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Butterworths Journal of International Banking and Financial Law

Implications of the failure of the Bank of England RTGS system

The slender thread of modified universalism after *Singularis*

Termination provisions of swap agreements II

In Practice

Developments in freezing foreign assets

Draft EU Regulation on Securities Financing Transactions

The 2014 French Insolvency Law reform: a missed opportunity

Cases Analysis

One Essex Court reports on the latest banking law cases

Market Movements

DLA Piper UK LLP reviews key market developments in the banking sector

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KEY POINTS

- Basel III already requires banks to assess the impact of specific environmental risks on a bank's credit and operational risk exposures.
- A recent report suggests Basel III is not being used to its full capacity to address systemic environmental risks.
- China, Brazil and Peru have engaged in a variety of innovative regulatory and market practices to control environmental systemic risks.

Author Kern Alexander

Are environmental risks missing in Basel III?

This article questions whether Basel III should address the macro-prudential or portfolio-wide environmental risks for banks.

The role of the financial system in the economy and broader society is to provide the necessary financing and liquidity for human and economic activity to thrive; not only today but also tomorrow. In other words, its role is to fund a stable and sustainable economy. The role of financial regulators is to ensure that excessive risks that would threaten the stability of the financial system – and hence imperil the stability and sustainability of the economy – are not taken. In the wake of the financial crisis of 2007-08, the G20 initiated at the Pittsburgh Heads of State Summit in September 2009 an extensive reform of banking regulation with the overall aim "to generate strong, sustainable and balanced global growth". At the same time, the Earth's planetary boundaries – defined as thresholds that, if crossed, could generate unacceptable environmental changes for humanity, such as climate change – are under increasing stress and represent a source of increasing cost to the global economy and a potential threat to financial stability. Indeed, World Bank President Jim Yong Kim stated at the World Economic Forum in 2014 that "financial regulators must take the lead in addressing climate change risks".

ENVIRONMENTAL RISKS

An important question arises as to whether international banking regulation (ie Basel III) adequately addresses systemic environmental risks. For example, the macro-prudential economic risks associated with the banking sector's exposure to high carbon assets. Basel III has already taken important steps to address both micro-prudential and macro-prudential systemic risks in the banking sector by increasing capital and liquidity requirements and requiring regulators to challenge banks more in the construction of their risk models and for banks to undergo more frequent and demanding stress tests. Moreover, under Pillar 2, banks must undergo a supervisory review of their corporate governance and risk management practices that aims, among other things, to diversify risk exposures across asset classes and to detect macro-prudential risks across the financial sector. Regarding environmental risks, Basel III already requires banks to assess the impact of specific environmental risks on the bank's credit and operational risks exposures, but these are mainly transaction-specific risks that affect the borrower's ability to repay a loan or address the "deep pockets" doctrine of lender liability for damages and the cost of property clean-up. These transaction specific risks are narrowly defined and do not constitute broader macro-prudential or portfolio-wide risks for the bank that could arise from its exposure to systemic environmental risks.

> "... Basel III already requires banks to assess the impact of specific environmental risks on the bank's credit and operational risks exposures, but these are mainly transaction-specific risks..."

INNOVATIVE PRACTICES

A recent report supported by the United Nations Environment Programme (UNEP) and the University of Cambridge suggests that Basel III is not being used to its full capacity to address systemic environmental risks and that such risks are in the "collective blind spot of bank supervisors". Despite the fact that history demonstrates direct and indirect links between systemic environmental risks and banking sector stability – and that evidence suggests this trend will continue to become more pronounced and complex as environmental sustainability risks grow for the global economy – Basel III has yet to take explicit account of, and therefore only marginally addresses, the environmental risks that could threaten banking sector stability. Despite no action by the Basel Committee to address systemic environmental risks at the international level, some countries – China, Brazil and Peru under the aegis of the International Finance Corporation's Sustainability Banking Network (SBN) – have already engaged in a variety of innovative regulatory and market practices to control environmental systemic risks and adopt practices to mitigate the banking sector's exposure to environmentally unsustainable activity.

These initiatives have been based on existing regulatory mandates to promote financial stability by acting through the

Spotlight

Biog box

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existing Basel III framework to identify and manage banking risks both at the transaction specific level and at the broader portfolio level. What is significant about these various country and market practices is that the regulatory approaches used to enhance the bank's risk assessment fall into two areas: 1) Greater interaction between the regulator and the bank in assessing wider portfolio level financial, social and political risks; and 2) banks' enhanced disclosure to the market regarding their exposures to systemic environmental risks. These innovative regulatory approaches and market practices are the result of pro-active policymakers and regulators adjusting to a changing world. Other international bodies, such as the SBN and UNEP Finance Initiative, have sought to promote further dialogue between practitioners and regulators on environmental sustainability issues and to encourage a better understanding of these issues by financial regulators.

China, Brazil and Peru, among others, have all embarked on innovative risk assessment programmes to assess systemic environmental risks from a macro-prudential perspective as they recognise the materiality of systemic environmental risks to banking stability. The Basel Committee should take notice. ■

Further reading

- Basel III drives changes to capital instruments [2012] 10 JIBFL 636
- Rebuilding international financial regulation [2011] 8 JIBFL 489
- Lexisnexis Financial Services blog: What next for the Basel III leverage ratio framework?

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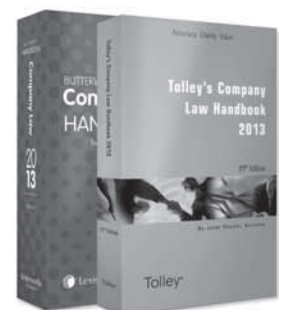

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KEY POINTS
- It is difficult to see on what basis the Bank of England might be liable to an RTGS account holder for an outage.
- There is more scope for users of CHAPS to make a claim.
- CREST is remarkably well insulated from problems caused by an RTGS outage.

Feature

Authors Roger Jones and Raymond Cox QC

Implications of the failure of the Bank of England RTGS system

This article considers what happens if the Real Time Gross Settlement (RTGS) System operated by the Bank of England (BoE) fails – ie there is an outage. After setting out the background to RTGS, and the critical role and importance of RTGS at the heart of the UK financial infrastructure, the implications of an outage are analysed. This is done in relation to the BoE which operates RTGS, and to CREST and CHAPS which in different ways are more immediately dependent on RTGS than retail payment systems which normally settle in RTGS at less frequent intervals or sometimes at the end of the day. It is difficult to see on what basis the BoE might be liable to an RTGS account holder for an outage. There is more scope for users of CHAPS to make a claim against a counterparty arising from the delays caused by an outage since uniquely, in normal operation, CHAPS payments require a compensating individual RTGS transfer before being executed; and this possibility should be taken into account in documenting transactions. There is also a brief reference to euro settlement in CREST through the TARGET 2 RTGS system.

RTGS OUTAGES

Introduction

On 20 October 2014, the Bank of England's (BoE) Real Time Gross Settlement (RTGS) System suffered a lengthy technical outage lasting almost ten hours. Whilst several financial market infrastructures (FMIs) including CREST and various retail payment systems settle through RTGS, the one most affected was the CHAPS system under which, unlike the other FMIs, individual payments are settled in RTGS before being executed. A report by Deloitte on the causes of the outage and effectiveness of the BoE's response is awaited.

Background

The problems arising from outages of RTGS systems are relatively recent, because the systems themselves are not old. Probably the best known forerunner of modern RTGS systems was the 1970 version of FEDWIRE in the USA which was based on a computerised, high speed (for the time) electronic telecommunications and processing network.

One of the earliest analyses of the essential nature of an RTGS system was undertaken in the so-called Noel Report (*Central Bank Payment and Settlement Services with respect to Cross-Border and Multi-Currency Transactions* dated September 1993 and published by the Bank for International Settlements (BIS)). This focused on the concept of intra-day final transfer which it defined as the ability to indicate and to receive timely confirmation of transfers between accounts at the central bank of issue that become final within a brief period of time.

Not surprisingly, the phrase "brief period of time" gave rise to considerable discussion, with central banks interpreting it with varying degrees of purity. Also, the legal environment was less developed than now with concepts such as "zero hour" under which transactions could be unwound back to the previous midnight still being relatively widespread. Furthermore, liquidity optimisation techniques were far less advanced than they have become. Nevertheless, the Noel Report was an important staging post in recognising the importance of payment systems, and particularly RTGS systems, in mitigating risk. The work done by the Noel Committee and subsequent central bank groups undoubtedly played a major part in the resilience of payment systems in the 2007/08 financial crisis, without which it could have been much worse.

As thinking developed, a March 1997 report by the Committee on Payment and Settlement Systems (CPSS) of the G10 central banks in respect of RTGS systems defined RTGS as effecting final settlement of inter-bank funds transfers on a continuous transaction by transaction basis throughout the processing day and this remains at the core of current thinking. This CPSS report was again published by the BIS which gave it added authority. Whilst the design and structure of RTGS systems differs depending on local needs, the core attributes are similar. In this article we focus on the BoE RTGS system, although many of the same considerations would apply to other systems.

> "A 1997 report… defined RTGS as effecting final settlement of inter-bank funds transfers on a continuous transaction by transaction basis throughout the processing day…"

The significance of outages

In addition to money transmission, the BoE's RTGS system is central to:
- the conduct of monetary policy operations;
- ancillary systems including not only payment systems but also other FMIs such as securities settlement systems;
- some other forms of wholesale transactions; and
- the provision of central bank liquidity.

With the increasing importance being attached by regulators to settlement of high value transactions in central bank funds, RTGS systems are critical to an increasing number of wholesale market operations. However, irrespective of the nature of the operation, liquidity is needed for a transfer of money through an RTGS system to be effected, hence the importance of participants having sufficient intraday liquidity when and where needed cannot be overstated. Also in an interconnected world, a delayed transaction in one RTGS system may affect others through, for example, the CLS (Continuous Linked Settlement) foreign exchange settlement system.

It follows, therefore, that the RTGS system sits at the heart of the UK financial infrastructure, and a major RTGS outage could have systemic implications.

"... a number of other FMIs... settle through RTGS but unlike CHAPS they are not dependent on RTGS to process each individual transaction prior to release"

Risks

Technical and operational failure is not the only issue which can affect RTGS systems. Legal robustness is essential. Reliance on third party utilities is frequently critical and ranges from such basic infrastructure as power and water to more sophisticated threats such as cyber warfare. Other possible issues may range from natural catastrophes and exceptional weather to political instability and industrial action. Another very important factor is the need to ensure that adequately trained staff and decision-makers are always available since unfortunately disruptive events can occur at the most inconvenient time.

Since for many of their operations, RTGS systems depend on the receipt of instructions from their participants, both financial institutions and FMIs (and vice versa), it is important that effective contingency plans exist in case the relevant data channels are disrupted, otherwise serious liquidity imbalances can occur potentially leading to gridlock. In times of financial stress, such effects could be magnified.

Contingency plans

It is of course important to recognise that disruptive events, whether malicious or accidental, can affect even the best designed and run IT systems. Best practice requires the operator to be able to resume operations within two hours. This normally requires the duplication of hardware and software on at least two sites which have independent utility connectivity and with the back-up site(s) being able to operate even in the event of the destruction of the primary site, including the non-availability of staff working there. It is regarded as good practice to switch primary operations between sites where this is possible. Distance between the sites is obviously important but can make real time copying of data more difficult.

In February 2014 the BoE became the first central bank to adopt a SWIFT system known as MIRS (Market Infrastructure Resiliency Service). This is a basic contingency infrastructure which is completely independent of the underlying RTGS system and avoids the potential problem whereby a software bug could affect both primary and secondary sites. MIRS relies on information contained in SWIFT messaging which many RTGS systems use for connectivity. SWIFT is the bank-owned co-operative which provides messaging services for financial services applications. However, it is not clear whether MIRS was actually activated in respect of the 20 October outage.

Finally, when a problem does occur, the importance of prompt and effective communication to the market, not only banks and other affected financial institutions but also financial market infrastructures which use the RTGS system for settlement, cannot be over-estimated. This is essential in order to enable them to manage their own risks.

LEGAL IMPLICATIONS

We turn now to consider some of the legal issues which may theoretically arise in relation to an outage of the RTGS operated by the BoE.

The BoE's RTGS system settles CHAPS payments between a paying bank and a payee bank by debiting the former's settlement account and crediting the latter's settlement account. Such banks are also known as direct settlement banks to distinguish them from banks which operate through agents.

As already stated, a number of other FMIs including Bacs, the Faster Payments Service (FPS), Cheque and Credit Clearing and LINK settle through RTGS but unlike CHAPS they are not dependent on RTGS to process each individual transaction prior to release. These retail systems tend to settle at periodic intervals on what is sometimes described as a Deferred Net Settlement (DNS) basis. Irrespective of the model used, it is underpinned by extensive legal documentation with DNS systems being collateralised.

Conversely, CREST sterling utilises a mechanism whereby the BoE effectively earmarks central bank funds owned by CREST settlement banks in such a way that they are only available to fund payments made by a settlement bank during a CREST settlement cycle. This enables CREST to settle individual trades irrevocably in its books knowing that funds are available to enable settlement in the BoE RTGS system subsequently. In normal operation this process only takes a minute or two and is repeated continuously. However, in the event of a BoE RTGS outage, the process is of course disrupted and in that case CREST could continue to settle trades by recycling

liquidity in its own books until the BoE RTGS system recovers. The whole mechanism is underpinned by a legally binding contractual arrangement.

The Bank of England

Part 5 of the Banking Act 2009 (BA 2009) provides the statutory framework for the conduct of payment systems oversight by the BoE. BA 2009 sets out criteria for the recognition of interbank payment schemes that are systemically important, currently seven in number: Bacs, CHAPS, FPS, CLS (the foreign exchange settlement system), the payment arrangements embedded in CREST and the central counterparties operated by LCH.Clearnet Limited and ICE Clear Europe.

Under BA 2009 operators of recognised payment systems are required "to have regard" to any principles and codes or practice published by the BoE (ss 188-9). No codes of practice have been published to date. However, in December 2012 the BoE, having consulted with Her Majesty's Treasury, published (for the purposes of s 188 of BA 2009) the *Principles for Financial Market Infrastructures* (PFMIs) issued by the relevant BIS committee (CPSS now CPMI) and the International Organisation of Securities Commissions (IOSCO).

The PFMIs seek to impose various obligations on FMIs, as encapsulated in 24 PFMIs, 18 of which are relevant to payment systems. These PFMIs include (by way of example) the principle that an FMI should have a sound risk-management framework for comprehensively managing legal, credit, liquidity, operational and other risks (Principle 3), as well as PFMIs 15 and 17 which focus specifically on general business and operational risk respectively.

The PFMIs also set out five areas of responsibility for central banks such as the BoE ("the Responsibilities"). These include the Responsibility that "FMIs should be subject to appropriate and effective regulation, supervision, and oversight by a central bank, market regulator, or other relevant authority."

It might be contended that the PFMIs assume that the BoE will ensure the efficient operation of the RTGS system, since without a reliable RTGS system there can be no appropriate or effective supervision or oversight of those FMIs for which the RTGS system performs an integral function.

However, it cannot be said that the Responsibilities as set out in the PFMIs have imposed statutory duties on the BoE (or any other duties recognised by English law). In particular, s 188 of BA 2009 makes it clear that any PFMIs that are published by the BoE (having obtained the Treasury's prior approval) are ones to which "operators of recognised inter-bank systems [ie not the BoE itself] are to have regard in operating their systems". The Government's Explanatory Notes to s 188 of BA 2009 make it clear that this provision is not intended to impose new obligations on the BoE itself: "Subsection (1) gives the BoE the power to publish PFMIs to which operators of recognised inter-bank payment systems must have regard in the operation of their systems. This formalises an aspect of the existing structure of oversight, under which the BoE currently expects payment systems to take account of the Committee on Payment and Settlement Systems' *Core Principles for Systemically Important Payment Systems*".

Whilst not imposing legal duties on the BoE, such principles are highly relevant as a touchstone for the assessment by interested parties (including international bodies such as the IMF) of the BoE's success or otherwise in overseeing the FMIs which settle through the BoE's RTGS system.

Interestingly, in its July 2011 paper regarding the observance by CHAPS of the CPSS *Core Principles for Systemically Important Payment Systems* (a precursor to the PFMIs), the IMF concluded that the BoE had only "broadly observed" (rather than just "observed") the Responsibility to ensure systems it oversees comply with the Core Principles, commenting (at p 12):

> "The BoE assesses the RTGS infrastructure against the Core Principles in an indirect and fragmented manner through its oversight of CHAPS (and other recognised systems that use it, such as CREST, FPS, and Bacs). However, not all activity in the RTGS is undertaken in regard to these recognised systems, and, given the importance of the RTGS infrastructure to the U.K. financial system, a direct and unified assessment would be beneficial."

"… it would appear that the BoE has determined that its RTGS system is not subject to what were the "Core Principles" (now replaced by the PFMIs)…"

The BoE's response to this conclusion (p 15 of the same document) commented as follows:

> "RTGS is not an interbank payment system but an accounting infrastructure that supports some payment systems. It would therefore not be appropriate to assess RTGS against the CPSS Core Principles as they apply to Payment Systems. The Bank will, however, this year conduct a unified assessment of RTGS based on its existing internal risk assessment, monitoring and management framework. That will be done at arms' length as well as by line management."

Accordingly, it would appear that the BoE has determined that its RTGS system is not subject to what were the "Core Principles" (now replaced by the PFMIs), although it is unclear to what extent this narrow interpretation of the PFMIs is accepted beyond the BoE itself. For example, the European Central Bank has determined

that the euro RTGS system TARGET 2 should be required to comply with the PFMIs subject to certain public policy exceptions and TARGET 2 is currently being assessed by its overseer on this basis.

Apart from the BoE's PFMI Responsibilities, the BoE has entered into standard form "RTGS Account Mandate Terms and Conditions" with settlement banks (the "Terms and Conditions"). The Terms and Conditions regulate the rights and obligations as between the BoE and the RTGS "Account Holders" (ie banks wishing to participate in the RTGS system).

As regards the BoE's obligations, the Terms and Conditions do not impose any obligation on the BoE to ensure that the RTGS system is not interrupted or that it operates in such a way as not to cause any loss to Account Holders. Clause 6.1(b) of the Terms and Conditions provides that:

> "[The Account Holder agrees and acknowledges that] the Bank, and its representatives and agents shall not be liable, save in the case of wilful default or reckless disregard of the Bank's obligations, for any Loss arising directly or indirectly from the operation by the Bank of the RTGS Central System or the Collateral Management Portal or any interruption or loss of the RTGS Central Systems or the Collateral Management Portal or loss of business, loss of profit or other consequential damage or any damage whatsoever and howsoever caused (including but without prejudice to the foregoing by reason of machine or computer malfunction or error and also any suspension or variation pursuant to clause 6.1(a) above)."

Whilst the Terms and Conditions provide (for example) that the BoE is subject to a (qualified) obligation to effect payment upon receipt of appropriate instructions from an Account Holder (see in particular clauses 6.1(i) and (j)), they do not impose any express obligation on the BoE to ensure that the RTGS system is not interrupted or that it operates in such a way as not to cause any loss to Account Holders.

In any event, clause 6.2(b) reflects the BoE's statutory immunity from liability in damages provided by s 244 of BA 2009, which is limited to action or inaction by the Bank which is not in bad faith or in breach of s 6(1) of the Human Rights Act 1998.

> "... the Terms and Conditions do not impose any obligation on the BoE to ensure that the RTGS system is not interrupted..."

In brief, therefore, it is difficult to see on what basis an RTGS Account Holder could seek legal redress against the BoE in respect of any RTGS system outage, notwithstanding that such an outage may have been caused by the BoE's recklessness or even its wilful acts or omissions, on the basis (*inter alia*) that the BoE is under no legally enforceable obligation to ensure that the RTGS system operates correctly.

CREST

CREST sterling is the UK's securities settlement system, operated by Euroclear UK and Ireland (EUI), which provides real-time Delivery versus Payment ultimately against central bank money for transactions such as gilts, equities and money market instruments. It settles continuously throughout the day. Most settlements in CREST are in sterling and we consider these first.

CREST is remarkably well insulated from problems caused by an RTGS outage, and indeed continued to operate on 20 October 2014, without the serious problems experienced by CHAPS. Fundamentally, that is because the CREST system allows CREST to settle the transactions using "earmarked" central bank funds, but crucially without simultaneous access to the RTGS accounts (as described below). When RTGS operates normally, CREST settlements will be reconciled with RTGS about every two minutes. But if there is an RTGS outage, it is possible, with BoE permission, for CREST in effect to continue to use the earmarked central bank funds to settle CREST transactions until RTGS is restored (recycling liquidity), and the CREST settlements can once again be reconciled with RTGS.

The key feature of CREST is that delivery is made against payment. But payment here consists of a promise to pay by the settlement bank of the buyer. The buyer may be the customer of a settlement bank A and the seller the customer of settlement bank B. The buyer discharges his obligation to pay the seller by the promise of his settlement bank A to pay settlement bank B. This promise happens at the moment of delivery of title.

Settlement bank A then discharges that obligation to pay settlement bank B by the undertaking of the BoE to pay bank B. This also happens at the same time as the moment of delivery to the buyer.

CREST then applies the payment by settlement bank A to bank B to its record of the Liquidity Management Account (LMA) for each bank. In effect, the LMA is a part of the records of the BoE which is operated by CREST. The BoE earmarks funds available in its accounts to settlement banks, and in effect hands the earmarked funds to CREST. Earmarked funds may not be used other than for CREST settlements. The settlement bank is only entitled as against the BoE to such part of the earmarked funds as CREST returns. Normally CREST will transmit details of the transactions on the LMA back to the BoE using RTGS about every two minutes. The accounts of the BoE are updated. The cycle is then repeated with earmarked funds being allocated to CREST.

In this way CREST is able to settle transactions for CREST members with the certainty of central bank funds, but without a simultaneous debit and credit on the RTGS system.

Biog box
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If there is an outage, the BoE may permit CREST in effect to recycle earmarked funds in the LMAs during the period when CREST is disconnected from RTGS. CREST may continue despite the outage. During the disconnection period there is a mechanism for LMAs to be topped up if required. It is also possible for the recycling to be extended overnight if required.

CREST also has euro and US dollar streams although they are much lower value than sterling. Euro also settles in central bank funds but through the euro RTGS system TARGET 2 using one of TARGET 2's proprietary ancillary system interfaces. Access is through the Central Bank of Ireland. Conversely, the US dollar stream settles bilaterally between the settlement banks. Although the mechanisms for sterling and euro differ, in both cases CREST settles trades with finality on its own systems before the ultimate transfer of funds is shown on RTGS.

CHAPS

CHAPS, or the "Clearing House Automated Payment System", is a payment system operated by the CHAPS Clearing Company Limited which makes real time gross payments in sterling, settled through the BoE's RTGS system on an individual basis before being executed. The CHAPS system is designed especially for high value and/or time critical payments, where immediacy of settlement and certainty are of paramount importance.

Settlement members use SWIFT messages to communicate, with the SWIFT proprietary process holding the message and sending on the critical details to the BoE's RTGS system. Settlement is effected across the RTGS system (and on the RTGS model) by the BoE debiting the paying settlement bank's member's account and crediting the payee settlement bank's member's account commensurately and in real time before the payment is released to the payee settlement member.

