10 OCTOBER 2013

FINANCIAL MARKETS LAW COMMITTEE

ISSUE 175—BANKING REFORM (RING-FENCING)

ADDENDUM

Further discussion of legal uncertainty which could arise from ring-fencing proposals: an addendum to the FMLC paper entitled *Banking Reform (Ring-fencing)*

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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 175 WORKING GROUP

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1. INTRODUCTION AND EXECUTIVE SUMMARY

Introduction

1.1. The role of the Financial Markets Law Committee (the "**FMLC**") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2. The implementation of the ring-fencing proposals for UK banks set out in the draft Financial Services (Banking Reform) Bill (the "**Bill**") represents a substantial change to the structure of the UK banking sector. In February 2013, the FMLC published a paper addressing areas of legal uncertainty arising from the proposed ring-fencing provisions in the Bill.[1]

1.3. On 17 July 2013, following the earlier publication of certain illustrative drafts of the principal statutory instruments to be promulgated under enabling provisions in the Bill, HM Treasury opened a formal consultation (the "**Consultation Document**") on the following draft secondary legislation:

(i) the Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order ("the **RfBO**");

(ii) the Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order ("the **Excluded Activities Order**");

(iii) the Banking Reform (Loss Absorbency Requirements) Order; and

(iv) the Financial Services and Markets Act 2000 (Fees and Prescribed International Organisations) Regulations.[2]

1.4. This addendum to the FMLC paper of February 2013 addresses areas of legal uncertainty arising from the RfBO and the Excluded Activities Order and has, in part, been prepared in response to the Consultation Document.

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[1] A copy of that paper, as well as other FMLC papers and letters, is available here.

[2] HM Treasury consultation document "Banking reform: draft secondary legislation" (Cm 8660), which requested responses by 9 October 2013. On 8 March 2013, prior to the publication of the Consultation Document, HM Treasury published a first draft RfBO and a first draft Excluded Activities Order. On 18 March 2013, HM Treasury published an amended, alternative version of the RfBO.

Executive summary

1.5. Part A of this addendum addresses the following provisions of the RfBO:

(i) The definitions of "large organisation", "eligible individual" and "relevant financial institution".[3]

(ii) *De minimis* and other provisions under which certain institutions are exempted from being a "ring-fenced body" (an "**RFB**").[4]

(iii) Provisions under which the deposits of an account-holder which has previously been certified as a "large organisation", an "eligible individual" or an "eligible family member" may become "core deposits" by expiry of time.[5]

1.6. Part B of this addendum addresses the following provisions of the Excluded Activities Order:

(i) The definition of an "exposure" and the related concept of a "financial institution exposure".[6]

(ii) The two "excluded activities"—*i.e.*, "dealing in commodities" and "dealing in investments as principal".[7]

(iii) Certain exceptions from the definition of "excluded activities" for specified types of risk-management transaction entered into by an RFB—broadly, hedging or treasury management activities and the provision of hedging services to account-holders.[8]

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3 RfBO, Art. 2(1). Broadly, an "eligible individual" means an individual who has provided a statement of eligibility (which has not expired), which statement includes an election to bank with a non-ring-fenced body and a declaration of high net worth. An "eligible individual" was referred to as a "certified high net worth individual" in earlier versions of the RfBO.

4 RfBO, Art. 6.

5 RfBO, Arts 8 and 9.

6 Excluded Activities Order, Art. 1(3).

7 *Ibid.*, Art. 3.

8 *Ibid.*, Arts 4 and 6.

(iv) The prohibition on RFBs using clearing, settlement or other services provided by inter-bank payment systems and the prohibition on short term financial institution exposures (and, in each case, certain related exceptions).[9]

A. THE RING-FENCED BODIES ORDER

2. DEFINITIONS OF 'LARGE ORGANISATION', 'ELIGIBLE INDIVIDUAL' AND 'RELEVANT FINANCIAL INSTITUTION'

2.1. Broadly, a UK institution that holds total "core deposits" with an average value in excess of a *de minimis* amount of £25 billion will be treated as an RFB for the purposes of section 142A of the Financial Services and Markets Act 2000 (the "**FSMA**", as proposed to be amended by the Bill) and be required to be ring-fenced, subject to specific exemptions for certain types of institution.[10]

2.2. The RfBO provides that an individual or "enterprise" may self-certify that s/he or it is an "eligible individual", an "eligible family member" or a "large organisation" (as appropriate) by providing a statement confirming such status; the statement must be counter-signed by a chartered accountant (or as an alternative, in the case of a "large organisation" only, its auditors).[11] In the absence of such certification, the acceptance by a UK institution of a deposit from the relevant individual or organisation will constitute a "core activity" (as the deposit will be a "core deposit"), unless an account-holder is a "relevant financial institution".[12]

2.3. Although it is not within the remit of the FMLC to comment on questions of policy, the FMLC believes that—as a matter of operability—the proposed return to this self-certification procedure for account-holders, which appeared in the original version of the RfBO published on 8 March 2013, is to be commended. Under this approach, it is the financial institutions which it is intended should not

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9 *Ibid.*, Arts 7 and 8.

10 RfBO, Arts 3 and 6. *Cf.* s. 4(1) of the Bill, which would insert a new s. 142A in the FSMA.

11 *Ibid.*, Arts 3 and 4 and Sch. 1.

12 *Ibid.*, Art. 3. "UK institution" in this context means a body corporate incorporated in the UK (s. 4(1) of the Bill).

engage in "core activities" without being ring-fenced that are required to confirm the status of the customers from which they accept deposits. Once a customer has the appropriate certificate, s/he or it may deposit any amount with any UK financial institution. The FMLC believes that this process should be relatively easy for both customers and banks to manage without incurring substantial costs or placing any restriction or minimum on the amount that an "eligible individual", "eligible family member" or "large organisation" may deposit with a non-RFB. The alternative approach (*i.e.*, of requiring banks to determine the status of their account-holders) would have created numerous areas of legal and operational uncertainty—for example, "enterprises" such as partnerships or unincorporated associations are not typically required to publish accounts, which would have resulted in their deposits being deemed to be "core deposits" under the alternative approach. Equally, to qualify as a high net worth individual (or an "eligible individual", in the revised language of the RfBO), the alternative approach would have required an individual to hold assets with a value of at least £250,000 with a single banking group.

"Large organisation"

2.4. However, the FMLC has identified various areas of uncertainty which remain in the current draft RfBO. First, as regards the definition of a "large organisation":

(i) The definition is a variation on the more familiar provisions of sections 382 and 477 of the Companies Act 2006 (the "**CA 2006**"), which define "small companies" for the purposes of statutory accounting and audit requirements respectively.[13] The reference to a "large organisation" in the RfBO introduces potential for confusion in the case of companies, owing to the subtle differences in the application of the relevant ceiling figures (*i.e.*, regarding number of staff and financial amounts) between the RfBO and the CA 2006.[14]

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13 The CA 2006 treats a company as "small" if it satisfies at least two of the "turnover", "balance sheet total" and "number of employees" requirements, whereas the RfBO treats an enterprise as a "large organisation" if it satisfies any one of those criteria. This difference arises by virtue of the "or" formulation used in Art. 4(2)(a) of the RfBO.

