18 August 2014

FINANCIAL MARKETS LAW COMMITTEE

Jonathan Faull
Director General
DG Internal Market & Services
European Commission
1049 Brussels
Belgium
Cc: Niall Bohan
Cc: Alain Deckers

Dear Mr Faull

Banking Reform (Ring-Fencing)

Discussion of legal uncertainties arising from the proposed regulation of the European Parliament and of the Council on structural measures improving the resilience of E.U. credit institutions

The role of the Financial Markets Law Committee (the "**FMLC**" or the "**Committee**") 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.

In February 2013, the FMLC published a paper addressing legal uncertainties arising from the draft U.K. Financial Services (Banking Reform) Bill.[1] The Committee then produced an addendum to that paper in October 2013 addressing areas of uncertainty arising from instruments including the Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order (the "**Excluded Activities Order**").[2] The Financial Services (Banking Reform) Act 2013 (the "**Banking Reform Act**") received royal assent on 18 December 2013.

On 29 January 2014, the European Commission published a proposal for a regulation on structural measures improving the resilience of E.U. credit institutions (the "**Proposed Regulation**"). The FMLC considers it important to comment on the legal uncertainties arising from the Proposed Regulation, including its interaction with the Banking Reform Act.

Uncertainties regarding the Article 21 proposed derogation procedure

Article 21 of the Proposed Regulation provides that the Commission may, upon request by a member state, grant a derogation from the requirements in Chapter III (Separation of Certain Trading Activities) to a credit institution. The availability of the derogation is subject to national primary legislation having been adopted in the member state in question before 29 January 2014.

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1 A copy of that paper, as well as other FMLC papers and letters, is available at: http://www.fmlc.org/Pages/papers.aspx.

2 *Ibid.*

This limits the availability of the derogation in practice to France, Germany and the U.K.

The FMLC understands that a legal opinion of the European Council Legal Service (the "**Legal Opinion**") is widely thought to have been issued, calling into question the validity of the derogation under E.U. law.[3] The FMLC has not had sight of the Legal Opinion. The FMLC surmises, however, that doubts have been expressed as to the compatibility of the derogation with, *inter alia*: (i) the requirement that a regulation have general application, as prescribed by Article 288 of the Treaty on the Functioning of the European Union (the "**TFEU**"); (ii) the requirement that provisions taking the form of derogations to the internal market must be of a temporary nature, as set out in Article 27 of the TFEU; and (iii) the supremacy of E.U. law.

Questions as to the validity under E.U. law of the derogation give rise to legal uncertainty, and specifically to the risk that certain banks may be required to comply with two differing regimes when the Proposed Regulation takes direct effect. This, in turn, would give rise *inter alia* to the issues identified in an appendix to this letter, in the case of the U.K. The FMLC would, therefore, recommend that the Commission clearly set out the basis for claiming that Article 21 of the Proposed Regulation is compatible with E.U. law; alternatively, where necessary, the FMLC would welcome further consideration of whether the Proposed Regulation might be reframed as a directive, thereby allowing member states the time and opportunity to align their national regimes with the proposal in the course of implementation.

The existing Article 21 derogation procedure gives rise to the further legal uncertainties set out below.

1. ***Uncertainty as to the compatibility of domestic legislation with the Proposed Regulation.*** Under Article 21(1) of the Proposed Regulation, the grant of a derogation is dependent upon the Commission declaring the relevant domestic legislation to be not incompatible with Chapter III (Separation of Certain Trading Activities) of the Proposed Regulation. Under Article 21(2), the Commission is granted up to six months in order to issue such a declaration. Subjecting the grant of a derogation to a significant lapse of time potentially gives rise to uncertainty for the credit institution in question as to whether it will be obliged to comply with two ring-fencing regimes. It would, therefore, be beneficial for the Commission to provide clarification as early as possible, and in any case prior to entry into force of the ring-fencing provisions of the Proposed Regulation, as to those member states whose domestic legislation will be considered to be compatible with the Proposed Regulation.