The rights and obligations of the settlement members as regards their participation in the CHAPS system are provided principally by the CHAPS Rules, a set of rules drafted by the CHAPS Clearing Company Limited to which all CHAPS settlement members subscribe.

In circumstances where the RTGS system fails such that CHAPS payments are unable to settle for a period of time, it is possible that a paying settlement member would be in breach of Rule 2.2 of the CHAPS Rules in circumstances where it had instructed a Payment but RTGS had failed and the payment had not been made. Under Rule 2.2, the settlement members must for the purposes of making payments through the CHAPS system:

> "… accept and give same day value to all Payments [defined at Rule 1.1 as 'a payment made through CHAPS (whether made under normal operation or effected as a Contingency Transfer) that satisfies the criteria listed in Rule 3.1'] denominated in sterling received within the timeframes set out in the CHAPS Timetable in the CHAPS Procedural Documentation".

Where the settlement member acts for a customer – in using CHAPS, the customer may, as between himself and his settlement member, be bound by the usages of CHAPS: see *Tidal Energy Limited v Bank of Scotland* [2014] EWCA Civ 1107, applying *Hare v Henty* (1861) 10 CBNS 65, 142 ER 374, 379. So too, a customer might claim against his settlement member for breach of contract in failing to deal with a payment for the customer in accordance with the CHAPS Rules. The CHAPS Rules make it clear that only the settlement members are in contractual relations with each other. But that would not prevent a customer of a settlement member from relying on the terms of his contract with the settlement member, including an obligation to deal with the payment in accordance with the CHAPS Rules. ■

> "… a customer might claim against his settlement member for breach of contract in failing to deal with a payment…"

Further reading

- What is payment in the 21st century? [2014] 11 JIBFL 675
- Managing settlement risk in retail payment systems: the proposal to pre-fund daily payment exposures [2014] 7 JIBFL 462
- Lexisnexis Financial Services blog: Payments regulation: the shape of things to come

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Feature

KEY POINTS

- The existence of the common law power to assist foreign insolvency proceedings has been confirmed by the Privy Council, but its scope has been significantly curtailed.
- The power to assist does not extend to the application of powers analogous to those conferred by domestic legislation which would not otherwise apply to a foreign insolvency; nor does it enable office-holders to do something which they would not be able to do under the law by which they were appointed.
- The power to assist may extend to compelling the production of information in support of a foreign insolvency, but the scope of this power is uncertain.

Authors Barry Isaacs QC and Andrew Shaw

The slender thread of modified universalism after *Singularis*

This article considers the decision of the Privy Council in *Singularis Holdings Ltd v PricewaterhouseCoopers* [2014] UKPC 36 and its implications.

THE PRINCIPLE OF "MODIFIED UNIVERSALISM": *CAMBRIDGE GAS* AND *HIH*

In *Cambridge Gas Transportation Corporation v Official Committee of Unsecured Creditors of Navigator Holdings plc* [2007] 1AC 508 (*Cambridge Gas*), Lord Hoffmann, giving the advice of the Privy Council, held that there is a common law power to provide such assistance to a foreign insolvency as could be given in equivalent domestic proceedings. Thus a plan approved by the US Bankruptcy Court could be given effect on the Isle of Man, despite it being neither a judgment *in rem* nor *in personam*. Such a plan could have been implemented in the Isle of Man under its Companies Act 1931 and could therefore be enforced without the need for parallel domestic insolvency proceedings.

Cambridge Gas was authority for three propositions. The first is the principle of modified universalism ("the principle"), namely that the court has a common law power to assist foreign winding-up proceedings so far as it properly can. The second is that the principle permits the court to do whatever it could properly have done in a domestic insolvency, subject to its own law and public policy. The third is that this power is itself the source of its jurisdiction over those affected, and that the absence of jurisdiction *in rem* or *in personam* according to ordinary common law principles is irrelevant.

The first and second principles were revisited by Lord Hoffmann in *Re HIH Casualty and General Insurance Ltd* [2008] 1 WLR 852 (*HIH*), in which he described the principle as the golden thread running through English cross-border insolvency law since the 18th century. Lord Hoffmann said that the principle requires that English courts should, so far as is consistent with justice and UK public policy, co-operate with the courts in the country of the principal liquidation to ensure that all the company's assets are distributed to its creditors under a single system of distribution.

THE PRINCIPLE IN RETREAT: *RUBIN*

The principle was given further impetus by the decisions of the Court of Appeal in *Rubin v Eurofinance* [2011] Ch 133 and *Re New Cap Reinsurance Co Ltd* [2011] 2 WLR 1095. Those decisions applied the principle to permit enforcement in England of avoidance judgments obtained in New York and Australia respectively. These decisions were the high watermark for the principle. Just a few years after the principle was highlighted and developed by Lord Hoffmann in *Cambridge Gas and HIH*, its scope was curtailed by the decision of the Supreme Court in *Rubin v Eurofinance* [2013] 1 AC 236 (*Rubin*).

The majority held that the same rules applied to the recognition and enforcement of judgments *in personam*, whether or not such judgments had been made in support of foreign insolvency proceedings. Accordingly, recognition and enforcement of foreign judgments in relation to preference or other avoidance proceedings were only permissible where the judgment debtor had been present in the foreign jurisdiction when proceedings commenced or where he had otherwise submitted to the jurisdiction of the foreign court.

The Supreme Court held that, as a matter of policy, the rules governing recognition and enforcement should be no more liberal in relation to foreign avoidance judgments than any other foreign judgment. A different rule for avoidance judgments was unacceptable for four reasons. First, there was no difference of principle between, for example, a foreign judgment against a debtor on a debt due to a company in liquidation and a foreign judgment for repayment of a preferential payment. Secondly, a different rule for insolvency judgments would not be an incremental development of existing principles, but a radical departure from settled law. The introduction of new rules for enforcement depends on a degree of reciprocity; and a change in the settled law has the hallmarks of legislation. Thirdly, a different rule would be detrimental to UK businesses, because of the need to defend proceedings overseas. Fourthly, the rules in relation to recognition and enforcement of foreign judgments were not unjust: officeholders usually have remedies against defendants in the United Kingdom, either directly (by bringing proceedings in the UK) or indirectly (for example, by application of foreign law under s 426 of the Insolvency Act 1986; by applying local law under Art 23 of the UNCITRAL Model Law on Cross-Border Insolvency ("the Model Law"); or, where the insolvent has its centre of main interests in the European Union, by direct enforcement under Art 25 of the Council Regulation (EC) No 1346/2000 on insolvency proceedings).

A majority of the Supreme Court (Lords Collins, Walker and Sumption) held in *Rubin* that *Cambridge Gas* was wrongly decided.

Since *Cambridge Gas* was a judgment of the Privy Council and *Rubin* was a decision of the Supreme Court, the status of *Cambridge Gas* outside the English jurisdiction was not clear.

Nonetheless, the Supreme Court did acknowledge the existence of a common law power to recognise and grant assistance to foreign insolvency proceedings. The principle also appeared to survive in areas other than recognition and enforcement. For example, in *Re Phoenix Kapitaldienst GmbH* [2013] Ch 61, Proudman J held that the English court had a common law power to provide a German administrator with relief identical to that available under s 423 of the Insolvency Act 1986, such relief not being otherwise available.

The principle has also underpinned various statutory developments of English insolvency law. For example, the Cross-Border Insolvency Regulations 2006 (CBIR) incorporate the provisions of the Model Law into English law. Following the decision in *Pan-Ocean Co Ltd v Fibria Celulose S/A* [2014] EWHC 2124 (Ch), the principle suffered a further setback. In that case, Morgan J held that the assistance which an English court can provide pursuant to Art 21(1) to Sch 1 of the CBIR is limited to relief available under English law. In this respect, the English approach to the application of the Model Law diverges from that taken in the USA.

THE RETREAT CONTINUES: *SINGULARIS*

Singularis Holdings Ltd was incorporated in the Cayman Islands and was subject to a winding-up order in that jurisdiction. The liquidators ("the liquidators") sought the working papers of the company's auditors, PricewaterhouseCoopers (PwC) in Bermuda, which was the place of registration of the branch of PwC which had carried out the audits.

Section 195 of the Companies Act 1981 of Bermuda allows the court, in respect of a company which the Bermuda court has ordered to be wound up, to summon before it any person deemed capable of giving information concerning the affairs of the company, and to produce any books and papers in his custody relating to the company. The Supreme Court of Bermuda recognised the status of the liquidators and ordered PwC to produce documents and attend court for examination on the basis of a common law power *"by analogy with the statutory powers"* contained in s 195 of the Companies Act 1981.

PwC successfully appealed against this order, and two points subsequently came before the Privy Council:

> "Lord Collins said that the approach taken in *Cambridge Gas*, where the application of the statutory procedure for approval of a scheme of arrangement on the Isle of Man was held to be unnecessary, was wrong…"

- Did the Bermudan court possess a common law power to assist a foreign liquidation by ordering the production of information, in circumstances where the analogous statutory power could only be exercised in a winding-up and there was no jurisdiction to wind-up the company; and
- if such a power did exist, could it be exercised where an equivalent order could not have been made by the court in the Cayman Islands.

On the second point the Board held that the Bermudan courts could not exercise a common law power to assist the winding up where the courts of the Cayman Islands had no such power. On the first point, a majority (Lords Sumption, Collins and Clarke) held that there was such a power. Lords Mance and Neuberger disagreed.

The Board also held that *Cambridge Gas* was authority for the proposition that the court had a common law power to assist a foreign insolvency only as far as it properly could, in line with the principle of modified universalism. The other propositions that the Board had derived from *Cambridge Gas*, namely that the common law power to assist includes doing whatever could properly be done in a domestic insolvency, and that this power is the source of the assisting court's jurisdiction, were expressly disapproved.

Each member of the Board gave a separate judgment, in part because of how the case had been argued below. At first instance and on appeal the liquidators' primary case was that, in circumstances where the legislation did not apply, the foreign court nonetheless had a common law power to apply its own domestic legislation by analogy as though the foreign insolvency were domestic. Argument concerning the existence of a common law power to order information only came to prominence in the hearing before the Privy Council.

Lord Collins directed his judgment towards debunking the liquidators' initial argument that the Supreme Court should apply s 195 by analogy as if the company were a Bermudan company. He held that this involved a fundamental misunderstanding of the limits of the judicial law-making power. Lord Collins said that the approach taken in *Cambridge Gas*, where the application of the statutory procedure for approval of a scheme of arrangement on the Isle of Man was held to be unnecessary, was wrong; and that courts which had followed this approach had been wrong to do so. For example, *Re Phoenix Kapitaldienst GmbH*, in which Proudman J held that the power to use the common law to recognise and assist an administrator appointed overseas includes doing whatever the English court could have done in the case of a domestic insolvency, had been wrongly decided.

Lord Sumption addressed the limits to the power to assist a foreign insolvency. He held that, in the absence of a statutory power, these must depend upon the common law; how far it would be appropriate to develop the common law did not admit of a single universal

Biog box

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answer. He therefore only considered whether there was a common law power to order production of information in the absence of an equivalent statutory power. In his judgment there was a power to compel the production of information which is necessary for the administration of a foreign winding up. This was a development of the common law which was justified as follows:

(1) While the power of the English courts to compel the giving of evidence was solely statutory, the same did not apply to information.
(2) In *Norwich Pharmacal v Customs and Excise Commissioners* [1974] AC 133, the House of Lords had recognised a common law power to order the production of information in certain circumstances.
(3) If the common law power to assist consisted only of recognising the insolvent company's title to its assets or the foreign office-holder's agency, it would be an "*empty formula*".

Lord Sumption cautioned that "*in recognising the existence of such a power, the Board would not wish to encourage the promiscuous creation of other common law powers to compel production of information.*" The power to assist a foreign insolvency at common law should be subject to certain limits:

- It was only available to assist the officer of a foreign court with insolvency jurisdiction, or equivalent public officers.
- It was not available to enable such officers to do something which they would not be able to do under the law by which they were appointed.
- It was available only when it is necessary for the performance of the office-holder's functions.
- Its exercise must be consistent with the substantive law and public policy of the assisting court, thus it would not be available to obtain material for use in litigation.
- Its exercise is conditional on the applicant being prepared to pay a third-party's reasonable costs of compliance.

Lords Clark and Collins agreed that there was a common law power to compel the production of information, and in Lord Collins' view this power was to be exercised for the purpose of "*identifying and locating assets of the company*".

Lords Mance and Neuberger disagreed. They foresaw problems with the need to make fine distinctions, which any application of the power would entail, for example between information and evidence. Lord Neuberger also felt that the logic of the Supreme Court's approach in *Rubin* was that new common law powers founded on the principle of modified universalism should not be invented by the courts.

ANALYSIS AND IMPLICATIONS

The thread of modified universalism, so far as the common law is concerned, remains intact, but it is now a slender one. In *Rubin* it was held that a change in the law relating to foreign judgments to apply a different rule in the context of insolvency was a matter for the legislature. In *Singularis*, it was held that it is not for the court to apply legislation by analogy as if it applied, even though it did not actually apply; this would be a plain usurpation of the legislative function.

The Privy Council has overruled *Cambridge Gas* on all points save the uncontroversial proposition that courts have a common law power to assist a foreign insolvency. A court cannot assist a foreign insolvency by applying apparently inapplicable domestic legislation as if it did apply. The most potent weapon available to the court to assist at common law has thus been removed.

The Privy Council has given little guidance on the limits of the common law power to assist a foreign insolvency. It is possible to discern two broad approaches. The minority judgments of Lord Mance and Neuberger express caution towards any increase of the powers to assist in a foreign insolvency already available at common law: these being, in broad terms, staying proceedings or the enforcement of judgments and the use of the statutory powers of the court in aid of foreign insolvencies, for example the use of the ancillary liquidation procedure. In contrast, the majority support an incremental development of the power to assist, but without indicating the extent of any such development or the areas in which it might operate. The power to compel production of information is ill-defined; the purposes for which the power might be exercised as described by Lord Sumption are much broader than those set out by Lord Collins.

One limitation applied to this power is of general application, namely that an assisting court will not be able to provide relief at common law which would not be available in the country of the insolvency. This is a recognition of the fact that modified universalism essentially envisages an extension of the jurisdiction of that court overseas, where that is compatible with local law and public policy. Beyond this, however, and as was pointed out by Lord Mance, the scope of the common law assistance which may be provided to a foreign insolvency is uncertain. Lord Neuberger observed that the extent of the principle is a very tricky topic on which the Privy Council, the House of Lords and the Supreme Court had not been conspicuously successful in giving clear or consistent guidance – as evidenced by the judgments in *Cambridge Gas*, *HIH* and *Rubin*. Having regard to the divergence of opinions in the judgments in *Singularis*, and the general terms in which the majority judgments were expressed, the principle of modified universalism still lacks clarity in its application, albeit that it is clear that its scope has been significantly curtailed. ■

Further reading

- What's left of the golden thread? Modified universalism after *Rubin* and *New Cap* [2012] 11 JIBFL 675
- When will a court not assist a foreign insolvency proceeding? Recent experience in England, the US and Germany [2013] 3 JIBFL 159
- Lexisnexis RANDI blog: R & I – pick of the cases in 2014

KEY POINTS

- A review of the FCA's findings and an analysis of the difficulties of discerning and then proving a loss suggest that, if anything, it may well be even harder to get a foreign exchange-related claim off the ground than it is to build a LIBOR claim.
- Unlike the way in which LIBOR is determined, the process by which the final rates are arrived at is not entirely clear.
- It seems that a customer could not claim for damages unless its specific currency contract was adversely affected by the wrongdoing.

Authors Paul Downes QC and Emily Saunderson

Foreign exchange manipulation: a deluge of claims?

This article considers the prospects for litigation based on foreign exchange manipulation.

Five banks were fined a record total of £1.1bn by the UK's Financial Conduct Authority (FCA) in November 2014 for failing to control business practices in their foreign exchange trading operations. Hefty fines were also levied by the Commodity Futures Trading Commission and the Office of the Comptroller of the Currency in the US, and the Swiss financial regulator, FINMA.

The FCA found that between 1 January 2008 and 15 October 2013, ineffective controls at Citibank NA, HSBC Bank Plc, JPMorgan Chase Bank NA, Royal Bank of Scotland Plc and UBS AG allowed foreign exchange (FX) traders in G10 currencies to put their employers' interests above those of their clients, other market participants, and the wider UK financial system.

Customers of the banks will be concerned to know two things: first, whether the wrongdoing would give grounds for a claim to rescind onerous currency transactions; and secondly, whether even without rescission the wrongdoing could form the basis of a claim for losses suffered as a result of the manipulation.

The failings criticised by the FCA, and other national regulators, related to manipulation of the spot foreign exchange "fixes", which are key benchmarks used in the FX markets, although the fines were for failings in staff management rather than currency manipulation.

The FCA's Final Notices in respect of each bank fined describe how traders at a number of banks manipulated the price of foreign exchange rates before key spot rate fixes in order to benefit from trades their clients had specified to be made at the fix rate. The Final Notices also explain how the banks used internet chat rooms to share information to facilitate the collusion in moving FX rates to the banks' advantage.

Coming so soon after regulators unearthed manipulation by banks of the LIBOR benchmark, it is tempting to assume that similar potential claims arise from foreign exchange manipulation as were touted, and in a few cases pursued, in respect of the misstatement of LIBOR. Additionally, the size of the global FX markets (the latest figures suggest trades averaged $5.3tn per day)[1] may lead to assumptions that manipulation must have led to huge customer losses.

Some commentators have predicted a "tidal wave" of civil litigation in relation to foreign exchange manipulation, and that it should be much easier for market participants to prove that they lost money.[2]

However, a review of the FCA's findings and an analysis of the difficulties of discerning and then proving a loss, suggest that, if anything, it may well be even harder to get a foreign exchange-related claim off the ground than it is to build a LIBOR claim.

THE FOREIGN EXCHANGE "FIXES"

The FCA produced five Final Notices, one in respect of its findings for each of the banks upon which it imposed a penalty.

The two benchmark fixes mentioned in the FCA Final Notices are the WM/Reuters 4pm UK fix ("the 4pm WM Reuters Fix"), and the European Central Bank fix at 1:15pm UK time ("the ECB Fix").

Unlike the way in which LIBOR is determined, neither the 4pm WM Reuters Fix nor the ECB Fix depends upon a number of panel banks submitting actual or indicative rates, and the process by which the final rates are arrived at is not entirely clear.

In its *Spot & Forward Rates Methodology Guide*, World Markets Company Plc ("WM") says that certain portions of the methodology and related intellectual property used to calculate its rates are proprietary and confidential, and are not therefore publicly disclosed.

> "World Markets Company Plc says that certain portions of the methodology and related intellectual property used to calculate its rates are proprietary and confidential..."

WM does say that it determines the relevant fix by taking transactional data entered into electronic trading platforms, including bid and offer rates and actual trades, over a one-minute period from 30 seconds before to 30 seconds after the fix at 4pm UK time. WM may use its own judgment to assess the validity of rates, and it has guidelines and procedures to

govern the application of its judgment. The median bid and offer rates are calculated using valid rates from the fix period, and the mid-rate is calculated from the median bid and offer rates, resulting in a mid-trade rate and a mid-order rate. A spread is then applied to calculate a new trade rate bid and offer and a new order rate bid and offer, and the new trade rates are used, in a way which is not specified by WM, for the fix.

The procedure for calculating the ECB Fix is even more opaque. The ECB says its FIX is "based on the regular daily concentration procedure between central banks within and outside the European System of Central Banks", and although it purports to publish the methodology on its website,[3] none of the underlying documents were, at the time of drafting this article, accessible. The ECB rate is said by the FCA to reflect the rate at a particular moment in time each day, which is usually around 1:15pm UK time.

"... it seems that a customer could not claim for damages unless its specific currency contract was adversely affected by the wrongdoing"

THE MANIPULATION

Where a bank trades with its customer at the fix rate, it does not charge commission on the transaction or act as an agent; it trades with the customer as a principal.[4] The bank in such a situation is therefore exposed to foreign exchange rate movements at the fix because:

(a) If the bank has net client orders to buy EUR/USD at the fix rate (ie the bank will be a seller of euros to its clients in exchange for dollars at the fix rate), and the fix rate is lower than the average rate at which the bank has agreed to buy Euros in the same quantity in the market (not at the fix), the bank will make a loss.

(b) Alternatively, if the bank has net client orders to sell EUR/USD at the fix rate (ie the bank will buy euros from its clients in exchange for dollars at the fix rate), and the fix rate is higher than the average market rate at which the bank sells the same quantity of that currency in the market (not at the fix), the bank will make a loss.

In managing its own exposure, a bank may affect the fix inadvertently. But if a bank is able to manipulate the relevant fix rate depending on the direction of its net client orders, it can profit from its clients' positions.

It appears that the manipulation occurred by the banks co-ordinating the timing of transactions so as to push the price in a desired direction shortly before the fix. Concerted efforts of this sort amount to clear market abuse. However, it is important to appreciate that this is wrongdoing of a different order to that involved in the LIBOR manipulation: there panel banks deliberately understated or overstated returns as to what rate they would be prepared to lend at on the interbank market.

Each FCA Final Notice gives one example of the relevant bank's attempts to manipulate the fix. None of the FCA examples include dates, which makes it difficult if not impossible for potential claimants to know if their trades are likely to have been affected.

The example used in the FCA Final Notice for Citibank describes a situation where the bank had net client buy orders at the ECB Fix in the EUR/USD currency pair. So, Citibank would be a net seller of Euros to its clients in exchange for US dollars at the fix, and it would benefit if the ECB Fix for EUR/USD was higher than the average rate at which it bought EUR/USD in the market (not at the fix).

Citibank's net client buy orders at the fix were €83m. By working with three other firms, Citibank increased the volume it would seek to buy for the fix to €542m, which was clearly well above what it needed to manage its own exposure. During the period from 1:14:29pm to 1:15:02pm, Citibank bought €374m, which accounted for 73% of all purchases on the EBS electronic trading platform during that period.

At 1:14:45pm the EUR/USD offer rate was 1.32159. By 1:14:57pm, the offer rate was 1.32205, and the fix was 1.3222. The FCA says that Citibank's trading in this example made the bank a profit of US$99,000.[5]

RELEVANT WRONGDOING

There can be little doubt that the banks' actions described in the FCA Final Notices were wrongful. They represent the clearest possible breach of the entire basis for currency dealing (ie that the rates at which the currency is traded are true market rates). The wrong could be advanced as a breach of an implied term in the agreement in question, or a misrepresentation, a tortious wrong, or anti-competitive conduct.

In such circumstances the parties to specific transactions could claim damages for the extent to which they were prejudiced. However, such claims face three principal difficulties:

- First, it is far from clear that there was a huge volume of transactions which were tainted by the above wrongdoing.
- Secondly, the relevant manipulation appears to have been transaction specific; unlike LIBOR where the manipulation was directed at the benchmark itself, and for significant periods it was clear that the benchmark was being artificially depressed. Thus, from the information published by the FCA, it seems that a customer could not claim for damages unless its specific currency contract was adversely affected by the wrongdoing.
- Thirdly, the extent of the manipulation appears to have been far smaller. In the Citibank example cited above, the manipulation resulted in a movement of one hundredth of one percent with the result that the net profit for the bank in a multi-million euro transaction was just short of one hundred thousand dollars.