14 *Viz.*, having fewer than 50 employees, an annual turnover of not more than £6.5 million and a balance sheet total of not more than £3.26 million.

For example, a company which has 50 or more employees but does not exceed the turnover or balance sheet total figures would be a "small company" for the purposes of the CA 2006 and yet a "large organisation" for the purposes of the RfBO. Confusion is more likely to arise in this regard by virtue of the fact that the two tests apply the same set of ceiling figures.[15]

(ii) For the purposes of defining an "enterprise" and applying the relevant ceiling figures, the definition of "large organisation" incorporates by reference certain provisions of a European Commission Recommendation concerning the definition of micro, small and medium-sized enterprises (the "**SME Recommendation**"), which Recommendation is non-binding and does not have the force of law.[16] As a matter of drafting, the FMLC queries whether the definition of an "enterprise" should in fact refer to Article 1 of the Annex to the SME Recommendation (the "**Annex**")—which defines "enterprise"—rather than the text of that Recommendation itself. Again, the reference to a "large organisation" is confusing—to continue the example from paragraph (i) above, the same company would be a "medium-sized enterprise" for the purposes of the SME Recommendation.

(iii) Furthermore, the provisions of the SME Recommendation are capable of being amended from time to time by the Commission; it is unclear whether such an amendment would have the effect of directly altering the RfBO in the future.[17] Although it is aware of a similar legislative approach having been adopted elsewhere by the UK legislature (in the transfer-pricing context), the FMLC considers that cross-referring to the non-binding SME Recommendation—which arguably is drafted

[15] The ceiling figures applicable to a "medium-sized company" under the CA 2006 are of course greater; however, equivalent provisions do not appear in the RfBO—*cf.* ss 465-467 CA 2006.

[16] Commission Recommendation of 6 May 2003 (2003/361/EC).

[17] Annex, Art. 9.

less precisely than UK legislation—may result in a lack of legal certainty.[18]

(iv) It also appears that Articles 3 to 6 of the Annex, which provide guidance regarding the calculation of staff headcount and the relevant "financial amounts" (*i.e.*, annual turnover and balance sheet totals), are intended to be incorporated by reference. Again, assuming this is the legislative intention, this has not been properly achieved by the drafting.[19] *Inter alia*, the Annex provides for the staff and financial data of "linked" or "partner" enterprises of an enterprise which is not an "autonomous enterprise" to be aggregated together.[20] However, the application of the concept of "linked" or "partner" enterprises is not expressed clearly in the Annex and, in many cases, it will be necessary to refer to a separate, non-binding "User Guide" published by the Commission to determine how those concepts should be applied in the case of corporate groups, partnerships or joint enterprises. The FMLC considers that the degree of cross-referencing involved in interpreting the relevant provisions of the SME Recommendation (and related guidance) is burdensome—and may result in material uncertainty—for market participants.

(v) Furthermore, assuming Article 4 of the Annex is intended to be incorporated by reference, the FMLC considers that the application of subparagraph (3) of that Article may give rise to legal uncertainty. That subparagraph provides that, in the case of newly-established enterprises without approved accounts, "the data to be applied is [*sic*] to be derived from a *bona fide* estimate made in the course of the financial year". In the absence of further guidance, firms may interpret and apply that provision differently and/or in a different

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18 S. 172 of the Taxation (International and Other Provisions) Act 2010 ("**TIOPA 2010**").

19 The reference in Art. 4(3)(b) of the RfBO should almost certainly be to "articles 3 to 6 of the Annex to that Recommendation [emphasis added]"; the text of the SME Recommendation itself contains only four Articles. *Cf.* s. 172 TIOPA 2010.

20 Annex, Art. 6.

manner to the PRA. The interpretation of this provision may be expected to be particularly relevant to SPVs incorporated to facilitate large-scale financial transactions, which will require certainty regarding the application of the ring-fencing regime to them.

(vi) The concept of an "enterprise" is concerned primarily with "self-employed persons and family businesses... partnerships or associations", rather than incorporated entities.[21] In the case of certain individuals, it may be unclear whether that individual should be treated as an individual (and hence subject to the certification process for "eligible individuals") or as an "enterprise" (and hence subject to the certification process for "large organisations"). For example, self-employed persons may fall into both categories. However, although a self-employed person may be an "enterprise", it is not entirely clear whether s/he would be capable of being a "large organisation", since the word "organisation" is not typically used with reference to individuals.

2.5. Accordingly, the FMLC makes the following recommendations regarding the definition of "large organisation" in the RfBO:

(i) To avoid confusion, the RfBO might refer to a "qualifying enterprise" (and, if the recommendation in sub-paragraph (ii) below is followed, a "qualifying company"), rather than a "large organisation". Any reference to small- or medium-sized companies or enterprises is misleading in this context, since the application of the ceiling figures for such entities under the CA 2006 or the SME Recommendation is different from their application under the RfBO.

(ii) Ideally, the RfBO would have a separate test for companies and for other types of "enterprise", since the SME Recommendation is primarily designed to be applied to unincorporated entities. The test for companies might then be made consistent with the relevant provisions of sections 382 and 477 of the CA 2006 (which could be

21 *Ibid.*, Art. 1.

incorporated by reference). This would assist in the certification process, as those provisions are already applied by companies and their auditors when determining whether the relevant company is subject to the "small companies regime" for the purposes of statutory accounting requirements. This would reduce the risk of incorrect classification of corporate account-holders and also reduce certification costs, as the ceiling figures would only have to be considered once against a single formulation for all incorporated enterprises. Of course, as the legislative intention appears to be that only one of the ceiling figures need be satisfied for the relevant company's deposits not to be "core deposits", the CA 2006 provisions would need to be incorporated with appropriate amendments.

(iii) A definition for unincorporated "qualifying enterprises" might then be stated separately but—so far as possible—should follow the same formulation as for companies.[22] The RfBO should also set out clearly on its face the circumstances in which such enterprises should be treated as part of a larger group and the relevant data aggregated, rather than requiring cross-reference to the SME Recommendation and associated guidance. At the very least, the FMLC would recommend that any sources to be incorporated by reference should have the force of law. The term "organisation" might be avoided to reduce uncertainty, if the legislative intent is that the deposits of a self-employed individual should be capable of being treated as those of an "enterprise". (Alternatively, if that is not the intention, this should be made clear in the definition.)

