FINANCIAL MARKETS LAW COMMITTEE
www.fmlc.org

c/o BANK OF ENGLAND
Threadneedle Street
London
EC2R 8AH

CHAIRMAN – LORD BROWNE-WILKINSON

31 January 2006

Professor Hugh Beale
Commissioner
Law Commission
Theobalds Road
London
WC1N 2BQ

FINANCIAL MARKETS LAW COMMITTEE
ISSUE 42: UNFAIR TERMS IN CONTRACTS

I write on behalf of the Financial Markets Law Committee ("**FMLC**") in relation to the Law Commission's recent recommendations on Unfair Terms in Contracts (Law Com No 292) and, in particular, section 29 of Part 6 of its Draft Unfair Contract Terms Bill.

The broad aim of the Bill is to limit the effect of unfair terms in consumer and small business contracts. The inclusion of protection for parties to small business contracts is new.

Section 29 sets out an exception to the proposed unfair contract terms regime and is intended to be the commercial contracts carve out, it having been recognised by the Law Commission, following discussions and correspondence with the FMLC[1] that (a) commercial contracts between substantial businesses should not fall within the regime, (b) contracts in the financial services sphere were already subject to regulation protecting small market participants and (c) that the need for legal certainty was paramount.

The commercial contracts exception is formulated by reference to a new concept - a "small business contract". A "small business contract" is a contract to which at least one of the original parties was a small business[2] when the contract was made, and where none of the listed exceptions apply.

The first exception, in subsection (2), is where the price payable under the contract exceeds £500,000. Indeed, all of the other exceptions (save for that set out in subsection (4), referred to below) also use the price payable test. Subsections (3) and (5) create an exception for contracts forming part of a series, scheme or arrangement where the total price payable of that series, scheme or arrangement exceeds £500,000. Subsections (6) and (7) make further provision about how a series of contracts qualifying for the exception may be identified.

---

1 See letter dated 20 June 2003 from the FMLC to the Law Commission, available at www.fmlc.org.

2 A small business is one which has no more than 9 employees (section 27 Unfair Contract Terms Bill).

Subsection (4) creates an exception for contracts for financial services where the provision of the services is a regulated activity performed by an authorised person or an exempt person. The terms "authorised person", "exempt person" and "regulated activity" are defined by reference to the meanings given to those terms in the Financial Services and Markets Act 2000 ("**FSMA**").

Issues

The FMLC identified two issues arising from the drafting of these exceptions which are set out below.

1. The "price payable" test

The term "price payable" is not defined in the Bill. In the Committee's view, issues will arise in practice with the "price payable" test. For example, in a swap or a loan which bears interest at a floating (i.e. variable) rate there may some difficulty in assessing what is meant by price payable. Alternatively, there is a possibility that price payable in these types of contract could be interpreted as meaning *fees* payable (excluding interest, which is the main financial consideration). It does not appear that it was the intention of the Law Commission to cause these difficulties and the Committee believe they could be avoided.

In the opinion of the FMLC, a test based on "value" would be more appropriate. In relation to a loan, this would be the principal amount of the loan and, as far as it can be determined, interest payable, and in relation to a swap, this would be the principal or nominal amount of the swap.

Interestingly, it is noted that the Explanatory Notes issued with the Bill refer to a "value" greater than £500,000 and not to a "price payable". This reinforces the argument that value should and was intended to be the appropriate test in these exceptions.

Drafting in the Insolvency Act 1986 could be adapted for use here. Article 4A of Schedule A1 Part I to the Act is the capital markets exception to eligibility for a CVA moratorium. This refers to a company being excluded from being eligible for a moratorium if, on a particular date, "it is a party to an agreement which is or forms part of a capital markets arrangement under which (i) a party has incurred, or when the arrangement was entered into was expected to incur, a debt of at least £10 million under the arrangement and (ii) the arrangement involves a capital market investment."