Biog box

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Of far more significance would be a claim for rescission of the sort advanced in the *Graiseley Properties v Barclays Bank Plc*, and *Deutsche Bank AG v Unitech Global Ltd* cases. Both *Graiseley* and *Unitech* began life essentially as interest rate swap mis-selling cases. They were amended to include implied misrepresentations by the banks as to LIBOR, which it was said gave rise to the right to rescission.

Parties to an onerous currency swap, or other currency transaction, might seek to rescind on the ground that the transaction was entered into on the basis of a representation (express or implied) that the currency exchange rates that the bank was applying were true market rates and that the bank had not previously engaged in any manipulative activity.

The banks are likely to point out that, unlike LIBOR, the manipulation here was very much more restricted in scope and therefore any implied representation that the bank's rates were true market derived rates was true; and that the limited examples from the FCA notice were isolated incidents which did not prejudice the individual client's trades.

Additionally, the difficulty of proving that any given currency transaction was tainted by manipulation appears more significant than in LIBOR-related claims because of the lack of information about specific wrong-doing in the FCA Final Notices.

CONCLUSION

The wrongdoing found by the FCA appears to have been less extensive than that connected with LIBOR manipulation. Thus it would be reasonable to assume that the resultant litigation would be unlikely to exceed that which has arisen from the LIBOR debacle. In that case, the claims have essentially been repackaged mis-selling claims with LIBOR manipulation added as an additional ground to attack the product concerned. It may well be that currency manipulation will go the same way, with only a limited impact on the scale of this particular class of litigation. ■

1 See the *Triennial Central Bank Survey from the Bank for International Settlements*, published in September 2013, which describes FX business as of April 2013.
2 See, for example, "Litigation deluge set to follow record forex fines", *Law Society Gazette*, 12 November 2014.
3 http://sdw.ecb.europa.eu/browse.do?node=2018779.
4 See, for example, the FCA Final Notice in respect of UBS AG, dated 11 November 2014, at App B para 3.3.
5 See the FCA Final Notice for Citibank at paras 4.38 to 4.44.

Further reading

- The foreign exchange fix: the reality [2014] 6 JIBFL 355
- LIBOR: More to LIBOR than *Graiseley?* [2014] 2 JIBFL 83
- Lexisnexis Dispute Resolution blog: LIBOR latest: recent judgment by Mr Justice Teare throws new light on the ongoing litigation between Deutsche Bank and Unitech Global

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KEY POINTS

- Under bail-in rules a bank administrator could cherry-pick derivatives liabilities for bail-in leaving third parties at significant risk.
- The UK Government has enacted "EU-independent" secondary legislation intended to protect derivatives by requiring netting before bail-in of the net claims.
- However, the implementation of this protection is deeply problematic, leading to a material risk that affected derivatives contracts will not benefit from the supposed protection.
- As a result affected derivatives contracts may not benefit from "clean" legal opinions as to their recognition and enforceability.

Author Dr Stephen Connelly

Difference and repetition: the UK's "protection" of close out netting from EU rules leaves counterparties worse off

This article explains how the UK Government's "EU-independent" secondary legislation on bail-in leaves derivatives contracts potentially subject to non-netted bail-in.

In a recent House of Commons exchange the Prime Minister David Cameron accused the shadow finance minister of "masosadism", thus inventing a word which might best be applied to the UK's approach to implementing the Bank Resolution and Recovery Directive (BRRD) by studiously pretending it does not exist. In many cases the solipsistic attempt to achieve similar results by means which are inferior to that suggested by the BRRD has left the constituencies HM Treasury (HMT) are trying to protect in a materially worse position under UK law. In this note the author will focus on one such instance: new protections for set-off, netting, and close out netting in derivatives contracts which are eligible for bail-in – bail-in being the cancellation, reduction, or deferral of a liability owed by a distressed bank, or its conversion into another form such as equity. It is submitted that HMT's attempt to reinvent the legislative wheel has failed with the result that recognised netting agreements may be compromised for capital adequacy purposes.

THE NEW UK BAIL-IN PROTECTIONS FOR SET-OFF AND NETTING ARRANGEMENTS

HMT claims that its new bail-in regime for banks has been developed independently of its EU-wide equivalent as set out particularly in the BRRD. HMT has stated that:

> "The draft Order [protecting derivatives from non-netted bail-in] is designed to implement the domestic powers introduced in the [Financial Services (Banking Reform) Act 2013], not to transpose the BRRD. However, in designing the safeguards, the government is firmly of the view that, in order to provide market participants with certainty about the operation of the bail-in powers and to avoid making substantive changes in order to transpose the BRRD, the provisions here should be as consistent as possible with the BRRD." *HM Treasury, Bail-in Powers Implementation (including draft secondary legislation) 12 December 2014*

One feature of both UK and BRRD bail-in is that while derivatives (and master agreements) may be bailed-in, legislators have assented to market participant demands that any such bail-in be undertaken on a net basis. The reason is clear: counterparties do not want a gross liability owed to it by a resolution bank cancelled at the same time as the resolution bank's administrator seeks to enforce a gross claim against the counterparty by that same bank. This is the classic problem of insolvency "cherry picking" in a new pre-insolvency guise.

In the UK this protection has just been implemented by the Banking Act 2009 (Restriction of Special Bail-in Provision, etc) Order 2014 (SI 2014/3350 in force 1 January 2015, hereafter the "Restriction Order"), which aims to prevent a bail-in of exposures under certain agreements until a netting of those exposures has taken place. Article 4(1) of the Restriction Order deploys a safe-harbour for anything that falls within its definition of "protected liabilities" and it is this definition which is the source of trouble. The relevant protection is available for a derivative, financial contract or qualifying master agreement (which we will treat together) which has already been:

- set-off or netted under its terms or terms of any set-off arrangement or netting arrangement (as defined) governing that derivative, or
- already subjected to Special Bail-In Provision (Art 4(1) Restriction Order).

Let us look at some of the terms deployed here.

MEANING OF "DERIVATIVE"

As is well known, the definition of "derivative" is problematic in its own right. Article 5(1) of the Restriction Order defines a derivative by reference to Art 2.5 of the European Market Infrastructure Directive (EMIR) which in turn refers us to paragraphs C4-C10, Annex 1 of the Markets in Financial Instruments Directive (commonly known as MiFID). Accordingly "derivative" will cover among other things: financial derivatives including swaps, options, futures, and other derivative contracts relating to *inter alia* interest rates, credit default, currencies, and securities, CFDs, and derivatives with respect to emissions, commodities, and climactic variables.

It might be thought that reference to an EU standard definition of "derivative" would be a key to ensuring recognition of UK Special Bail-in Provision. The problem is that the EU-standard is anything but – its implementation by member states has been sufficiently diverse as to prompt the European Securities and Markets Authority to initiate a consultation on amending and clarifying the MiFID definition in order to create cross-border certainty. A pertinent example is the scope of the FX spot exclusion in para C4, Annex 1 MiFID. It is customary to regard a derivative (in the broadest sense) as a spot if its term is three days or less, and as a derivative proper if its term is ten days or longer. However, as for contracts of three to nine days' terms, member states have taken differing approaches, with the UK's Financial Conduct Authority permitting great breadth in the scope of the FX spot exclusion. The result for the Restriction Order is a conflict: an FX spot of five days, say, is not a derivative for the purposes of MiFID reporting as implemented in the UK, but, because the Restriction Order refers directly to EMIR and MiFID and not its UK implementation, a five day FX spot may well be a derivative for the purposes of Special Bail-in Provision.

Yet a further twist is offered by the Excluded Liabilities provision in s 48B(8)(d) of the Banking Act 2009, which excludes from Special Bail-in Provision:

> "liabilities with an original maturity of less than 7 days owed by the bank to a credit institution or investment firm".

This may well exclude a seven day or less "spot" from bail-in altogether. If such an interpretation is valid this would reduce the level of confusion about the scope of "derivative" to those contracts of between eight to ten days maturity.

Meaning of "relevant arrangements" (see below) and "set-off arrangements"

HMT has described the role of the Protected Liabilities as follows:

> "The draft Order is consistent with the requirement under Art 44 of the BRRD that derivatives subject to netting arrangements should only be bailed-in on a net basis… together with certain master agreements." *Para 5.1, HM Treasury, Bail-in Powers Implementation (including draft secondary legislation) 12 December 2014*

The problem is that due to a last minute introduction of definitions of *set-off arrangement* and *netting arrangement*, the Restriction Order is not consistent with Art 44(3) BRRD to the extent it gives effect to Art 49 BRRD (the latter dealing specifically with derivatives). In short, we might assume that the BRRD drafters intended, when they referred to set-off and netting arrangements, to refer consistently with EU law to those terms as defined in relevant legislation. Bafflingly, to the extent that existing legislative definitions and doctrinal interpretations are available, these have been ignored by HMT which has sought to define *de novo*. Accordingly, the author now examines the generic term "relevant arrangements" before dealing with each of "set-off arrangements" and "netting arrangements".

The first thing to observe is that not all types of set-off fall within the protection offered by Art 4 Restriction Order. Of the Art 4(2)(b) conditions that are to be satisfied for a liability to be protected, condition 2 refers to:

> "[entitlement] to set off or net under particular set-off arrangements, netting arrangements or title transfer collateral arrangements into which the person has entered with the relevant banking institution ('the relevant arrangements')".

"The relevant arrangements" appear to preclude any set off that arises by operation of law. More specifically, it seems that equitable set-off and insolvency set-off (and any netting that might be constructed from them) are not protected liabilities because these forms of set off operate outwith the realm of contract; they are not particular arrangements. Help in delineating the scope of "set-off arrangements" is hardly provided by the definition in Art 2(1) Restriction Order which points us to s 48P(2) Banking Act 2009 – the definition is all but circular, referring to "arrangements under which two or more debts, claims or obligations can be set off against each other".

At one level the implications of this narrowing of protection may be limited, for:

- set-off and netting arrangements under the ISDA Master Agreement expressly set out to deal with all cases which the parties would feel ought to be set off (eg cl 2(c) ISDA Multicurrency Master Agreement); and
- Special Bail-in Provision is to occur before insolvency and thus before insolvency set-off rights are triggered.

However, the question arises as to whether set-off between different derivative master agreements is protected, for example between a multicurrency swap and an interest rate swap. The analysis suggests that unless there is some cross-product master agreement for set-off across these master agreements (such as a cross-agreement bridge) then the "relevant arrangements" are not in place, equitable set-off is either not available (if it ever was in equity for such disparate transactions) or potentially unprotected, and accordingly Special Bail-in Provision may deal with the respective swaps separately.

DEFINITION OF "NETTING ARRANGEMENTS"

The Restriction Order understandably adopts the definition of netting arrangements given in s 48P(2) of the Banking Act 2009:

> "'[N]etting arrangements' means arrangements under which a number of claims or obligations can be converted into a net claim or obligation, and includes, in particular, "close-out" netting arrangements, under which actual or theoretical debts are calculated during the course of a contract for the purpose of enabling them to be set off against each other or to be converted into a net debt."

Problematically, this new definition ignores existing statutory definitions of netting. Netting is already defined in the UK's (EU law implementing) Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (SI 1999/2971, the Settlement Finality Regulations) as:

Feature

Biog box

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"The conversion into one net claim or obligation of different claims or obligations between participants resulting from the issue and receipt of transfer orders between them…" *Reg 2(1)*

This Settlement Finality Regulations definition, insofar as it relates to close-out netting arrangements, is arguably narrower than the definition of "close out netting provision" in the Financial Collateral Directive as applicable in the UK through the Financial Collateral Arrangements (No 2) Regulations 2003 (SI 2003/3226, reg 3). This latter FCA definition covers the three industry modes of close-out as identified by Schuyler Henderson:

- acceleration of all obligations into one immediately due and payable amount representing current value (the Global Master Repurchase Agreement (GMRA) method);
- termination of such obligations and replacement with obligation to pay such an amount (ISDA method);
- an account of all sums due and creation of an obligation to pay a sum equal to the net of the sums then due (International Foreign Exchange Master Agreement (IFEMA) method).

It is submitted that conversion of various actual and theoretical debts into a net debt pertains to a specific sum of money owing, reducing it to zero if necessary. The conversion in question, as the Settlement Finality Regulations correctly state, is the conversion of obligations and claims into a single liquidated amount. This is the netting process. Close-out netting does something more: it requires the netting conversion to take place in each case, and then depending on the master agreement either accelerates, terminates and replaces, or creates a new obligation in equivalent amount. The process becomes two-stage.

The consequence is as follows. The ISDA close-out and *a fortiori* the IFEMA close-out do not convert specific obligations or set them off to leave the net obligation owing. Rather, they refer to that net debt but create a completely new obligation in respect of a sum generated by reference only to the net debt. There is no conversion; nor is there set-off of existing claims – the debt is an entirely new and separate payment obligation due and owing. If the interpretation of the statutory exception is construed narrowly, as it must be, then there is a risk that close-out netting under the ISDA and IFEMA agreements are at the very least open to challenge and non-recognition. A purposive interpretation of s 48P(2) of the Banking Act 2009 may save the relevant protection, but it will no doubt be asked why the UK steered away from an adequate existing definition in both UK and EU law.

The consequences of this narrower UK definition in the Banking Act 2009 creates an unintended mismatch with relevant EU law and confusion amongst market participants who will *inter alia* find that the Banking Act's protections vary depending on the industry standard master agreement deployed.

CONSEQUENCES FOR MARKET PARTICIPANTS

The foregoing discussion indicates material uncertainty about how close-out netting will operate under the Restriction Order. These concerns are not merely hypothetical in the sense that the Restriction Order only bites when the Bank of England makes what is termed "Special Bail-in Provision". The legal efficacy of close-out netting is central to the treatment of exposures under capital adequacy rules, for a financial institution may treat its exposures on a net basis for capital adequacy purposes only if a "recognised" close-out netting agreement is in place for those exposures (Art 296(1-3) of the Capital Requirements Regulation). Recognition turns *inter alia* on the provision of a legal opinion to the effect that under applicable law the netting will be enforceable, cannot be challenged, and the counterparties will indeed suffer no more than the expressly contracted for liability. The concerns detailed above suggest all kinds of possible challenges, especially where industry standard contracts are found to be outwith the UK's "novel" protection. Given the evident disquiet of the financial legal profession about the uncertain application and scope of the Restriction Order, it is to be expected that future legal opinions for this purpose will expressly assume that no Special Bail-in Provision is or will be made ie but for Special Bail-in Provision the close out netting would be effective. Comfort ought to be given by the Prudential Regulation Authority and European Banking Authority that this assumption will not militate against recognition going forward.

In addition, a regulatory arbitrage risk arises for UK banks. Derivatives eligible for bail-in in the UK are in a worse position than those falling to be dealt with by, say, the German resolution authority (the *Bundesanstalt für Finanzmarktstabilisierung* (FMSA)) at the very least as regards certainty concerning bail-in risk.

CONCLUSION

The result of all this is that there is material inconsistency between Arts 44.3 and 49 BRRD to the extent these relate to derivatives and the Restriction Order's independent attempt to protect set off and netting from premature bail out. The UK Government's political tactic of being at once different from the EU on bank resolution and consistent with it has given rise to uncertainty. This partly arises from an apparent oversight of the existing transposition of adequate EU law in the area of derivatives regulation in the UK, leading to discrepancies even within UK banking law. Readers should be aware that these problems extend to other aspects of the UK's new bail-in regime, notably in its creditor-friendly treatment of secured liabilities and its netting valuation methods. It is deeply concerning that HMT's attempts to "go it alone" have been so maladroit. ■

Further reading

- Draft proposals for new EU netting provisions: further harmonisation or fragmentation? [2014] 2 JIBFL 116
- Lexis PSL Financial Services: EU Bank Resolution and Recovery Directive
- Lexisnexis RANDI blog: Three-step strategy for resolution of failed institutions

KEY POINTS
- Most people active in the OTC derivatives markets either do not see the "Live/Historical" ambiguity or ignore it for commercial reasons.
- The issue is not really between Live and Historical but between how long it is that one can use a live quotation and at what point must one use an historical quotation.
- Market practice in relation to this issue has shifted over time.

Feature

Author Schuyler K Henderson

Termination provisions of swap agreements II

This article revisits the Live or Historical debate in light of the recent English case of *Lehman Brothers v Sal Oppenhiem.*

A recent English case, *Lehman Brothers Finance SA v Sal Oppenheim jr & Cie KGaA* [2014] EWHC 2627 (Comm), skirted an issue with which the occasional court and a few commentators have grappled: should determination of Market Quotation under the ISDA Master Agreement (Multicurrency-Cross Border) ("1992 Master"), if made after the Early Termination Date, be based on live or historical quotations?

An article in the November edition of this journal, *Problems in pricing? Mastering Market Quotation under the 1992 ISDA Master Agreement* [2014] 10 JIBFL 636, by Andrew Savage and Leah Alpren-Waterman, summarises the facts of the case, the relevant provisions of the 1992 Master that governed those facts and the opinion itself. I refer the reader to that well-written article for those elements and for definitions of terms. I also assume the reader's familiarity with the 1992 Master, with apologies to the generalist reader.

LIVE OR HISTORICAL?

The issue which I wish to address is an ambiguity in the 1992 Master: should the Non-defaulting Party ("Determining Party"), in determining, say, 30 days after the Early Termination Date, the amount due and payable to or by it ("Early Termination Amount") under the Market Quotation procedure, seek a quotation from each Reference Market-maker that is:

- the firm, dealing quotation of the Reference Market-maker on the date requested, that is, the Reference Market-maker agrees it will enter into the Replacement Transaction at the quoted price if the Determining Party accepts ("Live"); or
- the firm, dealing quotation that the Reference Market-maker would have provided on the Early Termination Date ("Historical").

This is not just a theoretical issue. The Determining Party needs to know what kind of a quotation is required and there are many reasons why quotations or valuations might be obtained after the Early Termination Date.

- The most significant, and inescapable, problem arises from automatic termination under the second sentence of s 6(a) of the 1992 Master Agreement ("AET"), if it was selected to apply to the Defaulting Party.
  - The Early Termination Date automatically occurs on, among other specified insolvency Events of Default, the filing of insolvency proceedings *against* a party, which proceedings are not dismissed within 30 days. Even if the Determining Party has knowledge of a third-party filing against the Defaulting Party, it does not know if that date will in fact be the Early Termination Date until 30 days have elapsed.
  - Even the most highly organised dealer may be unable to obtain quotations on the same day it learns of a bankruptcy filing *by* a counterparty, as evidenced by the facts of *Peregrine Fixed Income Limited (in Liquidation) v JP Morgan Chase*, 2006 US Dist LEXIS 8766 ("*Peregrine/JP Morgan Chase*"). The end-user will take longer, as discussed below.
- Proper valuation of some transactions may require a valuation period longer than a day, even where the Early Termination Date has been designated by the Determining Party and it has fully prepared itself for the process.
  - While a USD or EUR interest rate swap may be priceable in New York or London on the Early Termination Date, a Nikkei Index option, would typically require Tokyo to be open. The next business day or even later will be the date to obtain quotations, as properly held in *Oppenheim*.
  - Quotations too numerous for one day might be required and there might be delays in getting them, as illustrated by the Lehman insolvency.
  - A Determining Party may be seeking quotations for unusually complex transactions or transactions with problematic terms, as illustrated in *The High Risk Opportunities Hub Fund Ltd v Credit Lyonnais and Societe Generale*, New York Supreme Court (Index No 600229/00, PC no 16039), 6 July 2005 ("*High Risk*").

Most people active in the OTC derivatives markets either do not see the Live/Historical ambiguity or ignore it for commercial reasons discussed below. For example, around ten years ago at dinner, I asked the two senior derivatives documentation lawyers at a leading dealer what they thought of the ambiguity. They each said there was no ambiguity. Having said that, when I asked what the unambiguous answer was, one answered "Live" and the other answered "Historical".

The one court, in *Peregrine/JP Morgan Chase*, to look at the issue directly could not decide from the face of the 1992 Master between Live and Historical. It said, through quoting other cases (cites omitted):

> "Here 'the Court cannot conclude that the contract is unambiguous on its face'… 'An ambiguous term is one that is reasonably susceptible to more than one reading, or one as to which reasonable minds could differ'… ('The general rule is that ambiguity exists where a contract term could suggest more than one meaning when viewed objectively by a reasonably intelligent person who has examined the context of the entire integrated agreement and… is cognizant of the customs, practices, usages and terminology as generally understood in the particular trade or business.')… Both Plaintiff and Defendant offer plausible but conflicting interpretations of Section 14 of the Agreement… ('Because the plaintiff's reading of the Agreement is a permissible one, the Agreement is susceptible to more than one interpretation and is therefore ambiguous.')… The Court cannot properly dismiss the Complaint at this time.

"Converting a quotation into the Termination Currency at FX rates in effect on the date of obtaining the quotation strongly supports Live quotations"

THE CONTRACTUAL TERMS

What does the 1992 Master require of the Determining Party under Market Quotation?

- The Determining Party must obtain quotations "*on or as soon as reasonably practicable after*" the Early Termination Date.
  - Quotations are to be obtained from four Reference Market-makers: leading dealers in the relevant market of the highest credit standing meeting the Determining Party's credit criteria and, to the extent practicable, in the same city.
- In Market Quotation:
  - each quotation is for the amount that must be paid to or by the Reference Market-maker for a Replacement Transaction;
  - the Replacement Transaction must have an effective date of the Early Termination Date;
  - the quotations, to the extent *reasonably practicable*, are to be *as of* the same day and time (without regard to different time zones) *on or as soon as reasonably practicable* after the relevant Early Termination Date; and
  - the day and time *as of which* those quotations are to be obtained will be selected *in good faith* by the Determining Party.
- A quotation expressed in another currency amount is converted into the Termination Currency using FX rates in effect on the Early Termination Date or, if Market Quotation is determined later, the later date.
- Interest accrues on an Unpaid Amount from its original due date to the Early Termination Date.
- Interest accrues on the Early Termination Amount from the Early Termination Date to the date of payment.
- Section 6(e)(iii) provides for adjustments in respect of payments mistakenly made after the Early Termination Date.

Neutral contractual points

Market Quotation is clearly to be determined on the basis of quotations obtained on or after the Early Termination Date and not by reference to an earlier date as definitively noted in the *Oppenheim* opinion. That is not dispositive of our issue, subject to the discussion of "reasonably practicable" below. The requirement that the effective date of a Replacement Transaction must be the Early Termination Date similarly has no bearing on this issue. It is perfectly possible to obtain a Live quotation today for a transaction with a prior effective date: today's Live quotation will reflect any rate changes since the effective date. Adjustments under s 6(e)(iii) for payments made between the Early Termination Date and the date on which the quotations are provided are necessary if either Live or Historical quotations are being sought.

Contractual points supporting "Live"

Converting a quotation into the Termination Currency at FX rates in effect on the date of obtaining the quotation strongly supports Live quotations. Using an FX rate from a date other than the date as of which the quotation is provided could result in a distortion of the quotation, given that there may well be a relationship between the FX rate and the value of the Terminated Transaction on a given date.

The strongest contractual argument in favour of the Live approach is the requirement for a firm quotation from the Reference Market-maker coupled with the following sentence in Market Quotation:

> "The day and time as of which those quotations are to be obtained will be selected in good faith by the [Determining Party]… and, if each party is so obliged, after consultation with the other."

This would, on its face and in isolation, seem dispositive and the quotation required under the 1992 Master Agreement must be Live on the date obtained.