(iv) The FMLC notes that, in the Consultation Document, HM Treasury stated that "in deciding if an enterprise meets the criteria for a large

[22] Clearly this would require further consideration as to what combination of the relevant ceiling figures would need to be satisfied, due to the subtle difference between s. 382 CA 2006 and the SME Recommendation. See note 13 above.

enterprise, its partner and linked enterprises are included."[23] However, it would be beneficial for legal certainty if provisions dealing with groups could be set out clearly in the RfBO itself, for the reasons expressed at paragraph 2.4 above. Therefore, the FMLC suggests that the exclusions in sections 478 and 479 of the CA 2006 should also be applied, so that companies of the types contemplated by those exclusions are considered by reference to the financial strength of the group of companies to which they belong. Similar provisions should apply in the case of connected enterprises.

(v) Finally, the FMLC recommends that provisions dealing with new companies and enterprises without approved accounts be made clear. Ideally, for the reasons given above, such provisions would be included in the RfBO itself. Alternatively, if cross-references to the SME Recommendation remain, the FMLC would welcome further guidance regarding how a company or enterprise should make a "*bona fide* estimate" of the relevant data.

"Eligible individual"

2.6. An individual is an "eligible individual" if s/he has provided an up-to-date statement of eligibility, which certifies that on average in the period of one year ending on the date of the statement s/he held "free and investable assets" to the value of £250,000 or more. The statement must be countersigned by a chartered accountant. The FMLC believes that the certification method for such high net worth "eligible individuals" raises various points of legal and operational uncertainty.

2.7. The FMLC notes that the definition of an "eligible individual" is very similar to the definition of "certified high net worth individuals" in the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "**Financial**

[23] Consultation Document, p. 7, note 2. Many individual companies which are members of a larger group (*e.g.*, treasury or finance companies) do not have over 50 employees and may place substantial sums of cash on deposit without having either a substantial turnover or high-value balance sheets. For operational purposes (*e.g.*, cash pooling arrangements), groups of companies require the ability to maintain banking arrangements with one deposit-taking bank regardless of the size of the individual companies concerned.

Promotions Order").[24] Although it is not within the remit of the FMLC to comment on matters of policy, consideration might be given to whether the certification process for "eligible individuals" could be made consistent with the equivalent process in the Financial Promotions Order. This would have the benefit of maintaining consistency across legislation and would require individuals and their advisers to apply a familiar test, which would improve legal certainty.

2.8. The term "free and investable assets" is not clearly defined in the RfBO, although certain types of non-qualifying assets are described. Of those, the concept of "outstanding proceeds of any loan secured on [the primary] residence" is unclear and may give rise to operational uncertainty.[25] Once the proceeds of a loan have been mixed with other funds, it is not clear how the origin of an amount in the mixed fund is to be determined. If the term is to be used, it—and any related exclusions—should be clarified further in the RfBO. Alternatively, consideration might be given as to whether the Prudential Regulation Authority ("**PRA**") might be empowered to specify and explain further the meaning of "free and investable assets" in rules and guidance. By contrast, the FMLC notes that the equivalent provisions of the Financial Promotions Order do not refer to the assets in question being "free and investable". Instead, that Order refers simply to "net assets", subject to exclusions—*viz.*, for the primary residence (or loans secured thereon), qualifying insurance contracts and certain types of benefits.[26]

2.9. Unlike the equivalent certificate of high net worth in the Financial Promotions Order, the form of the statement of eligibility for individuals at Schedule 1 of the RfBO requires monthly valuation of the total assets held by an individual to determine whether s/he is an "eligible individual". As an operational matter, investment reports typically are produced less frequently (*e.g.*, quarterly) and other types of asset (*e.g.*, real property) are valued much less frequently. If individuals are unable to use professional valuations obtained in the normal course of asset

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[24] S.I. 2005/1529. Art. 48 and Sch. 5, Part 1.

[25] RfBO, Sch. 1.

[26] Financial Promotions Order, Sch. 5, Part 1.

management for these purposes, this may introduce considerable operational uncertainty and cost for such individuals.

2.10. Furthermore, the FMLC notes that the statement of eligibility strictly requires the monthly valuation (by a chartered accountant) of the "total free and investable assets" of the relevant individual, rather than the valuation of a pool of identifiable assets whose average value exceeded £250,000 over the relevant year, for example. In the case of very wealthy individuals, a literal reading of this test might produce operational uncertainty and may not reflect the legislative intention—it would appear to require such individuals to value *all* of their assets on a monthly basis, even where the average total value of those assets would be greatly in excess of £250,000. At the very least, guidance should be provided on this point, as different individuals and their accountants may interpret the valuation requirement differently. If such guidance is not provided in the RfBO itself, provision might be made at this stage for more sophisticated and appropriate rules to be laid down in separate regulations. The FMLC notes that the provisions of the Financial Promotions Order do not impose an equivalent requirement.

2.11. The Financial Promotions Order also permits an individual to certify that s/he has an annual income to the value of £100,000 or more. By contrast, an income-based test does not appear in the definition of "eligible individuals" in the RfBO. From a perspective of operational certainty and practicability, such a test might be expected to be considerably clearer in its application for individuals (and their advisers) than a test based on monthly valuations of total assets, such as that which appears in the RfBO.

2.12. Finally, it is unclear how the "eligible individual" test should be applied in the case of an individual trustee or executor placing funds on deposit as part of trust arrangements or pursuant to the administration of an estate. In particular, it is unclear whether it is the assets held by the individual for his or her own account or the assets held on behalf of the trust or estate which should be considered in determining whether the individual is an "eligible individual". It might be assumed that it would be the assets of the trust or the estate which would be relevant in such cases. If that is not correct, trust funds placed on deposit by a

trustee or executor who would not qualify as an eligible individual in his or her own right would appear to be "core deposits" irrespective of the amount of those funds. Accordingly, the FMLC would welcome specific provisions in the RfBO to clarify the treatment of individuals who are acting as trustees or executors (or in a similar capacity). For example, the Financial Promotions Order contains specific provisions regarding the trustees of certain "high value trusts".[27]

"Relevant financial institution"

2.13. Article 5 of the RfBO specifies the types of institution that are "relevant financial institutions"; the deposits of such institutions will not be "core deposits" pursuant to Article 3(2) of that Order.

2.14. Unlike the other types of institution listed, the term "investment firm" is not defined in the RfBO—this would appear to be an oversight in the drafting. The FMLC recommends that the term should be defined. Reference might be made to Article 4(1) of the Directive on markets in financial instruments ("**MiFID**"), which defines "investment firm", in which case the RfBO should also include a definition of MiFID.[28] Alternatively, the RfBO might refer to Article 4.1(2) of the "prudential requirements regulation" (as defined in the RfBO), as the definition of "credit institution" in the RfBO already makes reference to that Regulation.[29]

2.15. Finally, as a minor drafting point, the reference in Article 5(3) of the RfBO to Article 21 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (the "**Regulated Activities Order**") should be to "dealing <u>in</u> investments as agent", rather than "dealing <u>with</u> investments as agent" (emphasis added).[30]

27 *Ibid.*, Arts 49(2)(c) and 49(7).

