HM Government’s main aim throughout had been to try to strike a delicate balance between preventing assets being repatriated and allowing legitimate banking activities to continue.

⁴ Landsbanki Islands HF General Activities Licence [L1]

⁵ Landsbanki Islands HF General Activities Licence [L2]

3. DAY TO DAY IMPACT AND UNINTENDED CONSEQUENCES OF THE ORDER

3.1 For the reasons noted above, HM Treasury, on 8 October 2008, made the Order to freeze all the funds in relation to Landsbanki including those “owned, held or controlled” in relation to it by the relevant Icelandic authorities or the Government of Iceland. Unfortunately, a number of unintended consequences arose out of the Order as well as a number of questions about its interpretation and issues regarding its implementation.

A. Knowledge

3.2 A key difficulty faced by counterparties to Landsbanki on 8 October 2008 was that they became subject to the prohibitions and restrictions of the Order before they had actual knowledge of its existence, much less its terms. The Order was made at 10:00am and came into force at 10:10am but did not enter public circulation until the afternoon of 8 October. A number of counterparties to Landsbanki exercised contractual rights to terminate transactions and to exercise related close-out netting and/or set-off rights prior to becoming aware of the Order. In fact, financial institutions that subscribed to HM Treasury’s Asset Freezing Unit’s notification service were only informed after business hours on 8 October.

3.3 Consideration should be given to implementing a more effective notification procedure in the future. A notice should be circulated to relevant institutions (e.g. those who have signed up to the HM Treasury’s Asset Freezing Unit’s notification service) as soon as any such order is made so that they have knowledge of the Order when it comes into force and so can act accordingly.

B. Affiliates

3.4 The first questions raised by the Order, as early as the evening of 8 October 2008, related to the application of the Order to Landsbanki’s subsidiaries. Could third parties make payments to Landsbanki’s subsidiaries such as Landsbanki Securities (UK) Limited (which changed its name to Teathers Ltd on 7 October)

or even to a number of UK companies in which Landsbanki held minority equity stakes?

- 3.5 This issue was addressed by the first guidance note issued by HM Treasury on 9 October 2008 which made it clear that the Order related solely to Landsbanki and not its subsidiaries.
- 3.6 Market certainty would be considerably enhanced if the scope of any future asset freezing order in the financial sector was clarified in the original order, so that, for example, it were clear whether or not subsidiaries of any persons named as Specified Persons in the order were also to be considered Specified Persons for purposes of the order.

C. Termination and Close out of Trading Agreements

- 3.7 One of the most dramatic effects of the Order was the potential impact it had on the ability of counterparties to Landsbanki to terminate or “close out” transactions under financial product master agreements⁶ (“Trading Agreements”). The wide definition of the term “deal with” in the Order (potentially encompassing any dealings that would result in any change in volume, amount, location, ownership, possession, character or destination of frozen funds) arguably encompassed the exercise of termination, netting and set-off rights (which usually result in netting or set-off such that a single net sum is due between the parties) and meant that any exercise of such contractual rights could potentially constitute a breach of the Order. Unfortunately, it was not immediately apparent to many market participants that the words “deal with” could be construed so widely, and it caused considerable surprise that the exercise of such rights, which would normally be considered prudent behaviour by a creditor in the face of the events in Iceland intended to minimise risk, should potentially constitute a criminal offence. In fact, it was not generally understood in the market until the morning

⁶ ISDA Master Agreements for OTC Derivatives, Global Master Repurchase Agreements for sale and repurchase transactions and various types of securities lending master agreements published by the International Securities Lending Association among others.

of 9 October 2008 that the exercise of such rights was potentially prohibited by the Order.