2. ***Uncertainty as to the existence of a discretion to grant or refuse a derogation for individual credit institutions.*** It is currently unclear whether, where national legislation is not incompatible with Chapter III (Separation of Certain Trading Activities) of the Proposed Regulation, the Commission has any discretion to refuse a derogation in respect of the credit institution in question. The third paragraph of

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3 Press reports on the subject can be found at: http://www.ft.com/cms/s/0/8e451f24-f590-11e3-be21-00144feabdc0.html#axzz38Bme8myp; and http://uk.reuters.com/article/2014/06/17/uk-banks-britain-eu-idUKKBN0ER2I220140617.

Article 21(2) expresses the Commission's role in terms ("the Commission shall [...]"), indicating that it has no discretion to refuse the application of the derogation to a credit institution which is subject to national legislation not incompatible with the Proposed Regulation. Article 21(1), however, stipulates that "the Commission *may* grant a derogation [...]" in language which appears merely permissive.

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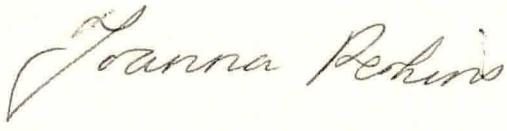
The FMLC would welcome clarification on this point.

3. ***Recourse of credit institution(s) in the absence of a request from the relevant member state.*** As discussed above, Article 21(2) provides that a derogation request is to be made by the relevant Member State, for a specified credit institution. The FMLC would welcome clarification as to whether, in the absence of a request from a member state, a credit institution has any recourse in order to obtain a derogation.

Copies of this letter have been sent to Niall Bohan, Head of Unit H1: Banks and Financial Conglomerates I, and Alain Deckers, Head of Unit H2: Banks and Financial Conglomerates II.

I and Members of the Committee would be delighted to meet you to discuss the issues raised in this letter. Please do not hesitate to contact me to arrange such a meeting or should you require further information or assistance.

Yours sincerely,



Joanna Perkins

FMLC Chief Executive

APPENDIX

Uncertainty in the absence of a derogation in the case of the U.K.

Should the Article 21 derogation procedure (or equivalent alternative) prove unavailable, certain credit institutions will be required to comply with two differing ring-fencing regimes. In the U.K., in addition to the regime under the Proposed Regulation, certain U.K. banks would also be required to comply with that established by the Banking Reform Act. In this context, the FMLC wishes to highlight the following issues of legal uncertainty.

1. ***Scope of application.*** The Banking Reform Act and the Proposed Regulation differ in scope. Broadly, under the regime established under the Banking Reform Act, a U.K. institution that holds total "core deposits" with an average value in excess of a *de minimis* amount of £25 billion will be treated as a ring-fenced body and be required to be ring-fenced, subject to specific exemptions for certain types of institution.[4] The Proposed Regulation instead applies to (i) E.U. credit institutions or E.U. parents (including their branches and subsidiaries, irrespective of location) that are identified as globally systemically important institutions ("**G-SIIs**"); and (ii) any credit institution, E.U. parent (including their branches and subsidiaries, irrespective of location) or E.U. branch of a non-E.U. credit institution which, for three consecutive years, has had its total assets amount to at least EUR 30 billion and trading assets of EUR 70 billion or 10 per cent. of total assets.

   Such differences in scope increase uncertainty as to the application of the requirements to a particular entity. The FMLC would therefore recommend that they be minimised.

2. ***Potential extraterritorial effect.*** The Proposed Regulation includes within its scope (i) non-E.U. branches of E.U. credit institutions and/or core credit institutions; (ii) non-E.U. branches and subsidiaries of an E.U. parent; and (iii) E.U. branches of non-E.U. credit institutions with E.U. branches. The Proposed Regulation does, however, provide under Article 27(1) that the Commission may adopt implementing acts determining that a third-country regime is equivalent to that under the Proposed Regulation, in which case the Proposed Regulation does not apply to the relevant E.U. branch of a third-country credit institution or non-E.U. subsidiary of an E.U. parent.[5] The FMLC notes that Article 27(2) provides that the Commission is empowered to set criteria for assessing whether or not a third-country legal and supervisory framework is equivalent to the Proposed Regulation. The FMLC would recommend that the Commission exercise such power in order to set clear, precise and objective criteria for determining the equivalence of a third-country regime.