This could be simplified in the current context such that the value of a contract would be determined by reference to a contract under which one party has incurred, or when the contract was entered into was expected to incur, a debt of at least £5 million under that contract, with a power to vary the amount. This could also be adapted for a series of contracts. We would suggest this as an additional exemption/set of exemptions. The figure of £5m is used by way of illustration: it is substantially higher than the £500,000 used for the "price payable" test (a multiple of 10); this is because the proposed exemption test is measured by reference to the principal amount involved in the financial transaction and not the consideration.

2. Regulation by the Financial Services Authority and other home state regulators

The exception relating to financial services contracts is, in the FMLC's view, too narrow as it only covers contracts under which one of the parties is either:

(i) an "authorised person"; or
(ii) an "exempt person" in relation to the relevant "regulated activity",

(each as defined in the Financial Services and Markets Act 2000 "**FSMA**").

An authorised person, as defined in section 31 of FSMA, in essence means:

(i) a person who has a permission from the Financial Services Authority to carry on one or more regulated activities;

(ii) an EEA firm authorised under Schedule 3 – this, in short, means credit, investment, insurance, collective investment scheme, management and insurance mediation firms who have been authorised by their home state regulator[3] and have obtained a passport under the relevant EU directive to provide services or establish a branch in the UK;

(iii) a Treaty firm authorised under Schedule 4 – this, in short, means a Treaty firm[4] which has received authorisation to carry on the regulated activity by its home state regulator[5] on terms providing equivalent protection to the UK regime and where the activity is not passportable under (ii) above;

(iv) a person who is otherwise authorised under FSMA, i.e. the Society of Lloyds[6], UK OEICs and the operators, trustees and depositaries of recognised EU collective investment schemes[7].

A person is exempt for particular regulated activities if either:

(i) it is within an exemption order made by the Treasury[8];

(ii) it is an appointed representative of an authorised person[9]; or

(iii) it is a recognised investment exchange or clearing house in respect of which a recognition order is in force in relation to the relevant regulated activity[10].

Most financial institutions in the U.K. will be subject to the regulation of the FSA, or exempt in one of the above categories but the law must not apply unfairly across regulated financial markets which allow participation of persons not so authorised or exempt, whether they deal with a regulated or exempt institution or with each other: therefore transactions which take place in regulated markets between persons who are neither authorised nor exempt also need to be certain. It is crucial to the fair, efficient and proper operation of such markets that all participants are bound strictly by the terms of the contracts they enter into. Individuals and small businesses who participate must not be put in a more privileged position than any other participant. In our view, there should be no detriment to such individuals, because, as the Law Commission has recognised, there is regulation governing their participation in such markets.

---

3 Home state regulator here means the competent authority (within the meaning of the relevant single market directive) of an EEA State (other than the UK) in relation to the EEA firm concerned (paragraph 5 of Schedule 3 Part II of FSMA).

4 Treaty firm means a person whose head office is in an EEA State other than the UK and which is recognised under the law of that State as its national.

5 Home state regulator here means the competent authority of the firm's home state for the purpose of its home state authorisation (paragraph 1 of Schedule 4 to FSMA).

6 Section 315 of FSMA.

7 Schedule 5 to FSMA.

8 Section 38 of FSMA.

9 Section 39 of FSMA.

10 Section 285 of FSMA.

Therefore, we believe the exception should be wider than drafted so as to include in addition any contract (not any person) which is subject to the rules of any recognised investment exchange or any foreign equivalent.[11] The meanings given to the terms "recognised investment exchange"[12] and "relevant market"[13] under FSMA, could conveniently be adopted for this purpose.

The FMLC would welcome the opportunity to discuss these matters with you further if that would be helpful.

Nicolas Browne-Wilkinson

Copy to: Douglas Robinson, Department of Trade and Industry

---

11 As a more general point the question arises whether the provisions dealing with this exception should include a rule-making power so that they can be modified as the market evolves. For example, it may be felt in due course that contracts by non-EEA firms which are subject to *equivalent regulation* should be covered by an exception even when the contracts are not subject to the rules of an investment exchange which is itself the foreign equivalent of a recognised investment exchange.

12 Section 285 of FSMA.

13 FSMA (Financial Promotion) Order 2005 Article 37(4).