FINANCIAL MARKETS LAW COMMITTEE

26 August 2015

Andrew Hoffman and Leanne Ingledew
Prudential Regulation Authority
20 Moorgate
London
EC2R 6DA

Dear Mr Hoffman and Ms Ingledew,

**Recovery and Resolution**

**Contractual Stays in Financial Contracts Governed by Third Country Law – CP19/15**

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.

The FMLC welcomes the proposed rule (the "**Proposed rule**") in the draft Stay in Resolution Instrument 2015 (the "**draft Instrument**") appended to the Prudential Regulation Authority (the "**PRA**") consultation paper CP19/15 on contractual stays in financial contracts governed by third country law. The Proposed rule would be an important step towards the aim of ensuring that, on the entry into resolution of a specified firm,[1] a stay of early termination rights would take effect even with respect to contracts governed by the law of a third country, thereby removing the disparity that currently exists between financial contracts governed by English law or, for that matter, the laws of other European Member States and financial contracts governed by the law of a third country.

In Europe, the Bank Recovery and Resolution Directive[2] ("**BRRD**") gives resolution authorities the power to suspend temporarily the termination rights of any party to such contracts.[3] Where the BRRD has been implemented (including by means of amendments to national legislation implementing the Credit Institutions Reorganisation and Winding-up Directive ("**CIWUD**"),[4] temporary stays imposed in one EU Member State will be recognised and given effect in every other. It follows that, in an EU context, a temporary stay will apply to financial contracts, even where the law of the resolution forum is different from the governing law of the contract. Moreover, to the extent that the rule in CIWUD on the recognition of resolution measures has been properly implemented, it is at least arguable that a temporary stay will apply to claims

[1] PRA-authorised UK banks, building societies and PRA-designated UK investment firms as well as their qualifying parent undertakings and any EEA or non-EEA credit institution, investment firm or financial institution which is a subsidiary of the above.

[2] Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms.

[3] See Article 71. The BRRD has been implemented in the UK by amendments to the Banking Act 2009.

[4] Directive 2001/24/EC on the reorganisation and winding-up of credit institutions. This directive has been implemented in the UK by means of the Credit Institutions Reorganisation and Winding-up Regulations (SI 2004/1045 as amended) which also provide for the recognition of insolvency measures taken in any EU or EEA state.

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under financial contracts brought in the courts of EU Member States, irrespective of the governing law of the contract.

Uncertainty remains, however, as to whether such temporary stays on termination rights would be recognised and given effect under the governing law—and in the courts—of a third country. The FMLC commented on this potential problem of a conflict of laws in a discussion paper published in 2013 on the then proposed BRRD.[5]

When the Financial Stability Board (the "**FSB**") published, in September 2014, a consultative document containing proposals aimed at enhancing legal certainty in the resolution of systemically important financial institutions ("**SIFIs**") within a cross-border context, the FMLC welcomed the proposals. The proposals comprised (i) a set of elements to be incorporated in Member States' statutory cross-border recognition frameworks; and (ii) the use of contractual mechanisms in the interim to achieve cross-border recognition, *inter alia*, in respect of stays on early termination rights in financial contracts.

In relation to the use of contractual mechanisms for enforcing temporary restrictions or stays on early termination rights, the International Swaps and Derivatives Association ("**ISDA**") developed a Resolution Stay Protocol (the "**Protocol**") for over-the-counter ("**OTC**") bilateral derivatives traded under the ISDA Master Agreement (1992 and 2002 versions).

Commenting on the Protocol in its response to the FSB consultative document, the FMLC noted that the limited application of the Protocol leaves a considerable area of legal uncertainty in relation to the enforcement of stays on termination rights. The Committee suggested that to widen the market coverage of the Protocol in the interim period, it may be beneficial for jurisdictions to require banks to include enabling provisions for the opt-in directly in new derivative contracts.

The Proposed rule addresses the FMLC's concerns stated above. By prohibiting firms from creating new obligations or materially amending existing obligations under financial contracts governed by third country law without the required counterparty agreement, it broadens the coverage of the Protocol and enhances legal certainty in relation to the enforcement of stays on termination rights. It is, therefore, a welcome step forward of very great significance.

Nevertheless, certain provisions in the draft Instrument give rise to legal uncertainty, and would benefit from clarification. These relate to the financial contracts to which the Proposed rule applies and the definition of excluded person. Each of these is discussed below.

Financial Arrangements

The Proposed rule applies to financial arrangements governed by the law of a third country. Financial arrangement is defined inclusively but, apparently, not exhaustively in the draft Instrument. This may create uncertainty as to whether firms are required to obtain the relevant counterparty agreement when entering into any arrangements which are not included in the non-exhaustive definition.

This open-ended approach is, in part, a result of incorporating BRRD definitions: "financial arrangements" in the draft Instrument includes "financial contracts as

[5] "Recovery and Resolution – Discussion of certain legal uncertainties arising from the proposal for a Recovery and Resolution Directive" (Financial Markets Law Committee Paper, February 2013) available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/issue_149_fmlc_paper_february_2013.pdf.

defined...[in] the BRRD", where the definition is again apparently inclusive but not exhaustive. In the BRRD, "financial contracts" includes "securities contracts", which is itself another term that is defined inclusively. (Securities contracts include contracts for securities, options and securities repurchase agreements.)

Although the definition of "securities contract" has been harmonised in the EU for this purpose—even if it has not been exhaustively delimited—it is not true to say that all third country legal systems adopt the same definition.[6] This raises a very real question as to whether a contract which is a "securities contract" under the governing law of the contract but which falls outside the inclusive list of securities contracts given in the BRRD will be subject to the Proposed rule on counterparty agreement.

To the extent that there is uncertainty, it may have arisen because the PRA has adopted BRRD definitions which were intended for a different purpose, namely: to define the scope of a resolution authority's power to impose a discretionary stay. Adopting non-exhaustive definitions for the purpose of imposing obligations on firms, however, is likely to lead to uncertainty about the extent and nature of those obligations. The FMLC would be grateful for clarification that "financial arrangements" and the concepts of which it is comprised are intended to be defined exhaustively for the purposes of the draft Instrument.

Excluded Person

The power given to resolution authorities under the BRRD temporarily to suspend termination rights does not apply to central counterparties ("**CCPs**"). In giving effect to this exclusion under the BRRD, the draft Instrument distinguishes between those CCPs which are recognised under Article 25 of Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories ("**EMIR**") and those which are not—only firms' arrangements with the former are excluded from the proposed obligation to obtain the relevant counterparty agreement.[7] This raises a broader conflict of laws issue in the event that the Bank of England, as resolution authority, imposes a stay in respect of non-recognised CCPs. In this context, however, it gives rise to practical uncertainty as to whether firms will be able to fulfil the obligation to negotiate the relevant counterparty agreement with foreign CCPs, given the systemic risk implications of their doing so in the third country in question.

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

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6 In the US, for example, securities contracts as defined under 11 U.S.C 747(7) is broad, encompassing *inter alia* guarantee of a settlement of cash, securities, certificates of deposit, mortgage loans or the interests therein.

7 The draft Instrument defines "excluded person" by reference to section 70D(1) of the Banking Act 2009. Section 70D (1) of the Banking Act 2009 defines "excluded person" so as to include (i) a recognised central counterparty; and (ii) an EEA central counterparty, or (iii) a third country central counterparty. "Third country central counterparty" is defined by reference to section 285 of the Financial Services and Markets Act 2000 and limited to recognised CCPs.