- 3.8 The delayed realisation of the scope of “deal with” in the Order due to the lack of precision in the definition of those words as well the slow dissemination of information about and, indeed, the text of the Order itself on 8 October meant that there were a considerable number of market participants who had exercised or were in the course of exercising early termination, close-out netting, set-off and related rights between the time the Order came into effect and the issue of the first licence. This was clearly a matter of great concern to those market participants, who had potentially committed a criminal offence if it could not be clearly established that it could rely on the defence in article 5(3) of the Order (that “he or she did not know and had no reason to suppose” that the Order applied to any such action).
- 3.9 This issue was of great concern to market participants and was the subject of industry calls (facilitated by the International Swaps and Derivatives Association (“ISDA")), the first of which was held late morning on 9 October and led to Allen & Overy (on behalf of ISDA members generally) and others on behalf of individual or groups of clients approaching HM Treasury with a view to securing a licence for Trading Agreement counterparties of Landsbanki to terminate and exercise netting and set-off rights in respect of transactions under such Trading Agreements. As noted above, HM Treasury issued Licence L1 on 9 October 2008, with effect from 2.30 pm, which permitted (among other things) any person to exercise their rights of termination, close-out, set-off and netting and allowed the operation of business accounts by customers of the London branch of Landsbanki.
- 3.10 Unfortunately, the issue of Licence L1 did not retrospectively “cure” any criminal offence arguably committed between when the Order came into effect and when Licence L1 became effective. While HM Treasury, which has control of whether or not a criminal prosecution would be pursued under the Order, indicated that it would not pursue or consent to the pursuit by the Director of Public Prosecutions of criminal proceedings on the basis of the exercise of early termination, close-out netting, set-off and similar rights under a Trading Agreement, this did not

eliminate the potential stigma of a criminal offence been committed before Licence L1 came into effect or, more importantly, cure any possible invalidity as a matter of general contract law of actions taken in relation to the exercise of early termination, close-out netting, set-off or similar rights caused by breach of the Order prior to that time. It appears that the Order is being relied upon by Landsbanki to argue that its contractual obligations were discharged by supervening illegality or frustration on 8 October 2008, notwithstanding the subsequent publication of licences which removed the legal basis for the illegality or frustration.⁷

- 3.11 As the issuance of the Order required some market participants to delay designation of the termination of transactions under these Trading Agreements until the issuance of the Licence, market participants were exposed to significant uncertainty and risks, and in some instances may have experienced real economic loss. As the termination and close-out or set-off outlined above would not, without any corresponding payment to Landsbanki of amounts owed to them after this process, result in any prejudice to UK creditors of Landsbanki, these risks and losses were potentially avoidable if the Order had been more narrowly drafted. It is recommended that any future order be more limited in its scope.

D. Application of the Order to NBI hf

- 3.12 On 9 October 2008, the day after the Order came into effect, the Icelandic Financial Supervisory Authority created a new bank, New Landsbanki Islands hf (subsequently renamed “NBI hf”), which is wholly owned by the Icelandic Government. NBI hf acquired a substantial part of the operations and assets of Landsbanki, assuming its deposit liabilities in Iceland and the bulk of its assets relating to its Icelandic operations. Nostro accounts were transferred from Landsbanki to NBI hf and NBI hf began to trade on various exchanges.

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See *Jefferies International Limited -v- Landsbanki Islands hf* [2009] EWHC 894 (Comm) at para 10.

- 3.13 There was (and there remains) uncertainty over the application of the Order to NBI hf. NBI hf is not a Specified Person in the Order. However, the Order prevents those bound by the Order from dealing with frozen funds. Frozen funds is defined in the Order to include "funds" (i.e. financial assets and economic benefits of any kind) which (1) are owned, held or controlled by the Icelandic Government and the Central Bank of Iceland (amongst other Specified Persons), and which (2) "relate to" Landsbanki (article 4(b) of the Order).
- 3.14 Funds owned, held or controlled by NBI hf are or may be indirectly owned or controlled by the Icelandic Government, as the 100% owner of NBI hf, and they may be held by the Central Bank of Iceland. As NBI hf acquired funds that were Landsbanki's funds (and therefore frozen funds) after the Order came into force, NBI hf's funds may be said to "relate to" Landsbanki.
- 3.15 To date, HM Treasury has not provided guidance to the market on this issue.