Contractual points supporting "Historical"

The sentence seemingly permitting the Determining Party to select the date as of which the Live quotation is obtained must,

however, be read in conjunction with the sentence immediately preceding it. That sentence requires that the Determining Party:

> "… will request each Reference Market-maker to provide its quotation to the extent reasonably practicable as of the same day and time (without regard to different time zones) *on or as soon as reasonably practicable after the relevant Early Termination Date*".

The reference to the quotations being "as of the same day or time" further suggests that quotations obtained over a period, whether of several hours or several days, should be Historical, if reasonably practicable. If two parties are making the determination, they are to consult as to the day and time as of which the quotations are obtained, again suggesting Historical. Interpretation of these sentences as requiring Live or Historical depends on the interpretation of "reasonably practicable", which is discussed below.

The interest accrual provisions of the 1992 Master (and its 2002 successor) support the Historical interpretation.[1] Interest accrues on the Early Termination Amount from the Early Termination Date to the date paid. The clear implication of this is that the Early Termination Amount is the one that *would* have been determined on the Early Termination Date. Interest from the Early Termination Date only makes sense with respect to an amount actually calculated *as of* the Early Termination Date and not to an amount calculated *as of* a later date.

If this analysis is correct, the quotation required under the 1992 Master Agreement would be a quotation as to what would have been a firm quotation on a prior time or date, the Historical interpretation.

MARKET PRACTICE

Market practice in relation to this issue has shifted over time. Fifteen or 20 years ago, at least several major dealers had schedule provisions allowing for adjustments to be made for changes in rates since the Early Termination Date, a clause only meaningful if the drafter believed that Historical quotations would otherwise be required. The most recent 1992 Master with that clause that I recall seeing from a major dealer was dated 2008.

Seven or eight years ago, at least one major dealer made a schedule revision in its standard 1992 Master to permit obtaining live quotations for a reasonable period after the Early Termination Date, with interest on Unpaid Amounts accruing to, and interest on the Early Termination Amount accruing from, the end of that period.[2]

A few dealers, starting about ten years ago, began specifically asking for Historical quotations. At least one major dealer, five years ago, had a policy always to request Historical quotations.

There are, however, commercial reasons supporting Historical quotations. If all quotations and valuations are based on rates prevalent on or around the same day, there will be less potential for a mismatch between what the Defaulting Party owes and what it is owed on termination of all its transactions, also a vital consideration for a major dealer (and its regulator). This incidentally, is the requirement of US bankruptcy laws applicable to US corporate (non-bank) counterparties.

It may be, surprisingly, that a result-driven analysis based on what is commercially most reasonable is irrelevant. A Federal District court held that the predecessor provision on which Market Quotation was based constituted liquidated damages under New York law. If this is followed, the commercial reasonableness of any particular result is not relevant.[4]

> "Interpretation of these sentences as requiring Live or Historical depends on the interpretation of 'reasonably practicable'…"

ISDA and most dealers now, however, believe the 1992 Master permits obtaining Live quotations over a period of time following the Early Termination Date. The words in the contract are the same but their perhaps wishful interpretation has changed.

What is "commercially reasonable"?

This informal and gradual change in interpretation to Live, in general, was for good commercial reasons. Historical quotations are not commercially meaningful for a dealer unless that is when it actually closed its positions on its books for a loss or gain and adjusts its portfolio, which for a dealer is the critical time. While the actual gain/loss of a dealer will generally be greater/smaller than the gain/loss determined under Market Quotation,[3] using quotations as of any other date exposes it to a risk of an unfavourable mismatch.

What is "reasonably practicable?"

There is, however, a requirement/limitation written into the timing of quotations, both on the Determining Party's obligation to obtain quotations and its right to select the day: quotations must be obtained on the Early Termination Date or 'as soon as reasonably practicable' thereafter. ISDA states the extension was provided because of:

> "*practical* difficulties that may arise in obtaining quotations from Reference Market makers on the relevant Early Termination Date… Parties should be careful in utilising this additional flexibility in Market Quotation, however, because any abuse of this flexibility could undermine its enforceability". *User's Guide to the 1992 Master Agreement* (ISDA 1993) (emphasis added)

The issue is not really between Live

and Historical as such, but between how long it is that one can use a Live quotation and at what point must one use an Historical quotation, and then back to when. This depends on the interpretation of "reasonably practicable".

A narrow interpretation would be that "reasonably practicable" relates to the objective, external *ability* to obtain the quotation rather than its efficacy from the perspective of the Determining Party. For example, an extension would apply only to an Early Termination Date falling on a Saturday or the transaction otherwise not being objectively priceable on a given day (as for a Nikkei Index option on a day when the Tokyo exchange is closed, as in *Oppenheim*). Valuation would be based on firm quotations that are or would have been given on the day when pricing ceases to be impracticable. On this analysis, if the Early Termination Date automatically occurred on a day when quotes could have been obtained, that is the date as of which quotations should be obtained, even if the Determining Party did not know of its occurrence.

A less narrow interpretation would take other absolute factors into account. If the Early Termination Date automatically occurred and the Determining Party did not know of its occurrence, firm quotations should be as of the first date on or after its becoming aware of the occurrence and the transaction being priceable, whether it gets them or not on that day. The dealer that closes out its positions and rebalances its portfolio on the Early Termination Date or the first trading date after becoming aware of its occurrence might prefer this.

A broad interpretation would permit consideration of general market conditions. While it was certainly practicable in principle to get a quotation for a USD interest rate swap on Lehman's Early Termination Date (for those with AET), was it practicable to get four quotations on, say, 59,000 transactions? Most transactions were strictly priceable but market turbulence prevented smooth operation of Market Quotation. The broad interpretation would permit the Determining Party to request Reference Market-makers to provide firm dealing quotations as the week (or two weeks?) progressed.

The broadest interpretation would analyse "practicability" in the context of the Determining Party's capabilities. Here "reasonably practicable" becomes subsumed by the concept of acting reasonably quickly. The "as of" date is the date obtained on the date that the quotation should have been obtained by a party acting reasonably expeditiously. Live would apply until the latest "reasonably practicable date" had occurred, and after that Historical, presumably back to the Early Termination Date.

> "In short, very few, if any, end-users would have been able to go out on 15 September, or even 16 September, to value Terminated Transactions"

The problem with the broadest approach is that capabilities differ, and differ substantially. A dealer, for instance, responds immediately to a counterparty's default. It has a team of specialists, experienced in the intricacies of s 6 of the 1992 Master, ready to spring into action. It will have real time access to all documentation and positions with the Defaulting Party and its group and all other credit relationships. Should this be the standard applicable to all?

Pity the poor end-user. Rare indeed is the end-user that is geared up immediately to price all transactions, analyse (indeed, find) all relevant documentation, consider all other positions with the Defaulting Party and its group, determine the appropriate method of calculation of each Terminated Transaction, or even be aware of the required steps to be taken. One might say: "Tough. The end-user should have known what it was signing up to." I have sympathy for that view, but perhaps we should not be too harsh on market participants who have not a clue about what the documentation says. The siren call of "standardisation" and "everybody uses the ISDA agreement" dulls the signer's intellectual curiosity to understand what is being signed. A panicked call to one of the relatively few law firms that thoroughly understands ISDA documentation may go unanswered while the firm attends to the needs of its major derivatives clients. Most end-users have maybe one or two people, not necessarily lawyers, responsible for their "standard" derivatives documentation. It is unlikely this person will have read the 426 pages of (the prohibitively expensive but regularly updated) *Derivatives: Law and Practice* by Simon Firth (Sweet & Maxwell, Last Release: August 2014), ranking 2,303,675 on the Amazon best seller list, or the 1,300 pages of (the more reasonably priced but increasingly old-fashioned) *Henderson on Derivatives* (Butterworths Law; 2nd edition 2010), ranking 1,407,146 on the Amazon best seller list. In short, very few, if any, end-users would have been able to go out on 15 September, or even 16 September, to value Terminated Transactions. Should they be held to the same standard as JP Morgan Chase?

Oppenheim

The opinion in *Oppenheim* to a certain extent muddied the distinction between, or perhaps conflated, two quite different issues: firm or indicative and Live or Historical. It is generally agreed that the definition of Market Quotation requires a firm quotation rather than indicative.[5]

That having been said, one has to

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query the reality of this in practice. It is said that Lehman had 59,000 Transactions with Deutsche Bank, 53,000 with JP Morgan Chase and 45,000 with UBS. A dealer does not typically replace Terminated Transactions. It shuts down its positions and rebalances its portfolio. It knows other dealers do the same thing. If (and I have no knowledge of this) Deutsche Bank had requested "firm" quotes from JP Morgan Chase on 59,000 transactions and JP Morgan Chase had requested "firm" quotes for 53,000 transactions from Deutsche Bank, does *anyone* believe there was an expectation of dealing on those "firm" quotes? If the parties do not expect to deal, is a "firm" quote a firm quote? Do only end-users, who actually may need a replacement, have to get *really* firm quotes?

With that quibble aside, I would note that the court in *Oppenheim* concluded that price quotations for Nikkei Index options could have been obtained on 16 September, and the court then picks that as the date as of which to value them. The court in fact applied the narrow Historical approach: valuation is obtained retroactively to the first date "reasonably practicable" after the Early Termination Date. It implied by way of *dictum* that, where the Early Termination Date had occurred by reason of AET, the appropriate valuation date would, if determined later, be the date as of which the Determining Party became aware of the occurrence, the "less narrow" interpretation of "reasonably practicable".

What I do not fully understand about the decision is why the court, having taken the Historical approach, then used an external, objective valuation analysis for the Nikkei Index options. Oppenheim perhaps made a fundamental mistake in accepting that type of valuation. If the firm quotations should have been obtained as of 16 September, why did Oppenheim not seek expert evidence as to what leading Reference Market-makers would have firmly offered on that date? While it is superficially sensible to say the "value is the value and that is what leading dealers would have offered", on 16 September 2008 banks were not in the mood to (firmly) offer *anything*.Recall that the financial crisis of 2008 was at the time called the "credit crunch". It is common knowledge that major banks were exceptionally hesitant to extend credit and were experiencing significant liquidity problems. They were extremely reluctant to do new business, particularly if it required upfront payments by them. How many leading dealers would have offered €6.5m to buy options worth €6.5m

> "What I do not fully understand about the decision is why the court, having taken the Historical approach, then used an external, objective valuation analysis for the Nikkei Index options"

from Oppenheim? Where were the dealers to get the funds on 16 September and how creditworthy was Oppenheim on 16 September? Using a retroactively determined firm quote as of 16 September would have saved Oppenheim some money, including the interest compounded on it at the Default Rate, (1% over *Lehman's* cost of funds) from the due date through July 2014.[6 7] ■

1. This is one of the curiosities of the 1992 Master Agreement, particularly given AET.
2. Bizarrely, this well thought through and perfectly rational clause was resisted by market counterparties on the grounds that it was not standard. The dealer eventually gave up on it, a sad commentary on the application of independent thought to standard documents.
3. This results from comparing an "objective" valuation to averaged quotations that take into account other factors. Indeed, the shrewd dealer may even choose to obtain Market Quotation for each Terminated Transaction from its side of the bid/offered spread, even though many of them would have netted positions out. The uninformed end-user Defaulting Party might think this evidenced bad faith.
4. *Drexel v Midland* 1992 US Dist LEXIS 21223 (SDNY). That having been said, the 1992 Master permits a Non-defaulting Party to use Loss if Market Quotation "would not (in the reasonable belief of the party making the determination) produce a commercially reasonable result." This significantly undercuts the rationale of the earlier *Drexel/Midland* opinion. An English court, in *Peregrine Fixed Income Limited (in Liquidation) v Robinson Department Store Public Company Ltd* (Commercial Court, Claim No 2000-Folio 277) [2000] ("*Peregrine/Robinson*"), has in fact held that this clause imports a reasonableness test into Market Quotation.
5. There is *dictum* in *High Risk* suggesting the contrary.
6. The due date was said to be 15 December 2008. I do not understand how this could be the case with respect to a 15 September Early Termination Date and a 16 September valuation date under the 1992 Master. The decision does not elaborate.
7. The title of this article should have been "Live or Historical: the Debate, Such As it is, Continues." The actual title, while broadly apt, is slightly whimsical. My first article, "Termination Provisions of Swap Agreements", was published in the *International Financial Law Review* in 1983. I could not resist. Bookends, and all that. The interest in this subject over 31 years may suggest either its significance or an unhealthy obsession on my part.

Further reading

- 1992 ISDA Master: practical considerations when calculating the payment due on early termination [2012] 9 JIBFL 586
- Section 2a(iii) of the ISDA Master Agreement: a brief retrospective [2014] 3 JIBFL 195
- Lexisnexis Loan Ranger blog: ISDA time limits – on defaults

KEY POINTS

- The aim of the Protocol is that adhering parties will only be permitted to exercise their "Default Rights" against each other to the extent permitted under the national regulators' special resolution regimes.
- The Protocol was necessary to ensure that the actions of international regulators were taken into account even if they would ordinarily have no legal effect under the governing law of the relevant ISDA Master Agreement.
- Under the Bank Recovery and Resolution Order 2014, the UK special resolution regime, *all* termination rights against banks under resolution are suspended for the duration of the stay not simply termination rights that arise due to events of "default" or "bankruptcy" as defined in the ISDA Master Agreement.

Author Sanjay Patel

"Won't you stay another day?" The ISDA Resolution Stay Protocol

By agreeing to the new ISDA Resolution Stay Protocol, the 18 biggest banks in the world have agreed to suspend their termination rights under derivatives contracts should another one of their number fail. Will the protocol help to stave off another global financial crisis?

The slow process of learning from the collapse of Lehman Brothers continues. The ISDA Resolution Stay Protocol is one of the most recent measures being taken to limit the market contagion that could arise if a major bank should fail again.

Part of the turmoil experienced in late 2008 was caused by the rush to terminate derivatives contracts in the immediate aftermath of Lehman Brothers Holdings Inc. filing for Chapter 11 bankruptcy in the US. In a report published in October 2011, the Financial Stability Board expressed concern that this rush to terminate derivatives contracts still had the capacity to thwart the steps being taken by global regulators to stabilise financial markets should another major bank fail.

However, the rush was inevitable because of the terms of the market leading standard form contract for over-the-counter (OTC) financial derivatives, the International Swap Dealer Association (ISDA) Master Agreement. Both the 1992 and 2002 versions of the ISDA Master Agreement contain termination provisions that provide that the commencement of almost any form of insolvency proceedings against either party to the Master Agreement constitutes a termination event, which in turn triggers the payment of a close-out amount. The rush to terminate derivatives means that banks become harder to value, harder to sell to potential purchasers and therefore more likely to remain in the hands of an unwilling state.

BACKGROUND TO THE PROTOCOL

In the words of East 17's terrible yuletide 1994 pop song, international regulators' solution to the problem was for banks' rights of termination against each other to be stay(ed) another day. In a joint letter authored by UK, US, German and Swiss regulators, ISDA was requested to draft a protocol which would provide "short term suspension of early termination rights and other remedies based on the commencement of insolvency proceedings".

A suspension along the lines contemplated in the November 2013 letter was intended to marry up with legislation giving financial regulators the power to suspend termination rights in the event of major bank failure. Understandably, regulators wanted to give themselves a short period of breathing space in order to focus on saving a failing bank rather than having to fight the fires created by widespread termination of OTC derivatives.

The fruit of ISDA's labour, the ISDA Resolution Stay Protocol ("the Protocol"), was published on 4 November 2014. The aim of the Protocol is that adhering parties will only be permitted to exercise their "Default Rights" against each other to the extent permitted under the national regulators' special resolution regimes.

WHAT NEED FOR THE PROTOCOL?

Legislators around the world have given financial regulators wide-ranging powers under their national legal systems to suspend obligations and termination rights under derivative contracts. However, these powers mean very little if they are not recognised by the governing law of a relevant ISDA Master Agreement (which is typically New York law or English law). The Protocol was necessary to ensure that the actions of international regulators were taken into account even if they would ordinarily have no legal effect under the governing law of the relevant ISDA Master Agreement.

By entering into the Protocol adhering parties agree that they will only exercise "Default Rights" (a phrase discussed below) to the extent permitted under any Special Resolution Regime to which they may be subject. As a result, for instance, where a Swiss bank enters into an ISDA Master Agreement governed by English law with a US bank and both parties adhere to the Protocol, the parties agree as a matter of English contract law that the US and Swiss Special Resolution Regimes should apply to the exercise of their termination rights.

UK "SPECIAL RESOLUTION REGIME"

In the UK, the special resolution regime affecting the exercise of termination rights under OTC derivatives is the Bank Recovery and Resolution Order 2014 (BRRO) which implements the EU Bank Recovery and Resolution Directive 2014/59/EU. The equivalent regime in the US is Title II of the Dodd-Frank Act.

Prior to the BRRO, the Banking Act 2009 already gave the Bank of England various "stabilisation powers" in relation to distressed banks. These stabilisation powers contemplate the transfer of the whole or part of a bank to another institution, a publicly owned "bridge

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bank", until a private purchaser can be found. The BRRO adds ss 70A to 70D to the Banking Act 2009. These new provisions mean that while the Bank of England is exercising one of its stabilisation powers, it may suspend obligations to make a payment or delivery under a derivative contract (under s 70A of the amended 2009 Act), and also suspend the termination rights of any party to a derivative contract (under s 70C of the amended 2009 Act). The period of the suspension of termination rights must end on midnight at the end of the first business day following the announcement of the suspension (s 70C(6) of the 2009 Act).

Section 70C of the 2009 Act creates an interesting asymmetry between *"a bank in respect of which the bank is exercising a resolution power ('a bank under resolution')"* and subsidiaries of banks under resolution. In relation to the former, s 70C of the 2009 Act does not limit the type of contractual termination rights that can be suspended by the Bank of England. However, in relation to the subsidiaries of a bank under resolution, the Bank of England can only suspend termination rights that *"are triggered by the insolvency or the financial condition of the bank under resolution"* (s 70C(3)(b) of the 2009 Act).

The difference between the Bank of England's powers in relation to banks under resolution and their subsidiaries shows that the BRRO regime was always intended to have a wider reach than simply suspending termination rights that arise due to events of "default" or "bankruptcy" as defined in the ISDA Master Agreement. In relation to banks under resolution, *all* termination rights are suspended for the duration of the stay. This tallies with the policy considerations behind the BRRO; if counterparties to a derivative contract could rely on non-default termination rights during the stay, the stay would not be as effective and stabilisation powers would continue to be difficult to wield.

PROTOCOL AND "DEFAULT RIGHTS"

The drafters of the Protocol did not have an easy task. Not only did the drafting of a single document need to take into account the BRRO's relatively subtle difference in treatment between a "bank under resolution" and a subsidiary of a bank under resolution, but also all of the niceties of Special Resolution Regimes around the world.

The way that the Protocol achieves its aim is by requiring adhering parties to exercise "Default Rights" in respect of a Master Agreement or a credit support agreement against another adhering party in a Special Resolution Regime *"only to the same extent that it would be entitled to do so under such Special Resolution Regime"*. This phrase (repeated throughout the Protocol) transposes the restrictions imposed by different Special Resolution Regimes into the Protocol.

It may seem odd for the Protocol to refer to the suspension of "Default Rights" given that Special Resolution Regimes suspend a wider range of termination rights than those that occur upon an "Event of Default" as understood in the ISDA Master Agreement. However, the definition of the phrase "Default Right" in the Protocol is very wide. According to the Protocol, a "Default Right" means, with respect to an ISDA Master Agreement or credit support documentation:

> "the 'right of a party, whether contractual or otherwise… to liquidate, terminate or accelerate such agreement or transactions thereunder, set off or net amounts owing in respect thereto, exercise remedies in respect of collateral or other credit support related thereto, demand payment or delivery thereunder or in respect thereof… suspend, delay or defer payment or performance thereunder, modify the obligations of a party thereunder or any similar rights'".

Contrary to what one might expect, the phrase "Default Right" appears to refer to any termination right in relation to the Master Agreement or any particular trades executed thereunder, whether those rights arise as a result of a default or not. While this definition may not tally with the natural meaning of the word "default", it does mean that the full breadth of the Special Resolution Regimes are incorporated into the contracts between adhering parties.

OPTING INTO THE PROTOCOL

All of the members of the so-called G-18, a group of the world's largest banks, have signed up to the Protocol by submitting an adherence letter to ISDA. Having opted in to the Protocol, the respective banks are deemed to have incorporated the Protocol into all ISDA Master Agreements that they have agreed with the other adhering parties as well as all the transactions to which their ISDA Master Agreement relates.

It should be noted that the Protocol is only incorporated into ISDA Master Agreements and ISDA credit support documentation, and is not incorporated into other financial standard forms that are not published by ISDA. As a result, the Protocol has no effect on the terms of the market standard agreement for repo transactions, the Global Master Repurchase Agreement (GMRA), as the International Capital Markets Association publishes that particular standard form. It seems likely that a similar protocol will be issued in relation to the GMRA given that it is so widely used and there has already been litigation relating to the application of the UK investment bank special administration regime to its termination provisions: *Heis v MF Global* [2012] EWHC 3068.

CONCLUSION

The Protocol is an admirable example of the banking sector, a major trade body and regulators around the world working together to bring about a co-ordinated solution to the kind of market dysfunction that the world saw after the collapse of Lehman Brothers. Regulators have already undertaken to take on the herculean job of transferring parts of failing banks to new institutions within a tiny time-frame; hopefully the Protocol should make that task at least a little easier. If it does, ISDA will deserve a good deal of credit. ■

Further reading

- Termination provisions of Swap Agreements II [2015] 2 JIBFL 83
- 1992 ISDA Master: practical considerations when calculating the payment due on early termination [2012] 9 JIBFL 586
- Lexisnexis Loan Ranger blog: ISDA time limits – on defaults

Feature

KEY POINTS

- Derivative regulatory reform will impose a requirement for eligible buy-side firms to clear certain derivative transactions on CCPs.
- This clearing obligation will pose new challenges to the buy-side of the derivative market, including how the new cleared relationship will be documented.
- Key issues for buy-side firms to consider are pre-default porting, no commitment by a clearing member to clear, termination rights, the termination process and collateral.

Author Nick May

An (un)clear view? Issues to consider in cleared derivative agreements

This article considers a number of the structural and legal issues which arise in a relationship to clear eligible derivative transactions on approved central counterparties and the consequential impact on the clearing agreement used to establish the cleared relationship, with the aim of providing some explanation and guidance to buy-side firms, particularly on why a variety of apparently unfavourable and asymmetric terms are included.

The European Markets Infrastructure Regulation (EMIR)[1] is a cornerstone of the European Union response to the credit crisis of 2008. One of the key aspects of EMIR is a requirement for certain counterparties to clear certain eligible derivative transactions on approved central counterparties (CCPs) as a means of reducing counterparty credit risk in derivative markets. The clearing obligation is being phased-in over the medium term (so that different categories of counterparties will be required to commence clearing at different times) and, while subject to current delays, this month marks approximately one year until this clearing obligation is expanded beyond the major financial institutions to some on the buy-side. This development will have a profound effect on derivative markets and one of the key aspects for buy-side firms subject to the clearing obligation will be how the new cleared relationship will be documented, particularly for buy-side firms who are more familiar (and comfortable) with trading on an over-the-counter (OTC) bilateral basis under a master trading agreement (such as an ISDA Master Agreement).