28 Directive 2004/39/EC.

29 Regulation 575/2013/EU.

30 S.I. 2001/544.

3. CLASSES OF INSTITUTION THAT ARE NOT RING-FENCED BODIES

3.1. Broadly, an individual UK institution which carries on the regulated activity of accepting deposits (pursuant to authorisation under Part 4A of the FSMA) will not be an RFB, but will instead be an "exempt institution", if:

(i) the institution has existed for at least three financial years and holds total core deposits the average value of which over three financial years is less than or equal to £25 billion; or

(ii) where the institution has not existed for at least three financial years, the institution holds total core deposits the average value of which over the institution's existence is less than or equal to £25 billion.[31]

3.2. These *de minimis* provisions are adjusted for groups; in such cases, the core deposits of each UK institution in the relevant group are aggregated. Each such UK institution will be an RFB unless the sum of the average core deposits held by the UK institutions among the group is less than £25 billion.[32]

3.3. As a matter of drafting, the *de minimis* threshold is expressed as "equal to or less than £25 billion" in Article 6(1)(a) of the RfBO but as "less than £25 billion" in Article 7(3). It is unclear why the language in those two Articles should be inconsistent.

3.4. The FMLC considers that the relatively complicated categorisation of UK institutions under the RfBO may create uncertainty for such institutions when applying the *de minimis* thresholds, whether on a *solus* or a group-wide basis. A UK institution which carries on the regulated activity of accepting deposits (and does not otherwise qualify for the exemptions for insurers, credit unions and industrial and provident societies) will fall into one of three categories—*viz.*:

(i) an RFB;

(ii) an "exempt institution" (as described at paragraph 3.1 above); or

[31] RfBO, Art. 6(1)(a). "Exempt institution" is defined in Art. 2(1) of the RfBO. Note that the *de minimis* exception (as well as the other exceptions for insurers, credit unions and industrial and provident societies) and rules for groups of companies were reproduced exactly in the Alternative RfBO (as Art 7 and 8, respectively).

[32] *Ibid.*, Art. 7.

(iii) a non-ring-fenced member of a group which includes an RFB.

This third category is not clearly defined in the RfBO but will comprise any deposit-taking UK institution which does not itself hold any core deposits but is a member of a group comprising other UK institutions which in aggregate hold more than the *de minimis* amount of core deposits.[33]

3.5. As regards the second category (*i.e.*, "exempt institutions"), there would appear to be no positive obligation on such institutions to require their account-holders to provide certification of their status. In many circumstances, even in the absence of any certification, it may well be clear to a UK institution or group that its deposit-taking activities would not exceed the *de minimis* threshold. Conversely, an institution falling in the third category will need to be certain at all times that it is not accepting any "core deposits", which would require it to become ring-fenced. It would appear that the effect of Article 3(2)—and, in the case of institutions in the third category, Article 8(2)—is that, in the absence of up-to-date certification or evidence that the depositor is a "relevant financial institution", all deposits held by such institutions are to be treated as "core deposits". In this regard, the FMLC notes that there is no certification process for depositors that are "relevant financial institutions", which may have the potential to create further uncertainty. In view of the relatively complicated interaction of Articles 3, 6 and 7 of the RfBO, legal and operational certainty might be improved by explanatory notes or PRA guidance regarding prudent management of the certification process by UK institutions—particularly for non-ring-fenced members of ring-fenced groups and for "exempt institutions" the deposit-taking activity of which is near the *de minimis* threshold. Although it is not within the FMLC's remit to comment on matters of policy, consideration might be given as to the application of certification requirements to institutions or groups the deposit-taking activity of which is very limited relative to the £25 billion *de minimis* threshold.

[33] Such institutions will not be "exempt institutions" because the definition in Article 2 only cross-refers to the exemption at Article 6(1), and not Article 7, of the RfBO.

3.6. Finally, the FMLC notes that the effect of Articles 3(2), 6 and 7 of the RfBO is that UK institutions will not be RFBs (and hence will not be subject to the restrictions placed on RFBs under the Excluded Activities Order, including the prohibition on having branches or subsidiaries outside the EEA) [34] in cases where:

(i) the total value of their average deposits is or exceeds £25 billion and those deposits would be "core deposits" but for the fact that they are held in an account with a branch of the relevant UK institution which is located outside the EEA; or

(ii) the total value of average core deposits held by institutions in the group is or exceeds £25 billion but the sum of the average core deposits held by UK institutions in the relevant group is less than £25 billion.

4. ACTIONS TO BE TAKEN WHEN DEPOSITS BECOME CORE DEPOSITS BY EXPIRY OF TIME

4.1. Articles 8 and 9 of the RfBO set out the procedure that must be followed if a non-RFB has not been provided with an up-to-date statement of eligibility, a family member statement or a statement which complies with Article 4(1)(a)—collectively referred to here as "**Eligibility Statements**". The draft RfBO amends the previous versions of that Order published on 18 March 2013 by re-introducing the Eligibility Statements requirements, introducing the concept of a "family member" and deleting certain provisions regarding joint account-holders.

4.2. Articles 8 and 9 will become effective where the relevant Eligibility Statement is older than 12 months for a Large Organisation, or 24 months for an Eligible Individual and/or Family Member, and the Eligibility Statement has not been replaced by a more recent statement.

4.3. To the extent a replacement Eligibility Statement is not provided, deposits held within the non-RFB will be classified as "core deposits" and be required to be transferred to an RFB, or repaid, on the day following the relevant "transfer

[34] Excluded Activities Order, Art. 10.

date".[35] A "deposit" for these purposes is a sum of money paid on terms that satisfy both limbs of the following test:

(i) the money is to be repaid, with or without interest or premium, either on demand or at a time or in circumstances agreed by, or on behalf of, the person making the payment and the person receiving it; and

(ii) the payment of the money is not referable to the provision of property (other than currency), services or the giving of security.[36]

"Deposits" will therefore capture amounts held in accounts such as current accounts, savings accounts and term (or time) deposit accounts.

4.4. The requirements under Articles 8 and 9 give rise to uncertainty as they potentially create a conflict between the terms of the deposit and the requirements of the RfBO. The FMLC is given to understand that early withdrawals or closures are often not permitted under any circumstances during the term of a term deposit, except in the event of the death of the customer. The terms and conditions of such deposits are therefore typically not drafted to allow for closure either by the customer or the relevant institution. Whilst affected banks may be able to change their terms and conditions to reflect the requirements of the draft RfBO (once known), this will still leave conflict with regard to deposit agreements entered into prior to that date. For deposits governed by such agreements, it is unclear how institutions will lawfully be entitled to close such accounts where the term would continue past the transfer date without being exposed to the risk of legal action. This will be of particular concern for deposits taken under foreign law.