E. Landsbanki, London Branch

- 3.16 It is also apparent from Licence L1 and Licence L2 that the Order had an enormous impact on the business of Landsbanki's London branch. While the original aim of the Order had been to prevent funds from being removed from Landsbanki's London branch to the detriment of savers in Icesave, such aim was unlikely to be served by the almost complete inability of Landsbanki London branch to contract with third parties or deal with assets held at third parties (which could have allowed such third parties to terminate contracts and transactions in such a manner as to erode the value of the "frozen funds" held at or by the London branch). This was clearly a concern for HM Treasury given the relative speed at which Licence L2 followed Licence L1 (the implication being that third parties did not find Licence L1 sufficient in order for them to deal with Landsbanki London branch) which provided for wide ranging exceptions from the Order to allow Landsbanki London branch to continue to do business.

F. Geographical scope

- 3.17 In terms of the geographical scope of the Order, the provisions applied to "any person in the United Kingdom" and all UK nationals wherever present including a

body incorporated under the law of any part of the United Kingdom (therefore including all of its branches outside the UK). The term “any person in the United Kingdom” was understood to include any natural or legal person present in UK at the time of any activity that would constitute an offence under the Order. In relation to legal persons, therefore, this would include a branch located anywhere in the UK. It would not, however, include a non UK incorporated subsidiary of a UK company, where the subsidiary is not present in the UK.

- 3.18 There was considerable uncertainty in the market regarding the proper interpretation of the geographical scope of the Order, in particular on the following two points: (1) whether a foreign entity with a UK branch was caught by the Order in relation to all of its dealings with Landsbanki, including those outside the UK and (2) whether a UK national employed by a non UK entity not present in the UK would be caught by the Order if to any degree involved in a dealing with Landsbanki by that non UK entity. In the latter case, there was uncertainty as the degree of involvement that would trigger liability (for example, being the nominal supervisor of a person who orders a transfer of funds to Landsbanki). There was also a feeling that it was unfair to impose criminal liability on a UK national acting in the course of his or her employment with a non-UK entity outside the UK, potentially conflicting with that person’s duty to the employer.
- 3.19 In guidance issued on 17 October 2008 HM Treasury made clear that the Order did not bind the non UK branches of a non UK company. It also made clear that a UK national working for a non-UK company abroad was not bound by the Order to the extent that the “person” performing the Landsbanki related activity was the non-UK company acting abroad rather than the UK national acting in a personal capacity. While the market was grateful for this guidance, particularly in relation to UK nationals acting abroad in the course of their employment with non-UK companies, some market participants doubted whether the guidance was consistent with the drafting of the Order (in other words, whether a clarifying amendment to the Order, with retrospective effect, should have been made).
- 3.20 The lack of clarity in the Order and the potential criminal liability made the markets take a cautious approach to the extent of the geographical scope of the

Order. The fact that this endured for 9 days before the Treasury guidance of 17 October 2008 was costly and inefficient as transactions were suspended and legal costs incurred attempting to address the uncertainty. It would therefore be beneficial for the market if the scope of any future asset freezing order was more clearly articulated to address the questions of geographical scope that troubled the markets in relation to the Order.

G. Impact on Loan Market

- 3.21 Borrowers from Landsbanki and agents under syndicated facilities where Landsbanki was a lender also faced a number of issues. For example: Could borrowers make payments to an agent where a lender in the syndicate was Landsbanki? If borrowers failed to make scheduled payments to the agent because Landsbanki was a lender, did that mean such borrowers were in default? Agents who had been advanced funds for scheduled payments to lenders by borrower clients were faced with a situation where they could not remit such funds to Landsbanki. Another difficulty was whether the order permitted a roll-over (renewal on the same or substantially similar terms) of loans where one of the parties to the relevant credit agreement was Landsbanki.
- 3.22 Lenders to Landsbanki were left in a difficult position similar to Trading Agreement counterparties to Landsbanki, asking themselves if they could terminate and accelerate the relevant facility agreements.
- 3.23 While the ability to terminate and accelerate was imperfectly addressed in Licences L1 and L2 (in the sense that a reference to acceleration as well as termination would have been helpful) it took until 29 October and Licence L4⁸ for confirmation that (A) debts to Landsbanki could be discharged by payment to Landsbanki London branch; and (B) that parties to a credit agreement with Landsbanki were permitted to roll-over on the same or similar terms (thus

permitting roll-overs at different rates of interest and with different maturity periods or dates).