This article considers a number of the structural and legal issues which arise in a cleared relationship and the consequential impact on the clearing agreement used to establish the cleared relationship, with the aim of providing some explanation and guidance to buy-side firms new to the cleared environment as to why a variety of apparently unfavourable and asymmetric terms are included (when compared to the traditionally more level playing field of an OTC relationship) and some of the key areas for negotiation in the clearing agreement.

CLEARING

As mentioned above, the clearing obligation is primarily intended to reduce counterparty credit risk in derivative markets. A full description of how CCPs operate is beyond the scope of this article, however in simple terms a CCP acts as a counterparty to derivative transactions so that a transaction entered into between counterparties (who are both clearing members of the CCP) on a bilateral basis is then "given-up" (or, more accurately, novated) to the CCP. The result is that the CCP stands between both counterparties, so that a transaction exists between each counterparty and the CCP on identical terms to the original bilateral transactions. The primary purpose of the CCP is to neutralise (to the extent possible) credit risk. Therefore, in order to protect itself against the risk of a clearing member defaulting, the CCP establishes a number of lines of protection. These vary by CCP, but typically include:

- high membership criteria in order to become a clearing member of the CCP and trade with it (including rating, operational and derivative portfolio size requirements);
- a requirement for clearing members to post collateral, both initial margin (or independent amount) posted when the trade is cleared and variation margin (or mark-to-market collateral) posted on an on-going basis;
- a requirement to contribute to a default fund (used to offset losses caused by the default of a clearing member); and
- a default management process in order to manage the defaulted member's portfolio (eg a forced auction of the defaulted clearing member's portfolio among the remaining clearing members).

Many buy-side firms will be unable or unwilling to become clearing members of a CCP due to the criteria mentioned above and will therefore be required to access the CCP through an existing clearing member (typically a bank or broker-dealer). This process (known as "client clearing") varies by CCP, but in Europe typically follows the "matched principal" model established in the European listed derivatives market. This involves the buy-side firm (or "client") entering into a transaction with the clearing member, who then establishes an identical back-to-back transaction with the CCP. The result is that there is no direct contractual relationship between client and CCP, but instead identical back-to-back transactions between client and clearing member and clearing member and CCP.

The structure of this "matched principal" model is crucial in understanding why the various asymmetric terms discussed below are typically included in a clearing agreement. This is because the clearing member has entered into a trade with the CCP and is therefore subject to the requirements of the CCP and is also on risk both to the CCP and the client. The protection that the client has against the risk of the clearing member defaulting is typically established in the rules of the CCP (for instance, a mechanism for the CCP to transfer (or "port") the client transactions of the defaulted clearing member to another solvent clearing member). It is

therefore important that the buy-side firm is familiar with the CCP rules, not least because most clearing agreements will be subject to the relevant CCP rules and contain statements that the client is aware of and understands the CCP rules, although buy-side firms will wish to ensure the extent of that knowledge is suitably qualified.

DOCUMENT ARCHITECTURE

Most clearing agreements will operate as an extension of, or under, an existing derivative trading agreement (either for bilateral OTC or exchange traded derivatives). For most buy-side firms this will reduce time in re-negotiating previously agreed "boilerplate" provisions, however it will be worth considering the terms of the existing agreement to ensure it is suitable for the clearing relationship. Cleared transactions, however, will usually operate as a separate group (or "netting set") of transactions under that agreement distinct from any other transactions, typically because the termination and collateral mechanisms will need to operate independently for cleared transactions.

It is worth noting here that the document architecture for clearing agreements is often unwieldy and cumbersome, as different provisions in the original agreement are switched on or off and additional lengthy drafting is inserted to deal with the particular requirements for cleared trades. As an example, the complexities and potential optionality of the collateral posting mechanics between clearing member and client require significant additional elections and amendments to a standard collateral arrangement for OTC transactions. Buy-side firms should therefore ensure that the documentation process is begun well in advance of any mandatory clearing deadlines to ensure the clearing agreement is sufficiently understood and negotiated.

NO COMMITMENT TO CLEAR

Most clearing agreements will contain no commitment by a clearing member to agree to enter into (and therefore clear) a client transaction. This reflects the standard position in an ISDA Master Agreement and in terms of business for listed derivatives that neither party is committed to trade, but poses issues for buy-side firms wishing to be certain that the trade will be cleared once executed (particularly if the buy-side firm is trading through an executing broker and is at risk for a trade failing to clear). The rationale for this lack of commitment is obvious as most clearing members are unwilling to accept potentially unlimited risk to a client that an unconditional commitment to enter into transactions creates. However, buy-side firms may wish to seek to include a conditional commitment to clear in the clearing agreement, which commitment may be subject to pre-agreed trading limits, no defaults existing and other similar conditions (all of which should be open to negotiation between the parties).

PRE-DEFAULT PORTING

As mentioned above, the CCP rules will typically offer protection to a client if its clearing member defaults (eg a process to port transactions to a different clearing member selected by the client). However, a buy-side firm is likely to be aware that its clearing member is in difficulty well in advance of the CCP taking formal action and the buy-side firm may wish to transfer the portfolio to another clearing member before a formal default is declared by the CCP. This process (known as "pre-default porting") is of obvious importance to a buy-side firm as it lessens the risk of being exposed to loss during the CCP post-default porting mechanisms. However, the pre-default porting process inevitably raises risks for the clearing member. These include that the CCP's operational processes may fail to transfer the entire portfolio or the client requesting a transfer of some but not all transactions, both of which create the risk that netting sets are disrupted and the clearing member's exposure to the client is increased.

As a result, it is typical for buy-side counterparties to seek to include a commitment from the clearing member that it will agree to pre-default port transactions and for the clearing member to impose conditions on that commitment. The extent of those conditions and the situations in which they should apply is usually open to negotiation, however most buy-side firms will wish to limit these to the extent possible to be certain that the portfolio can be transferred when its clearing member is in difficulties.

TERMINATION RIGHTS

Most buy-side firms active in derivative markets will be familiar with the well-established default based termination rights contained in master derivative trading agreements. While there may be some negotiation in the detail of these (plus extra termination rights sought by some counterparties), buy-side firms will be comfortable with the limited and symmetrical nature of these rights. The position in a clearing agreement however is radically different as those termination rights will continue to apply to the buy-side firms but are typically entirely (or nearly entirely) disapplied against the clearing member and replaced by a single termination event, which is the CCP declaring the clearing member in default under the CCP rules. On first impression this seems asymmetric and unfair to the buy-side firms as many of the most basic required protections are removed (for instance the right to terminate for non-payment or insolvency). However, this position is also reflected in many agreements for exchange traded derivatives, and there is some logic to it, as the CCP's post-default porting mechanisms will often require that the transaction between the clearing member and client is terminated at the same time (and at the same value) as the back-to-back transaction between the defaulted clearing member and the CCP. Thus, if the transaction is terminated by the client before the CCP declares the clearing member in default, there is a risk of a mismatch and that the CCP post-default porting mechanism will not operate correctly. Notwithstanding this explanation, the removal of the basic protections which standard termination rights offer will be a difficult issue for many buy-side firms to accept. This area therefore appears likely to develop as the market reaches a settled position.

TERMINATION PROCESS

Similar to the above, the termination process following a client default is radically different to the concepts in most derivative trading agreements which use market quotation or loss based methodologies to calculate termination amounts. These methodologies came under scrutiny in the aftermath of the credit crisis, however they are reasonably well

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established and understood.

By contrast, the methodology in a clearing agreement gives the clearing member significant discretion by allowing it to use the normal methodology in the underlying trading agreement, but also to take into account any losses or gains incurred in connection with closing out the back-to-back transaction with the CCP and/or entering into offsetting transactions to close out the client transaction (whether cleared or not and including internal transactions or transactions with affiliates of the clearing member). This position is reasonable because the clearing member is exposed to the risk of the back-to-back transaction with the CCP and it is natural that it should be allowed to take into account termination of the back-to-back transaction. Equally, it is arguable that the clearing member should have some discretion as to how its exposure to the client transaction is reduced or neutralised, as it will need to determine at the time whether entering into an offsetting cleared transaction or a different risk reducing transaction will achieve the best result. It is therefore possible to argue that this discretion is an improvement on bilateral OTC agreements, which are typically more restrictive.

Whilst there may be some limitations on how the clearing member calculates the termination amount (such as to act in good faith and not duplicate amounts), the amount of discretion offered to the clearing member and the difficulty for the buy-side firm to objectively verify the termination amount calculated will raise issues for buy-side firms. This is particularly true if this methodology is employed in the clearing agreement for other non-fault based events, where the termination amount is traditionally calculated on a mid-market basis. Buy-side firms may therefore seek to argue that the termination calculation should always mirror the termination of the back-to-back transaction with the CCP and that this methodology should not apply to non-fault events. Again, this is an area which appears likely to develop as the market reaches a more settled position on these issues.

ADDITIONAL PROTECTIONS

The clearing agreement may also contain a range of additional protections which buy-side firms will not be familiar with from OTC derivative agreements. These include a wide indemnity in favour of the clearing member, a limitation on the clearing member's liability and limited recourse provisions (so that the clearing member's liability is limited to amounts it receives from the CCP). These protections are often included in exchange traded derivative agreements and are usually included because clearing offers (comparably) lower margins to the clearing member, which requires a reduction to the amount of risk the clearing member will accept. Buy-side firms will therefore wish to look to other contractual arrangements to ensure these are adequately drafted and risk is appropriately allocated.

COLLATERAL

The final and perhaps most important aspect of the clearing agreement relates to collateral. As mentioned above, a key element of any clearing arrangement is the requirement to post collateral to the CCP. CCP's typically require variation margin on a daily basis (often in cash in the currency of the trade) as well as the independent amount when the trade is first cleared, for which there is typically a wider pool of assets eligible to be posted to the CCP. The CCP will often call for collateral multiple times in a day with very short settlement periods (typically same day). Clearing members will naturally wish to replicate these arrangements in clearing agreements with clients, and buy-side firms must be confident that these demands can be met (both financially and operationally) before entering into the clearing agreement. It is therefore essential for buy-side firms to understand the CCP margining methodology from an early stage.

Once the basic requirements are understood, there are a variety of areas for negotiation. These include the extent to which the CCP calls will be completely mirrored (both in valuation and eligible collateral to be posted), the frequency at which collateral calls can be made and the settlement periods in which they can be met and the range of eligible collateral to be posted to the clearing member. A further typical area for negotiation is a requirement for the buy-side firm to post additional (or "buffer") margin to the clearing member above the margin requirements of the CCP to protect the clearing member from additional exposure to the client. However, there is a degree of duplication between this buffer margin and the independent amount which is separately required to be posted to the CCP, thus buy-side firms willing to accept this requirement will wish to ensure that both the circumstances in which it can be called and the amounts are clear and appropriately limited.

CONCLUSIONS

As is clear from the above summary, a clearing agreement will raise a variety of issues for buy-side firms, both in terms of complexity and the introduction of new issues to meet the challenges of clearing which will not be familiar to those used to bilateral OTC arrangements. Whilst the cleared market for buy-side counterparties remains in its infancy, it seems likely that many of the issues identified above will remain and clearing agreements will come to more closely resemble exchange traded derivative documentation. Buy-side firms are therefore well advised to engage with clearing members as early as possible (and well in advance of any mandatory clearing deadline) to ensure sufficient time is allowed for the clearing agreement to be understood and sufficiently negotiated. ■

1 Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories.

Further reading

- OTC derivatives: Client clearing agreements – framing the main negotiation [2014] 7 JIBFL 452
- The proposal for segregated exchange of initial margin: are OTC derivatives markets safer? [2014] 10 JIBFL 639
- Lexisnexis Financial Services blog: EMIR + OTC derivatives + TLEs = some TLC required?

KEY POINTS

- "Make-whole" provisions require a borrower to pay a premium upon early repayment, usually calculated as the discounted value of the interest which would have accrued until maturity.
- These provisions can mitigate a lender's risk that, upon early repayment, it will not receive all of the income it has bargained for, including future interest.
- The English courts have not considered "make-whole" provisions extensively. It is unclear, for example, whether they are likely to apply where a loan is accelerated (rather than where a borrower voluntarily prepays) or, if so, when a "make-whole" premium may be unenforceable as a penalty.

Author Rian Matthews

"Make-whole" provisions under New York and English law

This article looks at the purpose of "make-whole" provisions in financial documents and their treatment under both New York and English law. This article also considers to what extent the position taken by the New York courts, including in the recent decision *In re MPM Silicones, LLC*, may influence how the English courts interpret and apply "make-whole" provisions in an English law context.[1]

Call protection, including "make-whole" provisions, are commonly used in finance documents in both the United States and the United Kingdom. The New York courts have considered "make-whole" provisions in a number of cases, and their scope and effect under New York law is fairly clear. "Make-whole" provisions, however, have received relatively less attention from the English courts, with the result that the scope and effectiveness of such provisions under English law is much less clear.

WHAT IS A "MAKE-WHOLE" PROVISION?

"Make-whole" provisions are used to protect a lender's position in the event of early repayment. They are typically bespoke to each transaction, but in general "make-whole" provisions will provide for a premium, usually calculated as the discounted value of the interest which would have accrued until maturity, to be paid by the borrower in the event of early repayment.

The rationale behind "make-whole" provisions is that, in the context of a term loan, the lender has contracted to lend for a specific period and at a specific interest rate, and should be entitled to the repayment of all principal, and also the interest accruing throughout the entire life of the loan. The issue upon early repayment is that the lender loses the remaining income which it was expecting for the duration of the loan. A "make-whole" clause mitigates this by ensuring that all, or more commonly a portion of, that lost income is compensated for.

WHEN DOES A "MAKE-WHOLE" PREMIUM FALL DUE?

The treatment of "make-whole" provisions in a bankruptcy context was recently considered by the New York courts in *In re MPM Silicones, LLC*.[2] In summary, the Bankruptcy Court for the Southern District of New York was asked to consider a petition from a certain class of holders of notes issues by MPM Silicones, which had voluntarily entered into Chapter 11 bankruptcy proceedings. The court considered, *inter alia*, whether the noteholders could enforce a "make-whole" provision in the terms of the notes which provided that the holders would be paid an "*Applicable Premium*" on early redemption. The noteholders argued that the borrower's decision to enter into bankruptcy proceedings and subsequent automatic acceleration of the notes constituted such early redemption and that they were entitled to the Applicable Premium.

Judge Robert D Drain, the judge at first instance, rejected this argument. Judge Drain's starting point was the doctrine of "perfect tender", which provides in a finance context that a borrower "*has no right to pay off his obligation prior to its stated maturity date in the absence of a prepayment clause*".[3] A "make-whole" provision is generally interpreted as a mitigation of the borrower's right to repay, allowing the borrower at its election to prepay a loan, but subject to (or in consideration for) paying a "make-whole" premium (reflecting the interest which the lender would have received had the loan run its full term).

"The issue upon early repayment is that the lender loses the remaining income which it was expecting for the duration of the loan..."

Drawing on "*settled New York law*",[4] Judge Drain concluded, however, that a "make-whole" provision would not be enforceable in the case of acceleration (save where there was clear, unambiguous wording providing for this). A lender forfeited any "make-whole" premium on early repayment where a loan was accelerated. Judge Drain stated:

> "[t]he rationale for this rule is logical and clear: by accelerating the debt, the lender advances the maturity of the

loan and any subsequent payment by definition cannot be a prepayment… in other words, rather than being compensated under the contract for the frustration of its desire to be paid interest over the life of the loan, the lender has, by accelerating, instead chosen to be paid early.”

The notes in question provided for early repayment in two circumstances. The first was repayment at the option of the borrower, subject to the borrower paying a “make-whole” premium to the lender. The second was by way of automatic acceleration upon the borrower entering into bankruptcy proceedings. Judge Drain concluded that the early repayment had been made under the second method owing to the borrower's entry into bankruptcy proceedings. The wording in the mandatory redemption clause (which referred to the repayment of “*all other sums due*”) did not clearly and unambiguously require payment of the make-whole premium, and so no such premium was payable. Judge Drain also held that, even if the first voluntary method was engaged, the relevant provisions did not in any event clearly and unambiguously provide for payment of the “make-whole” premium upon acceleration of the loan, and so the borrower could not be required to pay the premium on this basis either. The fact that the borrower had voluntarily entered into bankruptcy proceedings did not change the legal analysis.

MPM confirms that, under New York law, while each loan will fall to be construed according to its own terms, as a general proposition “make-whole” provisions will be effective where a borrower prepays voluntarily. However, absent clear wording (and, as discussed below, subject to certain other exceptions), “make-whole” provisions are unlikely to apply where a borrower is required to repay their loan early, eg because of acceleration following default or in an insolvency/bankruptcy context.

WILL THE ENGLISH COURTS APPLY A “MAKE-WHOLE” PROVISION IN AN ACCELERATION/INSOLVENCY CONTEXT?

The specific issues considered in *MPM* have yet to come before the English courts, and so it is difficult to say how the English courts might interpret such provisions. If they do, New York law may provide the English courts with some guidance with regard to the position under English law.

There are recent examples of the English courts following US courts on the interpretation of standard or common loan terms where English law was less developed. The English courts may be similarly receptive to US authority in respect of “make-whole” provisions. For example, in the *Group Hotelero* decision,[5] Mr Justice Blair in the English High Court considered and followed a number of leading Delaware cases on the interpretation of a Material Adverse Change (MAC) clause in certain facility agreements. MAC clauses had not been extensively considered under English law previously (similar to the current position in respect of “make-whole” provisions), and so the Delaware cases represented some of the only available authority on the scope of such provisions.

> “… parties are assumed to intend that any ‘make-whole’ premium should be payable where the borrower chooses to repay early…”

That said, there is reason to think that the English courts may pause before simply adopting the approach of the New York courts. The English courts may well accept that such provisions require the payment of a premium where a borrower elects to prepay; however, the English courts, unlike the New York courts, may be less willing to assume that any “make-whole” provision does not apply in an acceleration or insolvency context.

Per *MPM*, it appears that the approach under New York law relies on certain accepted assumptions regarding the operation of “make-whole” provisions: that “make-whole” provisions (and, therefore, the obligation to pay any premium) are intended by the contracting parties to come into play only where the borrower elects to repay a loan early. Where a loan is accelerated at the election of the lender, or automatically because of an event of default etc., “make-whole” provisions should have no application, because repayment is no longer at the borrower's election.

The link under New York law between a borrower's election to repay early and when a “make-whole” premium is expected to be payable is neatly illustrated by one of the exceptions to the above general rule on “make-whole” provisions. In short, while a “make-whole” provision will usually not apply where a lender accelerates a loan, it *will* typically apply where the borrower has, with a view to avoiding paying an agreed “make-whole” premium, deliberately defaulted in order to force the lender to accelerate the relevant loan. The New York courts can extend the application of a “make-whole” provision to cover such a situation, so as to prevent a borrower from (illegitimately) avoiding using an agreed pre-payment provision and paying a “make-whole” premium. This exception to the general rule on “make-whole” clauses, together with the more general rule itself (described above), both rest on the same foundation: that parties are assumed to intend that any “make-whole” premium should be payable where the borrower chooses to repay early.

It is unclear whether the English courts would be as willing as the New York courts to approach the interpretation of “make-whole” provisions on the basis of similar pre-existing assumptions. In

BMA Special Opportunity Hub Fund Ltd & Ors v African Minerals Finance Ltd,[6] the Court of Appeal was asked to consider the payment of a premium following the prepayment of a loan. The borrower had sought to repay their loan early in order to refinance the facility. The underlying contract provided that the borrower could prepay voluntarily, provided that it gave notice and paid a 6% fee (the "optional prepayment" provision). However, a separate provision called for mandatory prepayment of any value equal to the proceeds of any refinancing, with no other fee or premium being charged to the borrower in those circumstances (the "mandatory prepayment" provision). The borrower claimed its repayment was effected under the mandatory prepayment provision, meaning no premium was payable. The lender argued that the borrower had made a voluntary prepayment, therefore triggering the optional prepayment provisions and the 6% premium.

The Court of Appeal found that, on its proper construction, the borrower had prepaid under the "mandatory prepayment" provision and therefore no premium was payable. The Court of Appeal held that, while the borrower may have elected to refinance its loan, it could not be said it then "elected" to prepay the loan, thereby triggering the "optional prepayment" provision and premium payment. Instead, the correct legal analysis was that, upon refinancing its loan, the borrower was contractually required to repay under the "mandatory prepayment" provision. The loan agreement provided that no premium was payable where prepayment was mandatory, and therefore the borrower was not required to pay any premium.

The Court of Appeal accepted that, if the borrower could repay under the "mandatory prepayment" provision then this may, in effect, undermine the practical utility of the "optional prepayment" provision: why would a borrower, when refinancing its loan, invoke the "optional prepayment" provision and be required to pay a premium, when it could instead rely on the "mandatory prepayment" provision and avoid any such obligation? The lenders argued that the borrower's interpretation was therefore contrary to "commercial common sense", however this argument was given short shrift by the Court of Appeal. Per Lord Justice Akins:

> "'[C]ommercial common sense' is not to be elevated to an overriding criterion of construction… parties should not be subjected to… [an] individual judge's own notions of what might have been the sensible solution to the parties' conundrum… still less should the issue of construction be determined by what seems like 'commercial common sense' from the point of view of one of the parties to the contract."

The decision in *BMA* is limited to its own facts. But, standing back, the decision suggests that the English courts are unlikely to approach the interpretation of prepayment provisions (and, perhaps, "make-whole" provisions) with any pre-existing assumptions regarding the scope or purpose of such provisions. The rejection of any such assumption was central to the decision in BMA: the Court of Appeal was not willing to accept that, as a matter of "business common sense", the relevant repayment premium should be payable in every situation where a borrower chooses to repay early. The Court of Appeal, instead, concluded that on its proper construction the premium was only payable in certain limited situations.

BMA suggests that the English courts will focus on the express wording of any prepayment or "make-whole" provisions when considering their terms and effect. This is entirely consistent with the English law rules of contractual interpretation. The English courts may not therefore readily assume, or accept as a starting point, that a "make-whole" provision should not apply in an acceleration or insolvency context, or require clear and unambiguous wording before finding that such a provision does so apply.

> "The English courts may not therefore readily assume, or accept as a starting point, that a 'make-whole' provision should not apply in an acceleration or insolvency context..."

RULE AGAINST PENALTIES

If the English courts were to conclude that a lender could, *prima facie*, rely on a "make-whole" provision where the lender had accelerated a loan or acceleration had occurred automatically (eg upon insolvency), the court would then need to consider whether any obligation to pay a "make-whole" premium was enforceable. This question is answered by the rule against penalties.

The position under New York law appears to be that, while the correct analysis will depend on the facts in each case, "make-whole" provisions which are commonly used in financial transactions will usually constitute enforceable liquidated damages provisions.[7] Provided such clauses are not "plainly disproportionate" to the lender's possible loss, they will not be considered penalties.

Would the English courts take a similar approach on the question of penalties? The English courts have, in a number of decisions, considered to what degree the payment of interest which would have been due, but has not yet accrued, constitutes a genuine pre-estimate of loss, or is instead *in terrorem* to discourage the borrower from defaulting.

In *The Angelic Star*[8] the court stated:

> "Clearly a clause which provided that in the event of any breach of contract a long term loan would immediately

Feature

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become payable and that interest thereon for the full term would not only be payable but would be payable at once would constitute a penalty as being 'a payment of money stipulated as *in terrorem* of the offending party'."