4.5. Additionally, there will be a question over what "amount" will be required to be transferred or repaid where the term deposit is subject to an enforced closure. Currently, where an enforced closure occurs as a result of death, the institution is usually required to repay the full deposit amount plus interest accrued to the date

[35] The "transfer date" is likely to be either (i) 30 months plus one day following the date of the last Eligibility Statement for eligible individuals and family members or (ii) 18 months plus one day following the date of the last Eligibility Statement for large organisations.

[36] Regulated Activities Order, Art. 5(2).

of early closure. It is unclear whether the same principle should apply here or whether an institution will be required to pay interest as if the full term had elapsed. Similar questions apply with respect to the contractual terms of the deposit; where there are differences between the standard-form deposit terms of the transferor and transferee (as inevitably there will be), there will be uncertainty as to which terms apply following transfer and as to whether the depositor obtains rights as against the transferee, to the extent that the transferee's terms are less favourable than those of the transferor.

4.6. If an account-holder fails to respond to a notice provided by an institution, the relevant deposits will be transferred to an RFB or, where the institution is a member of a group which contains an RFB, that RFB.[37] These provisions give rise to several uncertainties:

(i) First, as regards the opening of accounts, if the customer has not nominated an RFB, no account will exist with that independent RFB and it is questionable how an account could be opened without the non-RFB transferring data in likely contravention of the Data Protection Act 1998. Additionally, the customer will not have provided information required for anti-money laundering purposes.

(ii) Secondly, it is not clear whether the relevant RFB is legally obliged to accept the deposits once it has been nominated or whether it will be legally entitled to refuse the money—if the latter, it is also unclear whether it would be required to justify its decision. It might be assumed that in such circumstances the deposits would be repaid to the account-holder. However, the RfBO does not contain provisions to deal with the situation where the account-holder has not provided the institution with additional account details. In such cases, it is not clear whether the institution should place the funds in a client account—possibly interest bearing—and treat that account as dormant or, alternatively, provide a cheque.

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37 *Cf.* RfBO, Arts 8(3)(d), 8(4), 9(2)(d) and 9(3).

4.7. A further difficulty arises where, between the date of the notice required pursuant to Articles 8(1) and 9(1) and the relevant "transfer date", the nominated RFB ceases to exist. If the account holder does not respond to the earlier notification, the institution must transfer the relevant deposits to the specified RFB. However, there is no fall-back provision dealing with the making of payment where the nominated RFB ceases to exist.

4.8. Finally, under Articles 8(5) and 9(4) as drafted, a non-RFB which is holding deposits which have become "core deposits" after the "transfer date" but where a transfer of the relevant deposits is pending would appear to be treated as an RFB. In circumstances where transfer does not occur promptly owing to technical difficulties or delays, for example, this may result in legal and/or operational uncertainty for the relevant institution.

4.9. The FMLC respectfully recommends that the legislation should be re-considered in light of these areas of uncertainty and that further clarity regarding these points should be provided either in the RfBO or—at the very least—in PRA guidance, where appropriate.

B. THE EXCLUDED ACTIVITIES AND PROHIBITIONS ORDER

5. DEFINITIONS OF "EXPOSURE" AND "FINANCIAL INSTITUTION EXPOSURE"

5.1. It is proposed that RFBs will be prohibited from entering into transactions which give rise to a "financial institution exposure" for the RFB, save as permitted under Article 8 of the Excluded Activities Order.[38]

5.2. An "exposure" is defined as meaning

> ...in relation to a person ("P"), the loss which may be incurred by P if (a) P's counterparty fails to meet their obligations (whether to P or to another person), (b) P realises assets, including assets from positions which are not reflected in P's balance sheet.[39]

This is a very broad definition. For example, it is unclear whether it would cover contingent losses or potential exposure to claims in tort or for damages, costs *etc*. The FMLC recommends that the Excluded Activities Order be amended to provide further clarity regarding the meaning and quantification of an "exposure".

5.3. A "financial institution exposure" is defined as

> (a) an exposure under, or which relates to, a contract with a relevant financial institution or (b) an exposure to, or which relates to, the securities or other financial instruments issued by a relevant financial institution.[40]

Uncertainties may also be created by the breadth of this definition. For example, it is unclear how an exposure would "relate to" a contract with such a financial institution which is not an exposure "under" such a contract.

5.4. As drafted, Article 8(1) of the Excluded Activities Order would give rise to legal and operational uncertainties in a number of areas—for example, in a number of areas the provisions would prevent an RFB entering into day-to-day transactions which are essential to the provision of retail services, good administration and/or

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38 Excluded Activities Order, Art. 8.

39 *Ibid.*, Art. 1(3).

40 *Loc. cit.* "Relevant financial institution" is defined in Art. 2.

regulatory compliance. It is not clear that this is an intended consequence. Prominent among these transactions and activities are:

(i) Insurance. *Prima facie*, an RFB would assume an exposure to an insurer simply by taking out an insurance policy with that insurer. The RFB would be exposed to the creditworthiness of the insurer in the event of a claim. Unless it is the legislative intent that RFBs should be prohibited from taking out insurance (in which case this should be made clear), the Order might contain an express provision or exception dealing with insurance.[41] Alternatively, if the intent is that RFBs should be prohibited from taking out insurance, a thorough review of other regulatory requirements should be conducted to ensure that an RFB would not be required to breach other law(s) by complying with the Excluded Activities Order—*e.g.*, UK requirements to maintain vehicle insurance.

(ii) Credit card issuance. Were a customer of an RFB to nominate a non-ring-fenced third party to pay its credit card debt to the RFB, this could create an exposure to the non-ring fenced third party. Similarly, an RFB acting as merchant acquiring bank (*i.e.*, as part of its credit card operations) would result in exposures to the issuers of the credit cards of the merchant's customers. *Prima facie*, both these transactions are prohibited under Article 8. This may create operational difficulties for businesses that are not "large organisations" and affect their ability to offer credit card payment facilities to their customers.

(iii) Correspondent banking. Broadly, Article 8(7) of the Excluded Activities Order specifies that an RFB is permitted to hold *nostro* and *vostro* accounts with non-ring-fenced "credit institutions", subject to the other provisions of Article 8. The Order clearly contemplates that certain exposures resulting from correspondent banking arrangements may be subject to the additional restrictions on "short term

[41] For example, in respect of real estate, plant and equipment, vehicles, employees' healthcare and against occupiers' and third-party liability.

exposures".[42] As an operational matter, it is uncertain whether the narrow scope of the exceptions in Articles 8(4) and 8(7) to the general prohibition would enable RFBs to continue to provide correspondent banking services to accountholders.