H. Impact on Government and Authorities in Iceland

3.24 Landsbanki was not the only "specified person" to whom the prohibitions set out in the order applied. The Order also named the Icelandic authorities and the Government of Iceland as "specified persons" to the extent funds owned, held or controlled by them related to Landsbanki, which had the practical effect of meaning that any payment to such entities needed to be checked to see if it related to Landsbanki, which was a manual and extremely time-consuming process for financial institutions and led to payments to and from Iceland almost grinding to a halt (a number of Icelandic entities ended up effecting and receiving payments via the central bank as a consequence). The situation clearly became so bad that following representations from financial institutions and public statements by the Icelandic authorities, HM Treasury issued a guidance note⁹ on 17 October 2008. The guidance note attempted to clarify the extent of the prohibitions and made it clear that the effect of the Order was not to freeze assets of the Icelandic authorities and government, but to the extent the Order still related to the authorities and government in Iceland (where funds owned, held or controlled by them related to Landsbanki) the guidance note did not resolve the above issues.

3.25 It is always necessary that guidance is clear and thorough but this is especially the case in an emergency situation where criminal sanctions are being imposed. In future, it would be better for simple and explicit guidance to be issued as early as possible in the process.

I. Correspondent Banking Relationships

3.26 Another tricky area was what to do with situations where institutions either had:
(i) an account in their name at Landsbanki (usually for the purpose of effecting or

receiving Icelandic Krona payments); or (ii) an account in Landsbanki's name at such institution, whether held in or outside of the UK.

- 3.27 Could a payment into an account held at Landsbanki in Iceland be seen as a breach of the order? With respect to amounts held in accounts in the UK it was clear that payments to Landsbanki in Iceland (or indeed even to the London branch prior to Licences L1 and L2) were not allowed, but what about credits to such accounts? The issue of nostro accounts held in Iceland became a big issue, even for institutions who did not hold their accounts at Landsbanki, since if counterparts to such institutions wanted to make payments to such institutions (usually in ISK) it was not clear that effecting such payments would not constitute a breach of the Order. Members of the Emerging Markets Trading Association (“EMTA”) discussed this issue regularly on industry calls and with ISDA. The above issues were addressed (again, from a clarity point of view, imperfectly) following representations by individual institutions and EMTA by the guidance note issued on 17 October 2008 and the issue of Licence L4 (and the related General Notice) by HM Treasury on 29 October 2008.
- 3.28 A further issue that required clarification around these correspondent relationships (but had equal application to Landsbanki customers’ accounts) was whether overdrawn correspondent accounts were “frozen funds” for the purposes of the Order since these accounts could be construed as constituting a debt due to Landsbanki. Following representations by several financial institutions, Licence L4 dealt with this uncertainty by confirming that payments into and out of such accounts were permitted.

J. Clearance and Settlement of Equity Trades through Exchanges

- 3.29 Given the wide definition of "frozen funds" (which included equity and debt securities) in situations where cash equity trades cleared and settled through exchanges where there is no central counterparty and where buyers and sellers are matched under the rules of the exchange or related clearing house (e.g. the London Stock Exchange and CREST), where a third party had been matched with Landsbanki pursuant to the relevant rules such counterparty would violate the terms of the Order if it settled the relevant transaction. Clearly this was not ideal

and counterparties lobbied HM Treasury to secure a licence that would permit such settlements. The difficulty with settlement of cash equity trades in the above described circumstances was resolved through the issue of Licence L5¹⁰ on 7 November 2008. What is particularly interesting about Licence L5 is its reluctant terms, which notes that the definition of “frozen funds” in the order is narrower than the definition of “funds” and seems to query if the licence is required at all, ignoring the fact that a prudent market participant would not take a risk with criminal liability.