If a borrower was required to repay all principal and interest (including all *future* interest) to a lender upon a breach of a loan agreement or default, then this could represent a windfall gain for the lender and be seen as highly oppressive for the borrower. This is because such a payment would not reflect the net present value of income or take into account that, once the principal is repaid, the lender can mitigate its loss by reinvesting that money in other loans etc.

> "... it appears that the English courts may well (broadly) follow the approach under New York law on the question of whether 'make whole' provisions constitute penalties"

The repayment of the entirety of a facility (ie principal and all future interest) upon default is, however, an extreme example. In practice, it is more common for such provisions to use a discounted rate (such as treasury rates) in respect of potential future interest. It could be argued that a discounted rate reflects an allowance for the time cost of money and potential mitigation by the lender. A discounted rate, therefore, may constitute a genuine pre-estimate of the lender's loss and may therefore not fall foul of *Angelic Star* (although this will ultimately depend on the facts in each case).

Further, and in any event, the rule against penalties should only arise where a payment obligation is triggered by a party's breach of contract. Therefore, if the condition upon which a "make-whole" payment would arise is an event of default (or any other specific event) which is not in itself a breach of contract, then this may not engage the law on penalties. This approach was endorsed in principle by Mr Justice Burton in *M & J Polymers v Imerys Minerals Ltd*,[9] however in the same case, His Lordship also stated that that where the condition requiring payment could not have arisen "*other than where there has been a breach of* [a contractual] *obligation*…[then] *as a matter of principle, the rule against penalties may apply.*"

In *M & J Polymers v Imerys Minerals Ltd*, Mr Justice Burton was also willing to take into account the relative bargaining strength of the parties in determining whether a clause in that case was *in terrorem* and should be treated as a penalty. This approach has been rejected in other cases, such as *County Leasing Ltd v East*.[10] However, if the English courts take up Mr Justice Burton's approach, this may provide a lender with additional comfort that, where a transaction involves sophisticated commercial parties advised by experienced lawyers, any agreed "make-whole" provisions are unlikely to be struck down as penalties.

In light of the above, and notwithstanding the *Angelic Star* decision, it appears that the English courts may well (broadly) follow the approach under New York law on the question of whether "make-whole" provisions constitute penalties. While the enforceability of any specific "make-whole" provision will depend on the facts in each case, in general it seems unlikely that "make-whole" provisions commonly used in financial transactions (ie which use discounted rates) will be considered to be penalties.

CONCLUSION

The inclusion of "make-whole" provisions in any loan document can be a key consideration in a lender's decision to advance funds, given that such a provision potentially provides comfort that the lender will be repaid on the terms it has bargained for. It is therefore unfortunate that the scope and validity of these provisions has not been clarified under English law.

Parties may look to, for example, New York authority for guidance on how the English courts may approach such provisions. However, parties should be mindful that the English courts are likely to focus on the express words of the parties' agreement when considering the scope and effect of any "make-whole" provisions, particularly given that such provisions are usually bespoke to any particular transaction. ■

1 I would like thank Gareth Eagles, Paul Carberry and Alex Hunt for their input into an earlier draft of this article. The views expressed in this article are solely those of the author.

2 Case No 14-22503-rdd (Bankr SDNY).

3 *Arthur v Burkich*, 520 NYS2d 638, 639 (NY App Div 1987).

4 See, eg, *In re South Side House*, LLC 451 BR 248 (Bankr EDNY 201).

5 *Grupo Hotelero Urvasco SA v Carey Value Added SL (formerly Losan Hotels World Value Added I SL) & Anr* [2013] EWHC 1039 (Comm).

6 [2013] EWCA Civ 416.

7 See *In re GMX Resources Inc*, No 13-11456 (Bankr WD Okla Aug 27, 2013); *In re Sch Specialty Inc*, No 13-10125 (KJC) 2013 WL 1838513 (Bankr D Del April 22, 2013).

8 [1988] 1 Lloyd's Rep 122.

9 [2008] EWHC 344 (Comm).

10 [2007] EWHC 2907 (QB).

Further reading

- The interpretation of contracts relating to financial transactions: postscript [2014] 11 JIBFL 724
- High yield bonds: An introduction to material covenants and terms [2014] 4 JIBFL 242
- Lexisnexis Loan Ranger blog: How does the LMA deal with high yield noteholders in its new suite of documents?

KEY POINTS

- The Bank of England has extensive powers over "banking group companies": it can modify their capital and it can transfer their shares, other securities, assets and/or liabilities to new owners.
- A "banking group company" is a parent of a bank, or a subsidiary, or a subsidiary of a parent. "Parent" and "subsidiary" follow the definition in s 1162 of the Companies Act 2006.
- But "banking group company" excludes a "mixed activity holding company" that controls the bank through a "financial holding company", and also excludes non-financial subsidiaries of the "mixed activity holding company".
- "Banking group company" also excludes "covered bond vehicles" and "securitisation companies" unless they are "investment firms" or "financial institutions".

Author Anthony Pavlovich

Banking group companies: which entities are caught by the Special Resolution Regime?

The Special Resolution Regime in Part 1 of the Banking Act 2009 provides extensive powers to deal with distressed banks and banking group companies. Practitioners therefore need to know which entities are included in the term "banking group companies". Section 81D of the Act provides half of the definition: undertakings in the same group as the bank. The other half of the definition comes from the Banking Act 2009 (Banking Group Companies) Order 2014. The Order repeats the definition from the Act but carves out two special cases.

POWERS OVER "BANKING GROUP COMPANIES"

The Banking Act 2009 ("the Act") was Parliament's considered answer to the financial crisis. Part 1 deals with the stabilisation of banks in financial difficulties (the remainder deals with the orderly management of insolvent banks). It provides for a "Special Resolution Regime", which includes a set of "stabilisation options" (ss 11-13). Following the Financial Services Act 2012, some options apply to "banking group companies" with general effect from 1 August 2014. Further options come from the Financial Services (Banking Reform) Act 2013 (effective 31 December 2014) and the Bank Recovery and Resolution Order 2014/3329 (effective 1 January 2015). The tools to achieve the stabilisation options are called "stabilisation powers". They include powers to transfer shares and other securities (ss 14-32); and to transfer property, namely assets and/or liabilities (ss 33-48A).

The Bank of England can now exercise the following options over "banking group companies" under ss 81B-CA of the Act:

- transfer their shares or property to a private sector purchaser (ss 81B, 81C, 11(2));
- transfer their shares or property to a subsidiary of the Bank of England (a "bridge bank") with a view to maintaining access to critical functions and then selling the business (ss 81B, 81C, 12(2));
- transfer their assets and/or liabilities to a subsidiary of the Bank of England (an "asset management vehicle") with a view to selling the assets or winding down the business (ss 81ZBA, 81C, 12ZA(3)); and
- exercise a range of "bail-in" powers to adjust their liabilities and transfer their securities (ss 81BA, 81CA, 12A(2)).

A further possibility, which strictly is not a "stabilisation option" as defined in the Act, is to cancel, transfer or convert their capital instruments (ss 81AA, 6B). As a last resort, the Treasury has a further option of "temporary public ownership" for holding companies of banks (ss 82 and 13), but that is beyond the scope of this article.

The conditions for exercising these options are extensive and detailed, and offer some protection against inappropriate use. Broadly, the "banking group company" must be related to a bank that satisfies the four "general conditions" in s 7 of the Act:

- the bank is failing or is likely to fail, either in terms of the threshold conditions under ss 55B and 55J of the Financial Services and Markets Act 2000 (FSMA), or in terms of its solvency;
- no other action to prevent that failure is reasonably likely;
- it is necessary in the public interest to act; and
- winding up would be an inferior solution.

Various "special resolution objectives" in s 4 provide policy guidance for the last two conditions. Note that these conditions only apply where the bank is incorporated in (or formed under the law of) any part of the United Kingdom. Different conditions apply to EU institutions and third-country institutions under the Recovery and Resolution Directive.

Furthermore, the action with respect to the "banking group company" itself must be necessary in the public interest. The Bank of England must consult the Treasury, PRA and FCA before making that decision. The Bank of England also has a duty to minimise the effect of its action on other undertakings in the same group.

Transfers to asset management vehicles are only available in connection with one or more of the other stabilisation options. Such transfers must be necessary

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to protect the financial markets or the banking group company, or to maximise the proceeds available for distribution.

Importantly, the "banking group company" must also be incorporated in (or formed under the law of) any part of the UK.

The definition of "banking group company", found in s 81D of the Act, is therefore of critical importance. Practitioners will need to advise whether entities that do not fall within the definition of a bank (s 2), building society (s 84) or credit union (s 89) may nonetheless be subject to the Special Resolution Regime because they are related to a distressed bank.

THE BASIC DEFINITION OF "BANKING GROUP COMPANY"

In fact, s 81D(1) of the Act provides only half of the definition:

> "In this Part "banking group company" means an undertaking –
>
> (a) which is (or, but for the exercise of a stabilisation power, would be) in the same group as a bank, EU institution or third-country institution… and
> (b) in respect of which any conditions specified in an order made by the Treasury are met."

The other half comes from that "*order made by the Treasury*", namely the Banking Act 2009 (Banking Group Companies) Order 2014/1831 ("the Order"), again with effect from 1 August 2014. Article 3(2) provides:

> "… the undertaking must be –
>
> (a) a subsidiary of the bank;
> (b) a parent of the bank; or
> (c) a group subsidiary."

Curiously, these two halves of the definition amount to the same thing:

The Act (s 81D(6) and (7)) provides that undertakings are in the same group if "*they are group undertakings in respect of each other*" within the meaning of the Companies Act 2006. Section 1161(5) of the Companies Act 2006 defines a group undertaking to be a parent or subsidiary or subsidiary of a parent ("parent" and "subsidiary" are defined in s 1162 of that Act).

The Order (Arts 3(6) and 2) defines a group subsidiary as a "subsidiary of a parent of the bank which is not a parent or subsidiary of the bank", again within the meaning of the Companies Act 2006. So a group subsidiary is the same as a group undertaking except that it excludes parents and subsidiaries. Parents and subsidiaries are added by Art 3(2)(a) and (b), so the definition is the same (except for the mention of stabilisation powers in s 81D).

Thus, the basic definition of a "banking group company" is the same as a "group undertaking" in s 1161(5) of the Companies Act 2006. It is a parent, subsidiary or subsidiary of a parent of the bank, with "parent" and "subsidiary" defined by s 1162 of the Companies Act 2006.

EXCLUSIONS FROM THE BASIC DEFINITION

There are, however, qualifications to this basic definition. The Order excludes two kinds of undertaking, so that the stabilisation powers will not apply to all group undertakings of a bank.

By Art 3(3), the relevant parts of the definition exclude a "mixed activity holding company" (MAHC), and certain subsidiaries of the MAHC, where the MAHC controls the bank through a "financial holding company". If the MAHC controls the bank directly then it will not benefit from the exclusion; the Order requires at least one parent of the bank to be included in the definition. Subsidiaries of the MAHC will not benefit from the exclusion if they are "financial institutions" (as defined in the Capital Requirements Regulation). Likewise subsidiaries of those subsidiaries will not benefit.

Art 2 defines an MAHC to be a parent that is not a credit institution, investment firm or central counterparty (as defined in the Capital Requirements Regulation and FSMA) but whose subsidiaries include such an undertaking (with a further requirement relating to the Supplementary Supervision Directive). It defines a "financial holding company" to be a "financial institution" whose subsidiaries are exclusively or mainly credit institutions, other financial institutions, investment exchanges, investment firms or central counterparties (as defined in the Capital Requirements Regulation and FSMA).

By Art 3(4), the definition excludes "covered bond vehicles" and "securitisation companies". Again, Art 2 provides definitions. A "covered bond vehicle" is broadly a limited liability partnership involved in a "capital market arrangement" under s 72B of the Insolvency Act 1986. A "securitisation company" is defined in s 83(2) of the Finance Act 2005 (and in certain tax regulations), but qualified by Art 3(5) for certain kinds of "warehouse company", as defined in s 83(6) of the Finance Act 2005 (and the tax regulations). Note that neither kind of entity will benefit from the exclusion if it is an "investment firm" or a "financial institution" (as defined in the Capital Requirements Regulation).

CONCLUSION

The Act and the Order provide a relatively straightforward basic definition of "banking group companies", including – broadly speaking – the full family tree of the bank. But the exclusions provided by the Order are more involved and require careful scrutiny to see whether a particular entity is included in the definition. ■

Further reading

- Stabilisation take two: the UK bail-in provisions and restructurings [2014] 4 CRI 137
- The Banking Act 2009: a brave new world? [2009] 4 JIBFL 179
- Lexisnexis Loan Ranger blog: Bank structure and resolution

KEY POINTS

- The financial crisis highlighted the need for deposit insurance regimes that effectively protect depositors and promote financial stability.
- Interest in Islamic deposit insurance is growing, spurred by the growth of Islamic banking, local plans to develop stable financial sectors, and Basel III.
- Well-developed Islamic deposit insurance schemes will be Shari'ah-compliant, tailored for local environments, and consistent with international effective deposit insurance standards.
- Risk-based deposit insurance premiums are preferable, to promote good governance and deter moral hazard, including by avoiding the subsidisation of risky banks by stable banks. Shari'ah-compliant models that allow risk-based premiums should be considered.

Author Hdeel Abdelhady

Deposit insurance frameworks for Islamic banks: design and policy considerations

This article considers models for Islamic bank deposit insurance, including how they should be funded and whether premia should be assessed on the basis of risk or a flat-rate applied.

The financial crisis underscored the importance of effective deposit insurance regimes to financial sector strength and systemic stability. A 2008 report of the G-20 Financial Stability Forum (FSF) (now the Financial Stability Board) "stressed the need for authorities to agree on an international set of principles for effective deposit insurance systems".[1] Subsequently, the Basel Committee on Banking Supervision (BCBS) and the International Association of Deposit Insurers (IADI) jointly produced Core Principles for Effective Deposit Insurance Systems, which set forth key characteristics of, and measures for assessing, deposit insurance systems.[2]

Noting the rapid growth of Islamic banking and other financial services, the IADI Core Principles for Effective Deposit Insurance Systems, November 2014, 15-16 (the "Core Principles"), recognise the need to establish "Islamic deposit insurance systems… for the protection of Islamic deposits in accordance with Islamic principles and rules". (The Core Principles contemplate not just deposit insurance schemes that apply to deposits with Islamic banks, eg frameworks that cover both conventional and Islamic deposits (eg Turkey) but deposit insurance systems that are themselves established and operate in accordance with Islamic rules and standards (eg Sudan).)

In jurisdictions with significant Islamic banking presence, the need for effective Islamic banking regulatory frameworks – including safety nets – may be assuming greater urgency: to conform to post-crisis international banking standards; gain positioning as reputable financial markets; and/or capitalise on demand for Islamic banking and other financial services. Plans for Islamic deposit insurance systems motivated by these goals are described in the box. Design and policy considerations that will and should arise in developing Islamic deposit insurance are discussed below.

CONFORMANCE TO EFFECTIVE DEPOSIT INSURANCE SYSTEM STANDARDS

Good Islamic deposit insurance schemes will need to conform to international standards reflected in the Core Principles.

ISLAMIC DEPOSIT INSURANCE: RECENT EFFORTS, PLANS

In 2014, the Indonesia Deposit Insurance Corporation announced plans to create a separate deposit insurance framework for Islamic bank deposits, including to ameliorate the potential adverse consequences for Islamic banks under Basel III (eg to quality as "stable" deposits under Basel's Liquidity Coverage Ratio (the "Basel LCR") framework, retail demand deposits must, *inter alia*, be covered up to specific numerical coverage limits by explicit, *ex ante*, deposit insurance schemes).[5]

In 2013, Qatar's Central Bank (QCB), Financial Centre Regulatory Authority, and Financial Markets Authority unveiled a strategic plan to build "a resilient financial sector… that operates at the highest standards of regulation and supervision," and includes an explicit deposit protection regime.[6] Qatar may consider, "at a later stage," risk-based deposit insurance premiums, as well as an Islamic framework (*takaful*-based) "as a consequence of the increasing scale of operations of the Islamic banking sector" in Qatar.[7]

Jordan was, as of November 2014, amending its law to establish an Islamic deposit insurance framework, to operate alongside its existing conventional system (IADI, *Shari'ah Approaches for the Implementation of Islamic Deposit Insurance Systems*, Discussion Paper, November 2014, 6) (the "IADI Shari'ah Approaches").[8] Under Jordan's existing deposit insurance framework, established in 2000, conventional banks are required to participate; Islamic banks may do so voluntarily (reportedly no Islamic bank has participated (as of November 2014)). Participation in the new Islamic scheme will be mandatory for Islamic banks.[9] According to the IADI, 19% of total deposits Jordan's banking system are with Islamic banks[10] (assuming that the 19% figure reflected late 2014 figures).

The Core Principles expect that deposit insurers be constituted and empowered appropriately for the economic, financial market, and legal and regulatory environments in which they operate.[3] As well, they enumerate some of the essential characteristics of a well-constituted deposit insurer, including that it have: clear legal character (eg an agency of government) and mandate; authority and independence needed to effectively carry out its functions; accountability to a higher authority; sufficient funding from clearly defined funding sources, at inception and continually; ability to promptly determine and pay claims; qualified staff and management; and, legal protection from claims arising out of actions taken within its scope of authority.[4] These essential characteristics of an effective deposit insurer can be readily incorporated into an Islamic deposit insurance system.

"As to Islamic frameworks, opinions differ as to legal and operational models, as illustrated by the… models of Sudan and Malaysia"

ISLAMIC LEGAL, OPERATING MODEL

Shari'ah scholars have disapproved of standard deposit insurance model – arguing that, *inter alia*, it entails (like conventional insurance) excessive uncertainty (*gharar*), as the insured risk might not materialise. As to Islamic frameworks, opinions differ as to legal and operational models, as illustrated by the Islamic deposit insurance models of Sudan and Malaysia, some of the salient features of which are discussed here.

Sudan

Sudan's banking system is wholly Islamic, as is, naturally, its deposit insurance scheme that is administered by the Bank Deposit Security Fund (BDSF).[11] Sudan's deposit insurance model is based on *takaful* (an Islamic mutual or solidarity model) and was approved by its central bank-housed Shari'ah High Advisory Board.[12] Participation is mandatory for domestic banks and branches of foreign banks.[13]

The BDSF maintains two deposit coverage *takaful* funds that enjoy separate legal status – one covers demand deposits and savings accounts; the other covers non-capital guaranteed investment accounts (Profit Sharing Investment Accounts, discussed below).[14]

Premium payments are in the form of voluntary contributions (*tabarru*), backed by participants' mutual commitment (*ta'awun*) to contribute to the respective funds (the voluntary nature of contributions diminishes the objectionable element of uncertainty (*gharar*) entailed in other deposit protection schemes).[15] Islamic banks, the Central Bank and the Ministry of Finance contribute to the fund for deposit and savings accounts.[16] The Central Bank, the Ministry of Finance and investment account holders contribute to the investment account fund; Sudan's Shari'ah High Advisory Board ruled that Islamic Banks may not underwrite the risk of investment account loss for which account holders are responsible, given the Shari'ah-based allocation of risk to account holders.[17] The BDSF is paid a fee for managing the *takaful* funds, under an agency with fee (*wakalah bil ujr*) arrangement, and the deposit *takaful* funds are owned by their respective contributors.[18]

Malaysia

Malaysia operates a dual deposit insurance framework that is managed by the Malaysia Deposit Insurance Corporation (MDIC) and covers, through separately funded, maintained, and segregated conventional and Islamic funds, covered deposits held by conventional and Islamic banks.[19]

The MDIC is, pursuant to a *kafalah bil ujr* (guarantee for fee) structure, a guarantor (*kafil*) of Islamic banks' obligations vis-à-vis eligible bank deposits (up to coverage limits and subject to priority of claims rules). In exchange, the MDIC receives from Islamic banks a fee (*ujr*) in the form of annual premiums.[20] The insurance fund is funded by Islamic banks (which contribute their own funds to cover deposit (demand) and savings accounts, and, on behalf of investment account holders, funds to cover investment accounts). The funds are owned by the MDIC.[21]

Under the MDIC's priority rules, deposit (demand) and savings accounts take priority over investment accounts; the rationale for the priority rules is that Islamic banks are not responsible to investment account holders for capital and uncredited profit losses.[22] The fee character of the premiums paid by banks to the MDIC is important, as it allows the MDIC to assess risk-based premiums.

As the MDIC has acknowledged, the *kafalah bil ujr* structure has been disapproved by "a number of the classical scholars"[23]; however, Malaysia's Shari'ah Advisory Council (the country's central-bank housed Shari'ah Board) and others have approved the arrangement on public policy and technical legal grounds.[24]

Under both the Malaysian and Sudanese systems, deposit coverage fund surpluses are invested only in Shari'ah-compliant instruments and deficits in funding are compensated via Shari'ah-compliant sources, whether from the government, the market, or Shari'ah-compliant borrowing from respective deposit coverage funds managed by the two deposit insurers.[25]

Treatment of Profit Sharing Investment Accounts

A key question that arises in the context of Islamic deposit insurance, as well in connection with other legal, regulatory, and governance issues, is how Profit Sharing Investment Accounts (PSIAs) should be treated. PSIAs are non-capital guaranteed, profit and loss sharing investment products that frequently are based on a form of Islamic partnership

between an Islamic bank and the account holder.

PSIAs can be restricted, where the customer directs or limits the banks' investment authority (eg by limiting the kinds of assets in which to invest), or unrestricted, where the customer places no similar limitations on the bank's investment conduct.[26]

Given the risk of loss borne by the PSIA holder, clear questions arise as to PSIAs' insurability under Shari'ah and the prudence of providing safety nets for a product that allocates risk of loss to the customer and is contracted for with full customer knowledge (it is hoped). These questions must be answered in accordance with Shari'ah and consider not only blackletter law, but also Islamic legal and policy imperatives that require transparency and integrity in the market (as evidenced also by historical practice), with appropriate calibration for modern Islamic banking.[27]

Sudan and Malaysia's deposit protection frameworks strike (in different ways and to different degrees) a balance between Shari'ah-based PSIA risk allocations and the public interest in protecting PSIA holders. However, those responsible for developing future Islamic deposit protection systems will be well served to scrutinise PSIA coverage approaches (or no coverage of PSIAs) in light of the manner in which PSIAs are commonly managed in their jurisdictions, as well as related regulatory treatment and oversight.

SCOPE OF MANDATE; ACCOMMODATE OR COMPENSATE FOR SYSTEMIC DEFICIENCIES?

As the Core Principles explain, and global surveys bear out, deposit insurers' mandates range from the perfunctory (eg "pay box," responsible only for payment of funds in the event of bank inability to pay) to "loss minimizer" (responsible for identifying and selecting "least-cost resolution strategies") to "risk minimizer" (comprehensive risk reduction and mitigation functions, and commensurate powers of, eg assessment, oversight, and intervention and resolution).[28]

In the context of Islamic banking and the jurisdictions in which Islamic banks operate, the relative degree of financial sector maturity (conventional and Islamic) and the strength of legal, regulatory, and enforcement regimes should inform choices as to the nature and degree of deposit insurer mandates. Where market and legal norms and rules are still developing, regulation is insufficient, and/ or enforcement is weak or enforcement culture is still taking shape, authorities can choose to limit the mandate of the deposit insurer to accommodate current structural deficiencies, or empower the deposit insurer to compensate for deficiencies. Empowerment is preferable to establish or enhance a jurisdiction's credibility, and may also yield experience and market insight on which to build additional market and regulatory infrastructure.