(iv) Foreign exchange ("**FX**") clearing. To the extent that an RFB is not able to participate directly in an overseas clearing system, exposures to the relevant system will be subject to the restriction on "financial institution exposures". To make payments in a foreign currency, a bank must hold a bank account in a major financial centre of the relevant country. RFBs will not be able to provide FX transmission services to customers unless they can incur the exposure to the loss of any money in such an account as a result of the failure of the relevant clearing system. As an operational matter, it is uncertain whether the scope of Article 8(4) would permit an RFB to hold sufficient amounts in overseas accounts to provide such services to customers, even though the clearing processes are shorter than five days.

5.5. As regards (i) above, the Excluded Activities Order amends the definition of "financial institution exposure" that appeared in the previous version of that Order which was published on 8 March 2013. That term

> … shall not include an exposure with a relevant financial institution which relates solely to the safeguarding and administration of assets of the ring-fenced body by the relevant financial institution.[43]

It is clear that this definition is intended to enable an RFB to place assets with custodians. However, it is less clear whether this additional exception is intended to enable RFBs to take out insurance policies. If this is the intention, the FMLC notes that this exception only relates to the safeguarding or administration of "assets" of the relevant RFB; this would not include insurance against liability to third-parties, for example.

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[42] *Ibid.,* Arts 1(3) and 8(4).

[43] *Ibid.*, Art. 1(3).

5.6. It is very likely that other potential "financial institution exposures" of RFBs that may arise from typical transactions of the type discussed above, which may not have been considered, will be identified. However, the absolute prohibition on such exposures is subject only to the specific exceptions set out in the Excluded Activities Order. The FMLC respectfully recommends that HM Treasury should consider granting the power to create further derogations from the prohibition in Article 6.

6. EXCLUDED ACTIVITIES

Commodities trading

6.1. The Excluded Activities Order creates a new excluded activity (*i.e.*, an activity in which an RFB is prohibited from engaging) of dealing in "commodities", subject to certain exceptions.[44] However, the drafting of this provision and the associated definition of a "commodity" create a number of legal and operational uncertainties.

6.2. As a matter of drafting, it is not stated expressly anywhere in the Excluded Activities Order that dealing in commodities is an "excluded activity" for the purposes of the Bill or that Order—the term "excluded activity" appears only in the heading of Article 3. Although that heading is a part of the Order, it would be preferable for the point to be put beyond doubt in a provision or additional definition, as it is to be presumed that the general exceptions (in Articles 4 to 6) to the prohibition on an RFB's carrying on an "excluded activity" should also apply to dealing in commodities.[45]

6.3. The definition of "commodity" in the Excluded Activities Order is adopted from section 9A of the Building Societies Act 1986. For the sake of consistency, and in view of the possibility of future European legislation regarding ring-fencing, consideration might be given to making this definition consistent with the

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[44] *Ibid.*, Art. 3.

[45] The Consultation Document (at p. 13) makes clear that this was the legislative intention, stating that the Excluded Activities Order "provides that a further activity—commodities trading—is an excluded activity." For supporting authorities for the view that a heading is an equally valid part of a statutory instrument, see F. Bennion, *Bennion on Statute Law*, 3rd ed. (London: Longman, 1990), p. 120; *cf.* s. 19(1) Interpretation Act 1978.

definition of "commodity" in MiFID.[46] The MiFID definition is slightly different from that in the Building Societies Act—for example, the former would include energy such as electricity. In the absence of policy considerations to the contrary, using the MiFID definition might have the benefit of familiarity. (Although it is beyond the scope of this Addendum, if the MiFID definition is to be preferred, consideration might then need to be given as to whether the Building Societies Act 1986 should also be consistent in this regard.)

6.4. The FMLC notes that the scope of this prohibition may also have unintended consequences which do not reflect the legislative intent. The definition of "commodities" would include goods which an RFB may wish to purchase for its own use—*e.g.*, natural gas for heating, food products for consumption by staff, electricity (if the MiFID definition is preferred) *etc.* The Consultation Document states that Article 3 of the Excluded Activities Order

> … provides that <u>trading</u> in commodities (as defined in the Building Societies Act 1986) is an excluded activity [emphasis added].[47]

However, this is not the case—Article 3 itself prohibits an RFB from "<u>dealing</u> in commodities [emphasis added]", whereas the heading for that Article refers to "commodities trading". Whilst it might be doubted whether purchasing commodities for consumption would be in the nature of "trading", "dealing in" is arguably broader and might cover commercial transactions in commodities.[48] On such a literal reading, an RFB would only be able to purchase such goods from a central bank under the "central bank exemption" in Article 5. Accordingly, the FMLC would recommend that the precise scope of the excluded activity be defined clearly in the Excluded Activities Order. For example, if the reference

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46 "Commodity" is defined for MiFID purposes by the Level 2 MiFID implementing Regulation (Regulation (EC) No. 1287/2006). *Cf.* the European Commission consultation paper "Reforming the structure of the EU banking sector" (16 May 2013).

47 Consultation Document, p. 13.

48 In any case, in the absence of a statutory definition, judicial guidance on the existence of a "trade" is notoriously difficult to apply—*cf.* the recent tax case of *Marson v Morton & Ors* [1986] 59 TC 381 for an non-exhaustive review of the so-called "badges of trade". The Oxford English Dictionary defines "to deal in" as "to carry on commercial transactions; to do business, trade or traffic… (… in an article)".

were to "trading" rather than "dealing", it might be made clear in further guidance that an RFB which purchases certain commodities for its own consumption should not be treated as carrying on an excluded activity.

Dealing in investments as principal

6.5. The excluded activity of dealing in investments as principal is defined in the Bill as "the regulated activity of dealing in investments as principal".[49] Accordingly, it would appear that "dealing in investments" means "buying, selling, subscribing for or underwriting investments" and that this definition is also subject to the further exclusions contained in the Regulated Activities Order.[50]

6.6. The FMLC notes that Article 3 of the Excluded Activities Order creates an exception to the prohibition on an RFB's dealing in commodities for the purposes of realising security taken for a loan provided by the RFB. However, there is no equivalent of that exception as regards the excluded activity of dealing in investments as principal. There are certain specific exceptions (*e.g.*, for debt-for-equity swaps—see paragraph 7.5 below).

6.7. In view of the degree of cross-referencing to both the FSMA (as proposed to be amended by the Bill) and also to the Regulated Activities Order which is required in interpreting the scope of the Bill and the Excluded Activities Order, legal and operational uncertainty might be increased by clear provisions or—at the very least—guidance setting out the scope of all of the exceptions to the two types of excluded activity. For example, it may be the realisation of security taken for a loan made by an RFB would not constitute "dealing in investments as principal" because one of the exceptions in the Regulated Activities Order is intended to apply, such that an equivalent to the exception for commodities would be otiose. However, further guidance would be beneficial to avoid uncertainty—the FMLC is given to understand that some commentators have also queried whether an RFB would be able to issue shares, subscribe for shares in a subsidiary or transfer loans advanced to accountholders, for example.

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49 The Bill would introduce the new ss 142D(2) and 142Z1 FSMA, to be read in accordance with Sch. 2 FSMA and any order made under s. 22 FSMA.

