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13 June 2011

European Commission
DG Justice
B-1049 Brussels

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Dear Sirs

FMLC Issue 97: Feasibility Study by the European Commission's Expert Group on European Contract Law

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 services markets which might give rise to material risk and to consider how such issues should be addressed.

You may be aware that the FMLC submitted a response (attached for reference) to the European Commission's Green Paper on policy options for progress towards a European Contract Law for consumers and businesses on 31 January 2011. The points raised in that response in respect of the constitutional basis for enacting a European contract law and the legal uncertainty generated by a new legal system are equally valid in relation to the Feasibility Study but, to avoid repetition, are not repeated here.

Annex IV of the Feasibility Study contains general provisions as well as provisions for contracts of sales of goods and related services contracts, excluding financial services. Therefore, it does not, at this stage, therefore deal with contracts within the remit of the FMLC.

The FMLC is aware that other organisations are responding in detail on the substantive legal uncertainty inherent in a number of the key provisions of that Annex. Given its remit, the FMLC does not intend to make detailed comments.

A number of the provisions, however, are uncertain in their meaning and scope or give significant elements of judicial control over contracts. As such, they would be of serious concern if ever applied in the wholesale financial markets. Chief among these are the provisions as to good faith and fair dealing, good business practice and the discretionary judicial control over the substance of obligations in various situations, particularly in chapters 7 and 8.

In addition, the provisions on interpretation of contracts give great importance to the subjective intention of the parties. This is likely to result in uncertainty of interpretation and in contracts being

held void for mistake in circumstances where a more objective approach would give contractual certainty both for the parties and third parties (e.g. lenders using contractual rights as collateral). Antecedent negotiations are an unreliable basis for interpreting contracts and are not available to third parties who may assume rights under the contracts by assignment or otherwise. Similarly, to take into account subsequent conduct could be prejudicial to third parties. The provisions on terms not individually negotiated would also cause difficulties, particularly at a time when world regulators are pressing for there to be greater use of industry standard terms.

It is of great importance in financial markets that contracts be enforceable in a consistent and predictable manner. Hedging and netting of different contracts (and consequently, regulatory capital treatment) depend on their being interpreted in the same manner without, for example, the requirement to allow more time for performance or to take into consideration the reason for a failure to perform or the consequences on the other party's business of exercising a right or terminating the contract.

It is also important in financial markets to know at what point a party owes obligations to the other. This is because of the commercial and systemic importance of hedging, allocation of capital and risk management. A system under which obligations and potential liabilities (with a seemingly very wide meaning of "loss") can arise prior to the conclusion of the contract therefore introduces additional risk as a consequence of the legal uncertainties inherent in Article 27. It is common in international financial transactions either to exclude such liability by contract or to use a legal system where such liabilities only arise if specifically agreed.

Were the provisions of the Feasibility Study to be used in financial contracts, there would be systemic risks of uncertainty in the performance of contracts and potential for mismatch in relation to the hedging of contracts with different parties where, for example, good faith, fair dealing or reasonableness might be interpreted differently in different contracts.

The FMLC would be happy to discuss any of the comments made in this letter further. Please do not hesitate to contact us with any questions.

Yours sincerely

Lord Hoffmann

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Enc: FMLC Issue 97 Paper of 31 January 2011

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[1] The FMLC is grateful to Charles Clark for his assistance with preparing this letter.