RISK-BASED PREMIUM

Risk-based premiums, properly applied, reflect the risks posed by specific banks, lines of business, or other factors. As well, they provide the deposit insurer (and relevant authorities) with a practical tool for promoting healthy practices by attaching clear, entity-specific financial rewards and costs that do not accrue in flat-rate premium systems that risk subsidisation of risky banks at the expense of prudent banks. Where financial sector stability is a priority, and particularly where other regulatory tools are insufficient, the risk-based premium approach is preferable, so long as the insurer is equipped to carry out its functions and assesses risk according to rules and procedures that are clear and uniformly enforced.

Of course, the Shari'ah-permissibility and mechanics of a risk-based premium approach would need to be determined in advance by competent authorities (preferably not Shari'ah scholars that serve in their private capacities on the Shari'ah Supervisory Boards (SSBs) of covered banks, in jurisdictions in which no national Shari'ah board or similar body is constituted). As discussed above, the Malaysian guarantee for fee (*kafalah bil ujr*) system permits risk-based premiums. However, as the *kafalah bil ujr* structure is unlikely to be embraced widely (in the Middle East particularly), alternative Islamic frameworks that allow risk-based premiums should be explored.

> "Where financial sector stability is a priority, and particularly where other regulatory tools are insufficient, the risk-based premium approach is preferable..."

EX ANTE FUNDING

Most explicit insurance schemes are funded *ex ante*, rather than *ex post* (funds collected from banks following a covered bank's failure). The Core Principles include *ex ante* funding among the "essential criteria" for effective deposit insurance systems.[29] As noted above, under the Basel III LCR, national authorities may treat retail deposits as "stable" only if they are, *inter alia*, covered by a "prefunded" deposit insurance scheme.[30] Not only does *ex ante* funding make the sufficiency and timely availability of funds more likely when needed, an *ex ante* regime lends credibility to the insurer from the consumer perspective and, importantly, bolsters the seriousness of the insurer and its mandate in the eyes of covered banks. An *ex ante* funding arrangement is particularly well-suited to jurisdictions that lack strong financial services legal, regulatory, and enforcement cultures.

SHARI'AH GOVERNANCE AND COMPLIANCE

As Shari'ah-compliance is obviously the lifeblood of Islamic banking, national authorities may consider whether an Islamic bank's compliance with applicable Shari'ah standards – as determined by its SSB, a national Shari'ah board, and/or as derived

Feature

Biog box
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from generally accepted Shari'ah rules and standards in the jurisdiction – should be among the factors considered in assessing entity risk and calculating risk-based premiums (if allowed). In this area, the composition of an individual bank's SSB may be relevant. For example, Islamic banks can be incentivised to diversify their SSBs by imposing board member term limits to address the real or perceived intellectual entrenchment, conflicts of interest, and time-related practical issues that arise when SSBs are dominated by "brand name" scholars that have been known to serve contemporaneously on multiple SSBs. Where matters such as the composition of SSBs are deemed outside the scope of deposit insurers' mandates (or outside their risk focuses), the same issues can be taken up by other regulators.

> "Islamic banks can be incentivised to diversify their SSBs... to address the real or perceived intellectual entrenchment, conflicts of interest and... practical issues that arise when SSBs are dominated by 'brand name' scholars known to serve contemporaneously on multiple SSBs"

PUBLIC AWARENESS; ISLAMIC BANKING CAPACITY BUILDING ROLE

Public awareness of deposit insurance regimes is clearly essential – depositors must know of the availability and limitations of deposit protection.[31] And, effective public communication contributes to a culture of rule of law in the financial sector, among both consumers and banks.

Moreover, an insurer that communicates effectively can serve in an important industry capacity building role. For example, the Islamic finance industry is underserved where high quality, industry-relevant educational content or other professional development offerings are concerned (particularly at junior and middle personnel levels). An empowered deposit insurer, presumably having valuable and industry-relevant information (excluding the confidential kind, of course), as well as convening power, could contribute to industry and financial services capacity building. (Sources of funding for such activities, eg government, surplus insurance funds, if accessible for such purposes, would need to be determined.)

A BALANCING ACT

The discussion above covers only a few of the Shari'ah, civil law, and policy issues that authorities will need to address in developing and operating Islamic deposit protection schemes. Authorities will have to balance Islamic mandates, international standards, and practical policy objectives: in doing so, Islamic and compatible conventional policy imperatives for good governance and market integrity should inform their choices. Whatever models are chosen, empowered deposit insurers are preferable, particularly in jurisdictions where legal, regulatory, and enforcement infrastructures are still taking shape. ■

1 FSF, *Thematic Review on Deposit Insurance Systems*, Peer Review Report, 8 February, 2012, i.
2 *Id.*
3 Core Principles at 11-15.
4 See generally, Core Principles.
5 See, eg, BusinessWorld Online, "Indonesia plans Islamic repo rules, separate bank deposit insurance", 3 December 2014; BCBS, *Basel III: The Liquidity Coverage and liquidity risk monitoring tools*, January 2013.
6 *Strategic Plan for Financial Sector Regulation*, 4, 28.
7 *Id.* at 28.
8 IADI, *Shari'ah Approaches for the Implementation of Islamic Deposit Insurance Systems*, Discussion Paper, November 2014, 6.
9 *Id.* at 10 & n 7.
10 *Id.* at 10.
11 *Id.* at 7-10.
12 *Id.* at 7.
13 *Id.* at 7-8.
14 *Id.* at 7-9.
15 *Id.* at 8-9.
16 *Id.* at 7-8.
17 *Id.* at 8.
18 *Id.*
19 Eg MDIC, *Note of Perbadanan Insurans Deposit Malaysia on Islamic Deposit Insurance*, 12 October 2009) (the "MDIC Note")
20 MDIC Note at 2-3; IADI *Shari'ah Approaches* at 15.
21 IADI *Shari'ah Approaches* at 18.
22 *Id.* at 16.
23 MDIC Note at 4.
24 *Id.* at 4-5.
25 IADI *Shari'ah Approaches* at 9, 16.
26 Only unrestricted accounts are of concern here; the discussion above of investment account treatment in the Malaysia and Sudan systems dealt only with unrestricted PSIAs. For a detailed discussion of PSIAs and issues that arise in their management, eg Hdeel Abdelhady, "Consumer-oriented insolvency risk allocation in Islamic retail profit sharing investment accounts", [2014] 4 JIBFL 236.
27 Eg Hdeel Abdelhady, "Specialized Insolvency Regimes for Islamic Banks: Regulatory Prerogative and Process Design", *World Bank Legal Review*, Vol 5 (2013) at 141-42 (discussing, *inter alia*, Islamic law and policy-based market regulatory practices).
28 Core Principles at 19-20.
29 Core Principles at 29.
30 Basel III LCR at paras 75-78 (the "presence of deposit insurance alone is not sufficient to consider a deposit "stable" (Id at para 77).
31 Eg Core Principles at 32-33.

Further reading

- Consumer-orientated insolvency risk allocation in Islamic retail profit sharing investment accounts [2014] 4 JIBFL 236
- Recent trends and new perspectives in global Islamic fixed income capital markets [2014] 11 JIBFL 713
- Lexisnexis Loan Ranger blog: The year in Islamic Finance

KEY POINTS

- Private placements are on the rise and lend themselves well as an alternative source of funding.
- Institutional investors like private placements because they tend to be longer-dated than bank loans and quicker to issue than publicly traded bonds.
- In Europe, diverging standards across different European regimes can add complexity and significant costs for cross-border placements. Coordination amongst key market participants is already under way in order to bring about a robust pan-European private placement market.
- Banks still have a role to play in private placements as clients prefer to have them coordinating the placements with the investors.

Feature

Authors Ranajoy Basu and Monica Dupont-Barton

The rise of private placements as an alternative source of funding: a time for innovation and growth

This article considers the rise of a pan-European private placement market and key considerations when structuring private placement transactions in Europe.

The recent financial crisis, the regulatory restrictions imposed by the Basel III regulations and the associated widespread de-leveraging by European banks have created a funding gap for European small and mid-sized companies and have caused them to seek access to alternative sources of capital. As a result, the European market in 2013-2014 has seen the lines between loans and bonds blur into hybrid products as companies look to a broader range of finance options to meet their varying needs.

The resulting funding mix is driven by a host of external factors, from governments pushing for local sources of capital, to the consequences of regulatory change as well as the increasing mix of capital providers.

One source of funding which has prompted a high level of interest in 2014 (both from corporates and institutional investors) is private placements. Traditionally a form of US financing provided by US insurance companies and pension funds for decades in the States, this is increasingly being used in Europe, in particular in Germany (in the form of *Schuldschein* loans) and France (in the form of Euro PPs). Importantly, the private placement market has remained open throughout the recent financial crisis. 2014 was a strong year for private placements in Europe with volumes exceeding US$40bn.

Consequently, 2014 has seen a high level of interest in Europe to drive forward the creation of national as well as a pan-European private placement market. An ongoing dialogue has ensued between the issuer, investor and adviser/arranger communities across Europe, with industry bodies including the International Capital Markets Association, the Loan Markets Association, the Association of Financial Markets in Europe and the Association of Corporate Treasurers actively promoting the need for a functioning and accessible European Private Placement market. Therefore, it is looking increasingly likely that a pan-European private placement market will join the mainstream of corporate finance in 2015.

SO WHAT ARE PRIVATE PLACEMENTS?

In the absence of a formalised definition, there has been some debate in the market as to what constitutes a private placement. Ordinarily, a private placement (PP) as the name suggests involves a placement of debt (often in the form of bonds or notes) with a small group of selected investors, often non-banking institutions. These transactions offer a number of real advantages, not least that they are cheaper and quicker to structure than bond market issues and they offer good medium to long-term yields, which are attractive to pension funds and insurance companies.

The US has long benefited from an active private placement market, where companies can raise finance by offering a small group of investors (typically pension funds and insurers) a chance to invest in debt, which does not involve the cumbersome process of public transactions as the securities are not offered to the public. The deals are placed directly with the investors or, in some cases, placed with a single investor, therefore the agents involved are not underwriters and they do not purchase the bonds themselves.

The securities are not publicly offered or listed (Regulation D) (although there are some recent exceptions to this rule) and are not registered with the US Securities and Exchange Commission (SEC). Issuers do not require a public rating for the debt. However, the US private placement notes are given a private rating by the Securities Valuation Office of the National Association of Insurance Commissioners (NAIC).

SO IS EUROPE PLAYING CATCH-UP?

In the European market, private placements are debt products that are not required to be listed on public markets or rated and can be structured either as securities or loans. The European market is fragmented, with each jurisdiction having its own form of private placement financing. While the UK was the first market to really grow in size, issuers from across Europe quickly came into the market, in particular in France, Germany and Italy.

WHO ARE THE PRIVATE PLACEMENT DEBT PROVIDERS?

The categories of investors that provide this type of financing are institutional investors in the form of pension funds and insurance companies and, in some cases, high net worth individuals and other significant large corporate investors. In the aftermath of the financial crisis, European insurance funds that in the past invested in government bonds are increasingly looking to spread their risk across a new asset class while earning more yield. Institutional investors like private placements because they tend to be longer-dated than bank loans and quicker to issue than publicly traded bonds, and they usually carry a slightly higher coupon than either. The longer tenors match the investors' long-term liabilities in pensions and savings.

In the small to medium enterprise (SME) space, while banks remain the primary lenders due to the size of transactions and the local nature of the commercial relationship, PPs have grown as a private form of debt. Particularly in countries such as Greece, where corporates have been traditionally dependent on bank financing and where bank lending has significantly contracted over the last few years, the Athens Exchange Group (Athex) has been very proactive to boost SME lending by allowing companies to issue €5m of bonds through its ENA STEP (support the entrepreneur) part of its alternative market listings.

Similarly, funding long term infrastructure investments has become significantly more expensive for banks, as a result of the Basel III reforms and changes to bank funding costs. Last year in particular, witnessed a greater acceptance of capital markets instruments and PP transactions as an alternative source of funding in the infrastructure market.

WHO CAN INVEST

Traditionally, private placements were a form of financing geared at mid-cap companies who could not access the public markets where the minimum size of the transaction is around US$300m. The private placement market allows for significant flexibility in issue size, with issuances ranging for as little as US$20m to as much as US$1bn for strong issuers. In Europe, as the private placement market developed, the profile of the issuers in this market tends to range from mid-cap to larger corporates. 2014 saw large public issuers and companies in FTSE 100 accessing the market because of its expeditious time frame and much lower cost structure than any public transactions. In addition, with the growth of cross border transactions in recent years, US insurance companies were afforded much broader regulatory discretion to make private placement investments in companies not located in the US. Therefore, European corporates (in particular those with US operations) sought funding by tapping transatlantic investors and raised US dollar denominated debt.

THE ADVANTAGES OF A PRIVATE PLACEMENT

The principal advantages ascribed to private placements are lower transaction costs and shorter time-to-market timeframes because there is no requirement to produce a prospectus or comply with other investor protection rules. Without this, transaction costs are greatly reduced and private placements can be carried out in a much shorter time frame. This makes them particularly attractive to companies who wish to raise funds quickly or sophisticated capital markets issuers wishing to transact in short timeframes. Direct contact between the issuer and the investors allows for the tailoring of products to the requirements of a specific investor or group of investors.

In contrast with the long held view that private placements are less liquid than public offerings, recent months demonstrated a much greater liquidity in the US and more private placement trades than at any other time in the market.

From a borrower perspective, private placements are a good product for companies with steady revenue streams or assets they need to finance. There is typically no commitment fee and the coupon is usually fixed. Recent private placements contain a delayed drawdown feature that allows borrowers to have six weeks to two months settlement periods or to have several closings. This can be advantageous for treasurers if they do not require debt straight away but they want to have funding commitment and lock down the interest. It also removes the need for hedging arrangements.

Private placements are less regulated as there is general acceptance among financial regulators and capital markets participants that they require less regulatory protection since they are offered to sophisticated investors without the need for the prospectus requirements and regulatory authority approvals put in place to safeguard retail investors.

A FEW KEY CONSIDERATIONS WHEN STRUCTURING PRIVATE PLACEMENT TRANSACTIONS IN EUROPE

Tax structuring

Tax structuring is often an important consideration for both issuers and investors. This is particularly relevant when structuring transactions in jurisdictions such as Greece. There are still hurdles to overcome in this regard before the pan-European market functions properly. The regulatory backdrop is being finalised, and no agreement has been reached so far on tax harmonisation and common insolvency rules.

The role of banks

Investors will need to build up resources, allowing them to assess risk in lesser-known companies (or for which information is not publicly or readily available). Also, banks still have an active role to play in the development of the PP market as companies prefer to have their banks intermediate the access to the private placement market rather than dealing direct with investors. Playing an active intermediary role would help prepare banks for the time when cheap central bank liquidity is finally turned off and new regulations start to bite,

encouraging them to help customers access alternative funding options. At that point, the pan-European private placement could move beyond its niche to become a more central player in corporate funding.

DOCUMENTATION

Traditionally a private placement is intended to be offered to a small syndicate of investors and therefore the issuer is required to prepare a private offering memorandum. This is more akin to an information memorandum prepared in relation to the syndication of a loan facility rather than a high yield bond offering and it contains a term sheet setting out the main terms of the financing. Public issuers for whom existing public disclosure is available may waive the requirement to provide a detailed memorandum, however they will be required to respond to due diligence questions.

The main document in a private placement is a note purchase form under which the initial investors agree to subscribe for the notes. This document contains the typical representations, warranties and undertakings in favour of the investors that are found in a debt financing. In the US, Model Form Note Purchase Agreements have become a standard form for the institutional private placement market. For non-US borrowers, the standard form to be used is called Model Form X with two variations – one for issues with a credit rating of A- or higher and one from issues with a credit rating of BBB- or higher. French European Private Placement documentation is loosely tailored on the Model Form X.

The issuer is required to enter into a separate subscription agreement or Note Purchase Agreement (NPA) with each private placement investor on a bilateral basis.

European corporates will ordinarily use the Model Form X and adapt it to conform it to the terms of a standard bank facility agreement. It is generally acceptable to US private placement investors that the representations and covenant package in an issuer's NPA should be substantially the same as the representations and covenant package in a bank facility agreement. If the issuer is English, the NPA can be governed by English law as US investors generally view England as a creditor friendly jurisdiction.

STANDARDISING EUROPEAN DOCUMENTATION

In the European context, there is a high level of interest to drive forward the creation of a pan-European private placement market by establishing a guide of best practice and facilitating the emergence of standard documentation. One of the reasons the US market has grown so strongly is precisely because it is a unified market, with common standards and common approaches to documentation. In Europe, diverging standards across different European regimes can add complexity to the process and significant costs for cross-border placements.

On 6 January 2015, the Loan Market Association (LMA) launched template documents to be used in European private placement transactions in the form of a loan agreement that is also capable of being evidenced as a note. It is based on the existing LMA term facility agreement for use in investment grade transactions. While the template is governed by English law, unsecured and aimed primarily at investment grade borrowers, the documents are drafted so that they can be easily adapted to other governing laws and market sectors, and can be tailored for a whole range of borrowers. The template documents also include a precedent subscription agreement, a term sheet and a confidentiality agreement.

THE MAIN FEATURES OF A TYPICAL PRIVATE PLACEMENT FINANCING

Ordinarily, the notes are issued with a fixed coupon and denominated in US dollars with maturities as long as 30 years. The most common tenors in Europe are five, seven or 10 years and it is not uncommon to have tranches of notes with different maturities.

The NAIC rating is a pre-requisite for US private placement investors that are US insurance companies as the NAIC requires that the financial assets of these investors be rated by it for regulatory purposes. The rating depends on the credit quality of the issuer. NAIC 1 and 2, given to investment grade companies carry less reserve requirements. For NAIC 3 (below investment grade) the reserve requirements increase dramatically. There is a NAIC exemption for border line credits.

The representations, warranties and undertakings in a Model Form X are significantly more extensive than would ordinarily be found in a Eurobond and more akin to a bank facility based on the LMA precedent for investment grade borrowers. As a guiding principle, it is generally acceptable to US investors that the covenants in the Model Form X are aligned to those in a bank facility agreement. There will generally be two financial covenants although stronger credits may negotiate one or no financial covenants. Investors strongly prefer maintenance covenants so that basket levels are maintained at all times but may accept incurrence covenants for higher NAIC rated companies. Model Form X contains several provisions in addition to those ordinarily contained in a bank loan agreement, for example covenants restricting subsidiary borrowings and restrictions on transactions with affiliates other than in the ordinary course of business.

In terms of covenant reporting, the private placement covenants will typically be aligned to any bank financing of the issuer so that it delivers the same reporting information across all debt facilities.

Similarly to a bond, Model Form X contains a call protection for early redemption by way of a make-whole payment for the life of the notes calculated by reference to a gilt or government bond plus a margin. The make-whole provisions would ordinarily (but not always) apply to the change of control provisions.

Although the notes are subscribed by each investor individually, the consents that may be required to waive or amend the terms of the NPA will be determined by a specified majority of the investors. As there is no agent appointed to act for the investors, it is important that the issuer maintains on-going relationships with individual investors to

Biog box

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TABLE 1: EUROPEAN PRIVATE PLACEMENT MARKETS: KEY FEATURES

French private placements	German private placements	English private placements
Euro PP has raised more than €7bn in the past two years, almost exclusively for French companies, arranged by French banks and funded by French insurers. This was partly due to assistance from the French government and the Banque de France keen to ease the process with a standardised system of documentation and disclosure. Pursuant to the French Monetary and Financial Code, only an institution that is licensed as a credit institution in France or recognised as such in France through the EU mutual recognition can conduct banking transactions in France on a regular basis. Therefore private debt funds cannot make loans to borrowers incorporated in France (or French branches of foreign companies) and private debt lending must take the form of a bond instrument. The obligations under a French bond are governed by a set of mandatory provisions enshrined in the French Code de Commerce which differs in several respects from the provisions of a standard loan agreement (eg in relation to debt buy backs). With respect to secured bonds, security may not be granted in favour of each bondholder. Instead the bondholders form a group with legal personality and security is granted for the benefit of the group.	The German Schuldschein sector, twice the size of the French market and far longer established, is a key part of the country's thriving midsized business sector. Schuldschein issuance is invariably in the form of a private and unlisted bilateral loan agreement. Its benefits are similar to a US private placement: longer tenures, diversification of lender base and no formal rating requirement. Where there are multiple lenders, there are no loss sharing or majority lender provisions or consent mechanics and each lender has individual claims against the borrower. It is therefore difficult to restructure the loans in the absence of creditor consent. The loan agreement contains a shorter list of events of default and the material adverse effect concept is not built-in expressly as there is an equivalent concept in the German civil code. Schuldschein loans were traditionally issued by German companies. However the market has recently attracted international borrowers such as Clariant (Switzerland), Sonepar (France) and Sainsbury's (UK). The majority of investors in this market are still German banks and insurance companies but European banks (such as Société Générale) are teaming up with German banks to arrange Schudlschein for borrowers in their jurisdiction.	In addition, last year, more than 40% of the total invested in traditional private placements by US investors went primarily to UK and European issuers, with French companies making up the second largest portion of investments after the UK. Britain has less in the way of a recognisable private-placement market than Germany or France, although it has a number of insurance companies and pension funds. British firms hare off to America to issue privately placed securities and most domestic activity consists of private loan agreements. The British Chancellor of the Exchequer, George Osborne, announced in December that interest accrued on private placement investments would be exempt from withholding tax, giving a significant boost to the development of the UK private placement market.

ensure they are familiar with the financial position of the company and can react quickly to a consent request.

PROCESS

Following the circulation of the private offering memorandum, placement agents will arrange a road show where the chief financial officer of the issuer will meet with investors to talk through the business. Following the road show, investors will submit further questions to the issuer. The level of due diligence is not as extensive as for a high yield bond offering but more extensive than for a loan because the investors will hold the debt for longer.

It is worth keeping in touch with investors once a year with an update call so that they can get any amendments when needed notwithstanding that noteholders do not ordinarily wish to be in regular contact with the relevant borrower.

IN CONCLUSION: THE ROAD AHEAD

As alternative credit providers make their presence felt in this market and the market develops as expected, European companies could soon have a thriving and credible source of new finance on their doorstep, rather than looking across the Atlantic as they have increasingly done in recent years. Market participants, particularly new issuers in this market and investors need to be kept updated with the developments and innovation to realise the opportunities that lie ahead. Our experience in recent years shows that this is already happening. 2015 may yet be the year of the private placement market. ■

Further reading

- Schuldscheine and N bonds in demand [2014] 9 JIBFL 592
- Dutch debt capital markets: a funding solution for SMEs? [2013] 9 JIBFL 589
- Lexisnexis Loan Ranger blog: Non-bank lending options for UK corporates – 2 years after Breedon

KEY POINTS

- The Punch Taverns restructuring is considered to be the most complex corporate restructuring since the rescue of Eurotunnel in 2007, taking over two years to complete and involving over 25 different professional advisory firms.
- Punch reduced its total net debt by £600m through the exchange of junior and mezzanine bonds for a combination of cash, new bonds and ordinary shares, and raising £50m through a deeply discounted placing.
- Implementation of the restructuring required the consent of Punch's shareholders as well as the consent of 16 classes of bondholders, monoline financial guarantors, hedge counterparties and liquidity facility providers across Punch's two whole-business securitisations.