50 *Cf.* Regulated Activities Order, Arts 15 to 20 and also the exclusions in Chapter XVII of that Order.

7. EXCLUDED ACTIVITIES—EXCEPTIONS FOR SPECIFIED RISK-MANAGEMENT ACTIVITIES

Article 4: Excluded activities: exceptions

7.1. Article 4 of the Excluded Activities Order provides for exceptions from the definition of "excluded activities"—primarily to ensure that RFBs are able to manage their risk prudently (*e.g.*, by engaging in hedging their own balance sheet and treasury management). To be within the exception, an RFB is only permitted to enter into a transaction which manages their risk if the "sole or main reason" is to limit the extent to which its business is adversely affected by (i) changes in interest or exchange rates or commodity prices, (ii) default risk, or (iii) liquidity risk. The Excluded Activities Order offers no guidance or certainty on what will constitute a "sole or main reason", nor does it contain provisions requiring the PRA to produce rules or guidance in this regard.

7.2. "Sole or main reason" tests are new to regulatory legislation, although "sole or main *purpose*" tests are an increasingly common feature in tax legislation, especially in anti-avoidance provisions. Despite the prevalence of such tests, applying a "main purpose" test is a process on which there is little useful judicial guidance. The recent First-tier Tribunal (Tax) decision in *IIiffe New and Media Ltd v HMRC* [2012] UKFTT 696 (TC) suggests that evidence as to why an overall transaction was undertaken and separately why it was structured as it was would be required. Additionally, the Special Commissioner's 2008 decision in *Snell v HMRC* (UK SPC 00699) would suggest that the risk-management decision to enter into a transaction could not be ancillary in the context of the transaction as a whole, nor could the risk management benefit be *de minimis* in size in the context of a particular transaction.

7.3. In the absence of further guidance, there is a strong likelihood that individual firms will interpret these provisions differently and/or in a manner inconsistent with the approach adopted by the PRA, as regards both what is justifiably a "sole or main reason" and also the evidence required to demonstrate the "sole or main reason" that is asserted. In order to increase legal certainty, the FMLC would recommend that the meaning of this term should be defined within the legislation

or—at the very least—that the PRA should be required to produce rules to promote consistent interpretation.

7.4. As listed above, the Excluded Activities Order currently excepts transactions undertaken to limit the impact of (i) changes in interest or exchange rates or commodity prices, (ii) default risk, and (iii) liquidity risk. The scope of these categories appears to be too narrow, thereby preventing an RFB hedging certain other risks that may adversely affect its business—for example:

(i) The exception would not enable an RFB to hedge exposures to indices such as the consumer price index. A number of firms that are likely to fall within the definition of an RFB offer products linked to such indices.

(ii) Article 4 also fails to consider transactions that the FMLC understands are necessary for funding purposes in current markets, for example the use of repurchase transactions which have not been carved out of either Article 4 or Article 8. There is an exception to the extent that such transactions are being entered into in order to satisfy churning requirements in relation to the liquidity buffer.[51] However, such narrow drafting would not enable an institution to manage institutionally wide liquidity requirements.

It is not clear that these limitations are intended consequences of the draft provisions.

7.5. Article 4(3) enables an RFB to enter into a debt-for-equity swap; however, the shares concerned have to form part of the "ordinary working capital" of the debtor and the debt in question must be a debt under a loan. The provision, whilst welcome in allowing a bank to manage debt claims through the work-out process, presents some operational uncertainty in the following respects:

(i) the reference to a "loan" excludes the possibility of an RFB participating in a debt-for-equity swap in respect of debt not arising under a loan;

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[51] Excluded Activities Order, Art. 8(12).

(ii) the requirement that the acquisition of shares be from the debtor would prevent the acceptance of shares in a third party, such as a parent of the debtor (which might commonly be seen in respect of pre-packaged insolvency proceedings); and

(iii) the reference to "ordinary working capital" in the Article is unclear—the term appears to confuse share capital with working capital and may not reflect the legislative intent.

7.6. As a more general point, Article 4 gives rise to a number of questions as to the interaction of the excepted activities with the various prohibitions in Articles 7 and 8. The priority of these provisions is not clear. A straightforward reading would suggest that the exceptions are subject to the prohibitions—*i.e.,* that an activity, even if excepted from the exclusions, may not be undertaken to the extent that it is prohibited under the prohibitions. This reading is potentially called into question by Article 4(2)(b), which expressly provides that a transaction within Article 4(2) must not give rise to a financial institution exposure which is prohibited under Article 8(1). This drafting creates uncertainty, as it would indicate that an excepted transaction would not be subject to the prohibition but for the express provision within the Article. This, in turn, would imply that other excepted activities are not subject to the prohibitions, in order to avoid concluding that the proviso is otiose. The FMLC recommends that the interaction between the exceptions and prohibitions should be made clear.

Article 6: Excluded activities: derivatives

7.7. RFBs are also permitted to provide certain "simple" derivative products to their customers by way of exception, pursuant to Article 6. In order to avail itself of this exception, an RFB must ensure that certain requirements are satisfied in relation to the investments sold—and that prescribed conditions are met. In order to qualify for the exception, the investment must be a derivative instrument which relates to currencies, interest rates or commodities and the potential profit or loss must be "directly proportional" to (i) the change in value of the relevant currencies or commodities or (ii) the change in the level of the interest rates to which the derivative relates. The Excluded Activities Order provides no guidance as to what the term "directly proportional" means—for example, it is unclear

whether it is intended to exclude embedded leverage. In order to provide clarity, the FMLC believes that this term should be defined within the Order itself.

7.8. The reference to IFRS 13 in Article 6(2) may also introduce further uncertainty, as that Article contemplates that IFRS 13 may be "amended from time to time". There is a risk that the reporting standards framework may change significantly over time, which might subject Article 6 to ambiguity prior to possible amendment. Similar issues arise regarding the cross-references to the FCA Handbook.

8. PROHIBITIONS—INTER-BANK PAYMENT SYSTEMS AND FINANCIAL INSTITUTION EXPOSURES

8.1. Broadly, the Excluded Activities Order prohibits RFBs from entering into a transaction to use an "inter-bank payment system" other than as a direct participant in that system, save where the relevant RFB is (i) not eligible to become a direct participant in the system concerned and/or (ii) where the cost is "disproportionate" to the benefit which the RFB expects to receive from using the system.[52] Without further guidance regarding the meaning of the term "disproportionate" and the method by which an RFB should assess the expected benefits of using the relevant system, it is probable that individual firms will interpret the provision differently and/or in a manner inconsistent with the approach adopted by the PRA. Accordingly, the FMLC would welcome further clarification or guidance on the second limb of the exception to the general prohibition.