K. Disclosure

- 3.30 Another area in which a great deal of confusion arose was in relation to disclosure requirements. These requirements were set out in paragraphs 2, 3 and 4 of the Schedule to the Order. But, on 8 October 2008, HM Treasury issued a notice which summarised the disclosure requirement in the following terms:

All financial institutions and other bodies and persons in the UK are required to inform HM Treasury of all funds that they have frozen in accordance with the Order. They must also provide HM Treasury with all relevant information necessary for ensuring compliance with the Order.

This notice is, on the face of it, much broader than the Schedule, which makes no reference to "frozen funds" or "relevant information necessary for ensuring compliance with the Order".

- 3.31 The fact that the reporting requirement was not clear and that the notice was much broader than the obligation in the Order led to a considerable amount of uncertainty. Many points were not clear to market participants including:

¹⁰ Landsbanki Islands HF Securities Settlement Licence [L5]

- a. whether the reporting obligation arose separately from HM Treasury's right to request information under paragraph 1 of the Schedule and whether any tipping-off provisions applied.
- b. initially, to whom and in what format reports were required to be made.¹¹
- c. whether, if firms give disclosure of dealings that they have had with Landsbanki in breach of the Order, the disclosure would be admissible in proceedings against the disclosing firms for breach of the Order.
- d. whether firms are required to report any more than the fact that they have or have had (since the coming into force of the Order) dealings or customer relationships with a specified person. If the disclosure obligation is wider than a simple confirmation, in effect, that the firm holds frozen funds, it is unclear whether further information to HM Treasury, other than under compulsion pursuant to paragraph 1 of the Schedule to the Order, is protected against breach of restrictions on disclosure of information.
- e. why, given the potential loss of protection for firms that voluntarily disclose more than they are required to disclose and the powers of HM Treasury to request information pursuant to paragraph 1 of the Schedule, firms should provide any additional information.¹²
- f. (prior to the publication of the notice accompanying the Landsbanki Freezing (Amendment) Order 2008 (SI 2008/2766) on 31 October 2008)

¹¹ The former point was, however, clarified by paragraph 8 of the Landsbanki Freezing (Amendment) Order 2008 (SI 2008/2766) which came into force on 31 October 2008, which made it clear that reports should be made to HM Treasury.

¹² The notice published on 8 October 2008 (quoted at 3.30 above) suggested that the disclosure obligation was broader than the Schedule. The notice accompanying the Landsbanki Freezing (Amendment) Order 2008 (SI 2008/2766) on 31 October 2008 suggested that the disclosure obligation is as set out in the Schedule, but "requested" provide more information than they were required to disclose.

whether firms were required to report dealings they had with Landsbanki which were permissible under a licence.¹³

- g. whether "customer" in paragraph 3(a)(i) of the Schedule bears a technical or common-sense meaning (i.e. FSA Handbook definition is very wide and includes counterparties).
- h. what "dealings" are required to be disclosed in paragraph 3(a)(ii) of the Schedule (transactions only, or negotiations/discussions).
- i. whether disclosure was required of "relationships" and "dealings" with specified persons other than Landsbanki, in the absence of any connection to Landsbanki or frozen funds. The Schedule contained no such qualification.

3.32 Disclosure obligations for firms in the UK always carry the risk that disclosure is prohibited and/or not protected against restrictions on disclosure of information in other jurisdictions. And, disclosures to HM Treasury for the purposes of a licence application or a request for formal guidance are not protected against breach of restrictions on the disclosure of information.

3.33 In order that future orders may not have similar problems, some suggested amendments to the Schedule are set out below, namely that:

- a. Disclosure is only required where a firm holds frozen funds. There is no purpose in disclosing the existence of "dealings" or "customer relationships" in the absence of frozen funds, or referencing the disclosure obligation to "specified persons".
- b. The Schedule should set out the details contained in the notice of 29 October 2008 (address of HM Treasury).

¹³ The notice confirmed that unless otherwise requested, relevant institutions were not required to provide routine reporting of transactions undertaken pursuant to specific or general licences issued by HM Treasury.