3. ***Prohibition of certain trading activities.*** Broadly, Article 6 of the Proposed Regulation prohibits entities falling within its scope from engaging in proprietary trading or investing (directly or indirectly) in

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4 Articles 7 and 8, Excluded Activities Order.

5 Article 4(1)(a) and (b), Proposed Regulation.

alternative investment funds. The FMLC notes that this prohibition applies irrespective of the grant of a derogation under Article 21. Differences in the scope, application and interpretation of the Article 6 prohibition and other similar prohibitions (including the prohibition for ring-fenced entities from carrying out the regulated activity of "dealing in investments as principal", and the so-called "Volcker rule"[6]) give rise to uncertainty for the entities potentially subject to them. It would, therefore, be beneficial for differences between the Article 6 prohibition and other applicable and comparable prohibitions to be minimised.

4. ***Prohibited activities for ring-fenced entities.*** National regulators are granted significant discretion under the Proposed Regulation as to the activities not to be undertaken by a ring-fenced entity, as contrasted with the relatively narrower prohibition under the Banking Reform Act regime. In the U.K., the Excluded Activities Order prohibits a ring-fenced body from carrying out the regulated activities of "dealing in investments as principal" and "dealing in commodities".[7] By contrast, under the Proposed Regulation, core credit institutions may be prohibited by their national regulators from carrying out "trading activities", defined under the Proposed Regulation as activities *other than* those listed in Article 8(1) thereof (broadly, taking deposits, retail and commercial lending, payment services and certain other activities). This grant of a broad power to impose a prohibition on a core credit institution from carrying out trading activities may give rise to significant differences in approach by national regulators. The FMLC would, therefore, recommend that the scope for such differences in approach be restricted.

5. ***Discretionary ring-fencing.*** Chapter III of the Proposed Regulation requires that national competent authorities assess the trading activities of core credit institutions[8] in light of certain specified metrics (as set out in Article 9(2) of the Proposed Regulation and further specified in regulatory technical standards to be adopted by the European Banking Authority (the "**EBA**")). In the case of a threat to the financial stability of the core credit institution or to the Union financial system as a whole, the national competent authority may require such core credit institution not to carry out certain trading activities.[9] Although constrained by the obligation to carry out assessments by reference to objective metrics, national regulators are granted significant discretion as to whether to require a core credit institution to separate its trading activities from those specified under Article 8(1) of the Proposed Regulation. Such discretion may give rise to material differences in application of the ring-fencing provisions of the Proposed Regulation between member states. It would be beneficial, therefore, for such discretion to be minimised.

6. ***Treatment of emissions allowances derivatives:*** Article 12 of the Proposed Regulation states that emissions allowances derivatives

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6 Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, amending the U.S. Bank Holding Company Act of 1956.

7 Article 3, Excluded Activities Order.

8 Article 10(1), Proposed Regulation.

9 Article 10(3), Proposed Regulation.

may (subject to certain conditions being satisfied) be sold by a core credit institution to its customers. The Excluded Activities Order, however, does not currently appear to permit a ring-fenced body to carry out such activity as an exception to the list of excluded activities in the U.K. Such differences in scope between the U.K. and E.U. ring-fencing regimes increase uncertainty. The two regimes should be aligned.

7. ***Definitions used:*** Uncertainties as to scope also arise as a result of the use of differing definitions under each of the U.K. and E.U. regimes. For example, the definition of payment services differs under the Proposed Regulation (which uses the definition in Directive 2007/64/EC) and the Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014 (the "**Excluded Activities Order**") (which refers to the narrower definition in the Payment Services Regulation 2009). To prevent confusion, it would be helpful for terms to be defined consistently under each of the U.K. and E.U. ring-fencing regimes.