8.2. As outlined at 5.1 above, the Excluded Activities Order also prohibits RFBs from entering into any transaction which gives rise to a "financial institution exposure", subject to specific exceptions.[53] *Inter alia*, the Order permits transactions which would result in a "short term exposure" (as defined), subject to limits on (i) the total amount of an RFB's short term exposures (ii) the RFB's exposure to the relevant financial institution, and (iii) the time for which the

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[52] *Ibid.*, Art. 7(2).

[53] *Ibid.*, Art. 8(1).

exposure lasts.[54] The definition of "short term exposure" contemplates exposures arising from foreign exchange transactions, transactions for the purchase or sale of securities and certain overnight or intraday payments business.[55] However, as an operational matter, it is not clear how those limits should be applied to Bacs, which is a payments system in which exposures last for three days. Although the absolute time limit for short term exposures is five working days, Bacs would not appear to fall within any of the limbs of the definition of a "short term exposure" at all—the two limbs of that definition dealing with money transmission or payments services only apply to exposures which exist intraday or overnight. Accordingly, it is unclear whether an RFB would be permitted to use Bacs (which is the system used for direct debit payments) where that would result in a financial institution exposure. Although it is not within the remit of the FMLC to comment on matters of policy, the FMLC notes that it is questionable whether restricting the use of Bacs by RFBs in this way reflects the legislative intent or whether this is an oversight.

8.3. Operational uncertainties also arise regarding the application of the prohibition on "financial institution exposures" to settlement systems. Settlement exposures are the sum of funds owed by the bank and those owed to it. The FMLC is given to understand that such exposures are typically calculated by a bank after the obligation to a customer to pay on behalf of that customer has arisen. As an operational matter, it is unclear what should happen if a bank gives an undertaking to pay on behalf of its customer and then discovers it has broken its settlement exposure limits to the system.

8.4. Indeed, the fact that an RFB may be expected to have multiple relationships with relevant financial institutions may result in operational uncertainties for RFBs owing to the difficulty in monitoring in real-time the net "short term exposure" to each financial institution to ensure that this remains below the percentage limits of Article 8(4), for example. Depending on the type of transaction, at the point an obligation becomes binding on an RFB the precise extent of the financial

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54 *Ibid.*, Art. 8(4).

55 *Ibid.*, Art. 1(3).

institution exposure may not be known to the relevant RFB. A similar issue may arise under Article 8(8) regarding documentary credits. Although it is not within the remit of the FMLC to comment on matters of policy, in view of the likelihood of RFBs encountering operational uncertainties regarding the proper application of the limits on permitted short term exposures to various types of payment and settlement business, it may be beneficial for certainty for the PRA to be empowered to make rules in this regard—such a power might be reserved to the PRA under Article 9 of the Excluded Activities Order.

8.5. The preceding comments address uncertainties regarding UK interbank payment and settlement systems. However, the FMLC notes that similar points (*i.e.*, regarding the length of the clearing or settlement cycle) may also arise in relation to foreign clearing systems—*e.g.*, overseas foreign exchange clearing.[56]

8.6. In light of the legal and operational uncertainties regarding the proper application of the prohibitions regarding inter-bank payments systems and financial institution exposures, the FMLC would welcome detailed consultation with clearing experts at banks and at clearing systems with a view to ensuring that the provisions of the Excluded Activities Order which relate to such systems provide sufficient certainty for market participants.

9. CONCLUSION

9.1. The FMLC welcomes the Consultation Document and believes that consideration and clarification of the points raised above regarding the RfBO and Excluded Activities Order is important for the creation of a ring-fencing regime which provides legal certainty for market participants.

9.2. In summary, of the various points referred to in this Addendum, the FMLC considers that the most important areas to address as regards the RfBO are:

(i) <u>The definitions of "large organisation" and "eligible individual".</u> The RfBO should state clearly on its face the tests to be applied to companies and other enterprises and include clear provisions dealing with groups or partner / linked enterprises. As regards "eligible

[56] See para. 5.4(iv) above for a discussion of other issues regarding overseas foreign exchange clearing.

individuals", consideration might be given to making the certification process consistent with the Financial Promotions Order. In any case, the application of the valuation requirements—and related definitions—requires further clarification.

(ii) Classes of institution that are not RFBs. The complicated categorisation of institutions under the RfBO creates uncertainty in applying the *de minimis* threshold of £25 billion. At the very least, consideration should be given to producing explanatory notes or PRA guidance regarding management of the certification process by institutions—particularly for non-ring-fenced members of ring-fenced groups and for "exempt institutions" the deposit-taking activities of which is near, or conversely is very limited relative to, the *de minimis* threshold.

(iii) Actions to be taken when deposits become core deposits by expiry of time. Consideration should be given to the possibility of conflict between the requirements of the RfBO and the legal terms on which amounts have been deposited with an RFB. Furthermore, detailed provisions or, at the very least, guidance should be provided regarding how deposits are to be transferred or repaid under Articles 8 and 9 of the RfBO.

9.3. Secondly, as regards the Excluded Activities Order, the FMLC considers that the most important areas to address are:

(i) Definitions of "exposure" and "financial institution exposure". These broad definitions require further clarification. The intended scope of the prohibition on "financial institution exposures" in Article 8(1) of the Excluded Activities Order should also be made clear—*prima facie*, that Article appears to prohibit transactions which are essential to the provision of retail services, prudent administration and/or regulatory compliance.

(ii) Excluded activities. As currently drafted, the degree of cross-referencing in the Excluded Activities Order to exceptions in the FSMA and the Regulated Activities Order may create uncertainty as

to whether certain activities would be "excluded activities". Legal and operational certainty might be increased if that Order were to set out clearly on its face the relevant exceptions. Consideration might also be given to ensuring that those exceptions apply consistently to both of the types of excluded activity, except where there this does not reflect the legislative intent. At the very least, further guidance in this regard would improve legal certainty—for example, the scope of the prohibition on commodities trading might be clarified in guidance.

(iii) Exceptions for specified risk-management activities. Further provisions or, at the very least, guidance should be provided regarding both the application of the "sole or main reason" tests in the Excluded Activities Order and also the meaning of the term "directly proportional" in Article 6. The intended scope of the exceptions in Article 4 of that Order, and also the interaction of those exceptions with the prohibition in Article 8(1), should be clarified.

(iv) Inter-bank payment systems and "financial institution exposures". The meaning of the term "disproportionate" in the exception to the prohibition on an RFB from using an inter-bank payment system other than as a direct participant requires clarification. Furthermore, legal and operational certainty would be increased by detailed provisions and guidance regarding the application of the various exceptions to the prohibition in Article 8(1) of the Excluded Activities Order—particularly in the case of Bacs and other payment and settlement systems. Consideration might also be given to reserving a power to make further rules in this regard, in view of the operational difficulties which may arise for an RFB in monitoring its net "short term exposures" to financial institutions.

As discussed above, however, there are also several other issues of secondary importance regarding both draft Orders which nevertheless merit further attention and analysis.

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