- c. The disclosure should simply be that the firm holds or has held frozen funds since the coming into force of the Order. HM Treasury can then use its powers under paragraph 1 of the Schedule to establish the further information that it requires.
- d. The Schedule should stipulate that firms are protected against self-incrimination.

L. Funds held by Landsbanki as Custodian

3.34 Another consequence of the Order was that any funds that Landsbanki held as custodian on behalf of third party beneficial owners were also frozen. This led to the granting of a further licence L6 which expressly permitted financial institutions to transfer funds to third parties or on the third parties' instruction, to or from NBI hf, where the third party was the beneficial owner of the funds and the funds were in the name of the Bank.¹⁴ These third party transfers were also permitted where funds had been moved from Landsbanki to NBI hf and were now held in the name of NBI hf, having previously been held in the name of Landsbanki Islands HF. A condition of the licence was that financial institutions were to establish that the third party was the beneficial owner of the funds by obtaining evidence of such.

M. General Points in relation to Retail and Commercial banking activities

3.35 The use of sanctions legislation to bring about an effective resolution to what was a credit-related issue had a number of unintended consequences. Matters such as the use of the direct debit guarantee scheme by Landsbanki customers to claim back monies (incorrectly in most cases) from UK banks caused further uncertainty as banks sought continual guidance on what were or were not "frozen funds". Furthermore, the only practical way in which banks and financial institutions could ensure they were complying with the legislation was to stop

every payment/trade that may have related to Landsbanki and the specified persons and undertake an assessment of whether it would or could be permitted under the various licences. This had a knock-on effect of further destabilising an already uncertain market as payments/trades that may well have been permitted were unduly delayed. Given the criminal liability of UK banks for any unauthorised transactions, it was unsurprising that a cautious approach was adopted.

N. Objective of the Order

- 3.36 The ultimate objective of the Order is unclear. It has been in operation for over six months. It remains in force for up to two years pursuant to section 8 of the Anti-Terrorism, Crime and Security Act 2001. Assuming the frozen funds are identified, how and when are they to be recovered?
- 3.37 Any recovery against Landsbanki would presumably be brought by the FSCS, which compensates UK depositors as described in paragraph 2.4 above in return for an assignment of the depositors' claims against Landsbanki. However, there are two obvious difficulties in recovering frozen funds from Landsbanki.
- 3.38 First, on Saturday 6 December 2008, a Moratorium was declared under the Icelandic Act No. 161/2002 on Financial Undertakings. This Act prevents creditors from bringing enforcement proceedings against Landsbanki.¹⁵ As Iceland is a member of the EEA and Landsbanki is a credit institution, the Moratorium takes effect throughout the EU and EEA pursuant to the EC Directive on the Reorganisation and Winding Up of Credit Institutions (2001/24/EC).
- 3.39 Secondly, it appears that the FSCS would rank alongside all of Landsbanki's other unsecured creditors. If Landsbanki is wound up in Iceland, the FSCS' claim would rank alongside "claims of an equivalent nature" in Iceland pursuant to article 16 of the EC Directive.

15

An amendment to the Act which came into effect on 21 April 2009 lifts the previous stay on proceedings initiated prior to the coming into force of the Moratorium.

4. CONCLUSIONS

- 4.1 The FMLC acknowledges that HM Government faced an incredibly difficult situation and was forced to act quickly. Given the level of uncertainty caused in this instance, however, the FMLC would like to set out some recommendations as to how this process might be handled better in the future. The FMLC recommends that any future orders should not be as broad as this Order. Future orders should focus on a narrower prohibition initially and the geographic scope of any such order should be made clear from the beginning.
- 4.2 Potential issues should be considered in advance (even in an emergency situation) rather than relying on a multiple licence approach (especially given that it has been seen that this can lead to some of the licences being contradictory in places and unclear) which also requires several guidance notes to be issued to the markets.
- 4.3 The key, especially in an emergency scenario, is that any future action taken should be clear and considered and should aim to cause as little confusion and unnecessary disruption to the financial markets as is possible.

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