Authors Guy O'Keefe, Edward Fife and Harry Bacon

Punch Taverns' successful restructuring of £2.2bn of whole-business securitisation debt

This article aims to provide a brief history of the Punch Taverns group, a summary of its whole-business securitisation structures and to describe the events ultimately leading to Punch's restructuring in 2014. It also considers some of the key challenges that Punch faced when seeking consensus with stakeholders on restructuring proposals, the structural difficulties created by financial and contractual linkages across the group and the complex interrelationships between stakeholders holding influential stakes across several levels of its capital structure.

In October 2014, Punch Taverns successfully completed the restructuring of its two whole-business securitisations, drawing to a close over two years of negotiations with creditors holding circa £2.2bn of securitisation bonds as well as with the shareholders of the group's parent company, Punch Taverns plc. The restructuring involved junior and mezzanine lenders agreeing to exchange their existing bonds for a combination of cash, new bonds and ordinary shares in Punch Taverns plc, in most cases subject to significant haircuts, together with a group of Punch's existing stakeholders agreeing to inject £50m of new money through a deeply discounted equity placing. The restructuring reduced Punch's total net debt by circa £0.6bn and avoided Punch defaulting on its debt under its two securitisations.

A ROUND OF ACQUISITIONS, THREE WHOLE-BUSINESS SECURITISATIONS...

The Punch Taverns group was established in 1997 through the acquisition of the original Punch Taverns portfolio of pubs from Bass. In the years that followed, Punch rapidly expanded through a series of large acquisitions, including the purchase of Inn Business Group and the UK pub estate of Allied Domecq in 1999, the acquisition in 2003 of the Pubmaster estate, the acquisition in 2004 of the InnSpired Group and the demerger and subsequent acquisition of the Spirit Group in 2005, to become one of the leading operators of leased and tenanted pubs in the UK.

... AND A PACKET OF DEBT

During the 1990s, whole-business securitisations became an increasingly popular corporate finance tool. With the exception of the re-acquisition of Spirit in 2006, which was funded by a convertible bond issue, all of Punch's major acquisitions were financed through the issuance of one or more classes of securitisation debt.

The steady cashflows generated by Punch's pub portfolios (earned through rental income, sales of beer and other drink products to tenants and shares of revenues from gaming machines) made them suitable for whole-business securitisation, and the liquidity and comparatively attractive rates offered by asset-backed capital markets debt provided a ready source of funding even for Punch's largest acquisitions.

Punch raised finance through several securitisations, which were variously refinanced, restructured and amended such that, following the demerger of Spirit in 2011 (itself financed by a securitisation), it was left with:

- "Punch A", formed from the merger of the Punch Funding and Punch Funding II securitisations in 2003, comprising the business and assets of Punch Taverns Holdings Ltd and its subsidiaries, including an estate of circa 2,200 pubs financed by circa £1.1bn of gross debt; and
- "Punch B", originally acquired together with the Pubmaster estate in 2003, comprising the business and assets of Punch Taverns (PMH) Ltd and its subsidiaries, including an estate of circa 1,500 pubs financed by £853m of gross debt.

INDUSTRY IN DECLINE

It is essential for a whole-business securitisation to be underpinned by steady, predictable cashflows, which can be used as the basis for accurately modelling the debt capacity of the borrower, and appropriate debt service levels over time. Interest, debt service and free cash-flow cover ratios, as well as leverage ratios, are also set based on expected future performance at the time of issuance of securitised debt.

Following the smoking ban in 2007 and the onset of the UK recession in the wake of the 2008 financial crisis, Punch's earnings began to decline beyond levels predicted in its historical business plans. Changing consumer preferences, such as the general shift from drinking in pubs to the purchase of beer and wine from supermarkets and off-licences, and increasing emphasis on healthier lifestyles (with a corresponding reduction in alcohol consumption), also contributed to reduced revenues. Together with increases in future debt service levels as a result of step-ups in interest and principal amortisation on senior classes of bonds, this left Punch unable to comply with debt service cover ratio covenants without the provision of financial support to the securitisations. Punch also needed to implement a programme of pub disposals to generate sufficient free cash to make payments on its debt, although a significant proportion of the proceeds were required to be deposited into restricted accounts.

It was against this backdrop that Punch concluded in 2012 that both securitisations were over-levered, unsustainable in their current form and required significant changes including a material reduction in debt, an extension of debt maturities and changes to financial covenants. In the absence of such an agreement, Punch expected one or both securitisations to breach its financial covenants, which could result, if not remedied or waived, in the appointment of an administrative receiver to the relevant securitisation.

NECESSARY CONSENTS

Any consensual amendment to the fundamental terms of Punch's bonds or its securitisation documents required the consent of each of the nine classes of bonds issued by Punch A and seven classes of bonds issued by Punch B. Such changes would constitute 'basic terms modifications' requiring a high quorum for bondholder meetings: 75% of the bonds of each class would be required to vote on resolutions (or 25% at an adjourned meeting), of which 75% of the votes cast would need to be in favour to pass the necessary resolutions. A holder of more than 25% of any class of bonds could, therefore, block the approval of a restructuring of Punch A or Punch B (and a holding of over 6.25% could in theory do so at an adjourned meeting).

A bondholder identification process revealed that a number of institutions held significant stakes, with the potential to block a restructuring, including:

- members of the ABI Special Committee of Noteholders, who held the majority of the most senior classes of bonds in Punch A and B; and
- several UK and US hedge funds, who held significant stakes mainly in bonds (mainly junior classes) and, in some cases, Punch's equity.

Implementation of a consensual restructuring was also dependent on the consent of the contractual counterparties to the securitisation, including the security and note trustee, monoline financial guarantors, the providers of liquidity facilities, hedge counterparties as well as agents, registrars and account banks.

In all, over 25 separate consents were required to implement a consensual restructuring of both Punch A and Punch B.

DEFAULT ANALYSIS

Perhaps the most contested aspect of Punch's restructuring was the likely outcome for the Punch group in the event of a default and appointment of an administrative receiver in either or both securitisations.

In each securitisation, bonds were issued by a special purpose vehicle which advanced the proceeds to the securitisation's main operating company by way of a secured loan. The issuer granted security over its rights under the secured loan (among other things) to secure its obligations under the bonds. The securitisations' principal operating and financial covenants were set out in the loan agreement between the issuer and borrower, breach of which entitled the security trustee to accelerate the secured loan and appoint an administrative receiver to the borrower.

A covenant breach by the borrower would not, however, automatically lead to an issuer default entitling bondholders to direct acceleration of the bonds and enforcement of security. Only where the borrower's repayments under the secured loan were insufficient to enable the issuer to meet its payment obligations in respect of the bonds (taking into account certain liquidity facilities available to the issuer), or upon the issuer's insolvency, would the bondholders be entitled to direct acceleration of their bonds and enforcement of security.

The recoveries of bondholders in Punch A and Punch B would, therefore, be significantly influenced by the course of action taken by an administrative receiver following a default.

The range of possible courses of action varies from one extreme, being the continued operation of the securitised business until repayment in full of all outstanding liabilities, to another, being a fire-sale of all secured assets and application of the proceeds to repay as much debt as possible. Either course of action would result in the occurrence of an issuer default at different points in time, and would have significant consequences on the value of secured assets to which bondholders would have recourse upon acceleration and enforcement of security.

The default analysis was further complicated by (i) financial and contractual linkages between the securitisations and the wider Punch group and (ii) the rights of creditors and an administrative receiver under Punch's securitisation documents, which were often labyrinthine after years of amendments and supplements.

While the assets and business of both securitisations are ring-fenced, financial linkages (such as obligations of Punch B and other members of the Punch group in respect of the Pubmaster pension scheme and various inter-company loans) and contractual linkages (such as supply and services arrangements) meant that a default of one securitisation could not be considered in isolation; appointment of an administrative receiver in either securitisation could have consequences for the solvency of the wider group and as a

consequence affect the viability of the other securitisation.

As a further consideration, the economies of scale and other synergies preserved by keeping the securitisations together would be jeopardised if either securitisation were to default, putting further pressure on already stressed revenues of the remaining business.

Despite detailed financial analysis and consultation with potential administrative receivers as to their likely actions upon appointment, the uncertainties in default were sufficiently material that it was hard to determine with any confidence the likely recoveries of each class of creditor to the securitisations, and impossible to state definitively that a particular class of creditor or shareholder would recover nothing if either or both securitisations were to default.

IMPLEMENTATION

The uncertainty as to the appropriate default analysis had a significant impact on the methods by which any restructuring could be implemented.

A pre-pack administration of one or both securitisations (initially favoured by senior creditors) was considered but ultimately rejected as, among other things, the uncertain default analysis made it impossible to establish a clear value break in the capital structure.

Punch also considered at length the possibility of implementing a deal by way of a scheme of arrangement. Initially, it was thought that a scheme could enable Punch to consolidate creditor classes and thereby reduce (i) the number of consents required to implement a restructuring and (ii) the "hold-out value" of significant individual stakes.

To approve the consolidation of creditor classes, a court would need to be satisfied that the rights of members of each class (both before and after implementation of the scheme) were sufficiently similar to enable class members to consult together with a view to their common interest. Several factors made it extremely difficult to reach this conclusion and achieve consolidation of any of the different classes of creditor to the securitisations, most notably (i) Punch's intricate capital structure, (ii) complex intercreditor arrangements in Punch's securitisation documents, particularly pre- and post-default payment waterfalls, (iii) the uncertainty as to the appropriate default analysis, and (iv) the complexity of the restructuring proposals that evolved over time through engagement with stakeholders.

A scheme of arrangement was therefore not felt to offer particular advantages that would outweigh the potential cost, delay and timing inflexibility that it would involve.

In a novel structure, the restructuring was ultimately implemented by way of a bondholder consent process which provided for all existing bondholders to participate in the restructuring on the same terms, whether or not they had voted to approve it. The exchange of existing bonds for cash, new bonds and ordinary shares was implemented through mandatory actions in the clearing systems, rather than by transfer on a delivery-versus-payment basis to an exchange agent as might usually be done.

This structure ensured that all of the bonds affected by the restructuring could be redeemed and cancelled immediately upon closing by way of book-entries in the clearing systems, and avoided the use of customary cash squeeze-out provisions to redeem and cancel bonds of holders voting against the proposals (which was not a viable option due to cash constraints). To be certain of settlement on the closing date, however, it required over 30 categories of transactions to be processed in under three hours. This required months of planning with the paying and exchange agents and the clearing systems to implement.

Further complexity was introduced by the need to undertake a comprehensive bondholder certification exercise to ensure that: (i) holders of existing bonds were eligible to receive new bonds and shares under applicable securities laws; and (ii) allocations of new securities were correctly calculated at the level of beneficial holders of bonds to take into account fractions of securities and stubs (rather than at the level of direct participants in the clearing systems).

DISCUSSIONS BEGIN

On 7 February 2013, after months of initial consultations with key shareholders and certain creditors, Punch announced the terms of a proposed restructuring. These proposals contemplated separate restructurings of Punch A and Punch B that were not inter-conditional, and included no equity component (by way of either cash injections by existing shareholders or equitisation of junior bonds). Any issue of new equity by Punch Taverns plc was explicitly rejected by Punch's major shareholders in advance of the announcement and it was a condition of their support to the proposals that they included no such terms.

The following 12 months of negotiations were often intense, with significant differences of view as to the appropriate default analysis and implementation mechanisms, to the point that some stakeholders publicly announced their opposition to the deal.

This phase of the restructuring culminated on 15 January 2014, when Punch formally launched a restructuring for approval by bondholders on terms that sought as far as possible to reflect the feedback received in response to the iterations of proposals advanced throughout 2013. Following public rejection by a number of significant stakeholders, Punch withdrew the proposals in February 2014 to provide time for further discussions and development of an alternative deal.

EVER-CHANGING BATTLEFIELD

A number of significant trades in Punch's shares and bonds took place over the course of the deal. Several investors sold down their positions, leading to new stakeholders joining negotiations. Frequently, these new parties had different objectives or economic imperatives from the stakeholder they replaced (due, for example, to having less capital at risk). The effect of such changes was particularly marked where the new party acquired a blocking stake as a result of the trade.

As well as the introduction of new stakeholders, several of Punch's significant

Feature

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hedge fund investors diversified their investments by acquiring positions across the capital structure. These cross-holdings (many of which were very significant) radically changed the dynamics of negotiations and further undermined any possibility that Punch A and Punch B could be restructured independently; any solution would need to apply to both securitisations and be capable of implementation throughout the capital structure.

SUPPORT CEASES

Throughout 2013, Punch used its cash resources to provide financial support to both securitisations to provide a stable platform for negotiations with stakeholders. This was, however, not indefinitely sustainable and in February 2014 Punch announced that it had provided no further support to either securitisation in the most recent financial quarter. One or both securitisations were, therefore, anticipated to fail their covenants when tested in April 2014. Absent implementation of a restructuring or the grant of a covenant waiver, a default was expected in June 2014.

CREDITOR-LED RESTRUCTURING EMERGES

Focus shifted to facilitating the development and implementation of creditor-led proposals. Covenant waivers were sought and obtained in May 2014 to provide further time for negotiations. The waivers set out clear, albeit ambitious, milestones to achieve the launch of a restructuring by the end of June 2014.

Restructuring advisers Talbot Hughes McKillop (THM) were appointed to provide independent financial advice to the securitisation companies (to complement independent legal advice from Ashurst LLP). This bolstered the independence of the securitisation companies and introduced a new channel of communication to help broker a deal between stakeholders.

By the end of May 2014, the terms of a creditor-led restructuring had emerged. These were supported by key senior and junior creditors and contemplated equitisation of junior bonds in both securitisations as well as the injection of new money by seven existing junior creditors through a deeply discounted placing.

The possibility of new equity meant that, for the first time, stakeholders had a source of value to be allocated among junior creditors that (i) reduced the leverage and interest burden of the securitisations (both key requirements of the ABI Committee), and (ii) did not place unrealistic demands on Punch's decreasing cash reserves. This greatly improved the prospects of finding a consensual restructuring solution.

The terms of the creditors' proposals were, however, extremely complex and involved the issue of ordinary shares by Punch Taverns plc, five new classes of bonds by Punch A and one new class of bonds by Punch B.

Extensive work was required to analyse the detailed terms of the proposals and to plan a pre-transaction reorganisation of the securitisations to insert several new holding companies required by amendments to the security structure and intercreditor arrangements proposed by creditors. Significant analysis also had to be undertaken to address financial assistance considerations arising in connection with the issue of new shares by Punch Taverns plc as part of the proposed debt-for-equity swap and discounted placing and to ensure that the special tax status afforded to the issuers as securitisation companies was preserved following the restructuring.

To allow sufficient time to undertake the necessary preparatory work, further covenant waivers were obtained in July 2014 on the basis of a long-form term sheet setting out detailed terms of the proposed restructuring and conditional on a deal being launched by mid-August 2014 and implemented by October 2014. Key stakeholders holding circa 60% of Punch's bonds, including members of the ABI Committee and the junior creditors responsible for developing the key terms of the proposals, signed a lock-up agreement and undertook to vote in favour of any transaction launched on the terms proposed.

The terms of the restructuring were recorded in over 10,000 pages of securitisation documents, negotiated over a period of four weeks between more than 10 counterparties and a team of lawyers from over 10 firms. In addition, implementation of the transaction required the preparation of a combined circular and prospectus in relation to the issue of ordinary shares by Punch Taverns plc, two circulars to solicit consents from all 16 classes of Punch's bondholders and two debt prospectuses in relation to the issue of new classes of bonds by Punch A and Punch B which had to be prepared to retail standard due to the new bonds being issued with low denominations to minimise the number of fractions arising upon the exchange.

CONCLUDING REMARKS

Punch obtained the last outstanding consent to the restructuring on 7 October 2014 and closed the deal the following day, bringing to an end over two years of negotiations.

It is likely that the deal will be remembered by many for the long, difficult, and often public battles leading to the final agreement of the terms of a restructuring between stakeholders. However, the legal and practical challenges presented by a simultaneous restructuring of two whole-business securitisations, in a short timetable, were also material.

Agreeing a deal, and overcoming the challenges necessary to implement it, allowed Punch to create a more robust balance sheet and a base for further deleveraging over time. ■

Further reading

- Reorganisation and cash collateralisation of a securitisation [2008] 3 JIBFL 120
- Getting into bed with bondholders [2012] 4 CRI 120
- Lexisnexis RANDI blog: Ask the Chief Restructuring Officer – Q&A with Kevin Lyon

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In Practice

Authors Jeremy Andrews and Charles Allin

Developments in freezing foreign assets

The decision of the English High Court in *ICICI Bank UK Plc v Diminico NV* [2014] EWHC 3124 (Comm) clarifies the availability of freezing and disclosure orders in support of proceedings commenced outside the United Kingdom.

The English High Court has power in certain cases to grant a freezing order preventing the dissipation of a defendant's assets pending the conclusion of a claim and requiring disclosure of those assets. That such orders can be given worldwide effect has long been regarded an important feature of the English Court's jurisdiction.

Section 25 of the Civil Jurisdiction and Judgments Act 1982 gives the English court the power to grant interim relief, including freezing and/or disclosure orders, in aid of proceedings commenced outside the UK. The recent decision of the English court in *ICICI Bank v Diminico* helps to define the limits of this power.

FACTS

A bank, ICICI, provided a US$25m working capital facility to Diminico, a Belgian diamond distributor with bank accounts in London but with no other presence in the UK. The full amount was drawn down. In early 2014, Diminico ceased fulfilling its contractual obligations and ICICI sought to recoup its debt. Proceedings were commenced in Belgium and ICICI obtained an attachment order from the Belgian Court against Diminico's assets in Belgium, but information disclosed by Diminico's Belgian banks revealed negligible assets in Belgium, despite Diminico's accounts showing turnover of over US$300m. This led ICICI to suspect that Diminico was deliberately channelling funds abroad to avoid the effect of the Belgian attachment order, and it consequently applied to the English Court for orders freezing Diminico's assets worldwide and requiring detailed disclosure of those assets.

JUDGMENT

Where a defendant is neither resident in England and Wales nor subject to its jurisdiction for some other reason, the English court will only grant a worldwide freezing order under s 25 in exceptional circumstances, namely where the applicant can persuade the court that:

- there is a "*real connecting link*" between the order sought and the English court's territorial jurisdiction;
- it is appropriate for the English court to act as an "*international policeman*" in relation to the foreign assets; and
- it is just and expedient for the English court to grant the order.

In applying these principles, the English court indicated it would not have granted the application for a worldwide freezing injunction had it been maintained (ICICI had withdrawn this part of its application prior to the hearing):

- There was no "*real connecting link*" between the worldwide order sought and the territorial jurisdiction of the English court. Diminico was a Belgian company with no presence in England and Wales.
- The English court did grant a domestic freezing injunction over Diminico's English assets (there being held to be a "*real connecting link*" between such domestic freezing order and the territorial jurisdiction of the English court). However, the existence of those assets did not render Diminico within the jurisdiction of the English court and therefore had no bearing upon its decision not to grant worldwide relief.
- There was no effective sanction which the English court could apply to enforce compliance by Diminico with any worldwide freezing order and nothing making it appropriate for the English court to act as "*international policeman*" in relation to assets abroad.
- It was therefore inexpedient and inappropriate to grant a freezing order in relation to Diminico's assets held outside England and Wales.

The application for worldwide asset disclosure by Diminico was refused for the same reasons.

LESSONS

It should not be assumed that obtaining a worldwide freezing order from the English court in support of foreign main proceedings will be a *fait accompli*. The extent of the support available from the English court under s 25 will largely depend upon:

- whether the defendant has assets within England and Wales (if it does, a domestic freezing order may be available);
- whether the defendant is resident within England and Wales, or is someone over whom the English court has jurisdiction for some other reason (if it is, a worldwide freezing order may be available).

It follows that, where the desirability of a worldwide freezing order is identified but is unavailable in the jurisdiction of the main proceedings:

- prospective claimants should carefully assess counterparties' links with England and Wales at an early stage, since applications for English freezing orders must be made without delay; and
- if the defendant is neither resident within England and Wales nor otherwise subject to the jurisdiction of the English court, prospective claimants should consider:
  - whether exceptional circumstances exist such that an English worldwide freezing order might yet be granted; and
  - seeking advice from all jurisdictions in which the debtor's assets are located to ascertain the availability of freezing and/or asset disclosure relief in support of foreign proceedings. ■

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In Practice

Authors Nigel Dickinson, Daniel Franks and Charlotte Brown

Draft EU Regulation on Securities Financing Transactions

This article identifies the key differences between the Parliament's and the European Council's approaches to the European regulation on the reporting and transparency of securities financing transactions.

BACKGROUND

On 8 January 2015, the European Parliament published its draft report (dated 22 December 2014) on the European Commission's proposal of 29 January 2014 for a European regulation on the reporting and transparency of securities financing transactions ("the SFT Regulation"). The Parliament's publication of its report is the first opportunity to compare its position with that of the European Council, which had proposed its own revised draft of the SFT Regulation on 14 November 2014. The Parliament's report demonstrates significant differences between the Parliament's and the Council's opinions on some key issues. It will now be for the Parliament and the Council to reach agreement on the text through the ordinary legislative procedure.

The impetus for an SFT Regulation began with the 2008 financial crisis, which regulators considered highlighted the need to improve regulation and supervision not only in the traditional banking sector but also in the so-called "shadow-banking" sector. At the same time as the Commission published its initial proposal for an SFT Regulation, it also published a draft regulation on structural measures improving the resilience of EU credit institutions, one effect of which is expected to be a shift in activity in securities financing transactions from credit institutions to the shadow-banking sector.

The remainder of this article focuses on the Parliament's proposal for the SFT Regulation, as set out in its latest report, identifying, where appropriate, the key differences between the Parliament's and the Council's approaches.

SCOPE OF SFT REGULATION

The scope of the SFT Regulation is limited both by reference to the type of transaction/arrangement and by the type and jurisdiction of the parties.

Type of transaction/arrangement

The SFT Regulation contains separate rules relating to securities financing transactions (SFTs) and to rights of reuse. An SFT is defined as:

(1) a repurchase transaction;
(2) a securities or commodities lending or borrowing transaction;
(3) a buy-sell back transaction or sell-buy back transaction; and
(4) a collateral swap.

TABLE 1

	Transparency and disclosure		SFT haircuts		Reuse
	Mandatory reporting of SFT to trade repository	Disclosure of SFTs and reuse to investors/ shareholders	Requirement to follow methodology in calculating haircuts on SFTs	Minimum haircut on SFTs if collateral is not government securities	Limitations on reuse
Counterparties (see note below for definition and territorial effect)	✓		✓	✓ (unless either party to the SFT is a credit institution)	✓
UCITS management companies and UCITS investment companies		✓			
Managers of alternative investment funds (AIFMs)		✓			
Credit institutions established in an EU member state		✓		✓ (if SFT is not centrally cleared and other party is not credit institution)	
Undertakings admitted to trading on a regulated market or on a multilateral trading facility		✓			

In addition to these categories, the Commission may, by delegated act, expand the list of the types of transaction that will constitute an SFT, having regard to whether such other types of transaction have an equivalent economic effect and pose similar risks to SFTs.

The scope of the definition of SFTs reflects a key difference from the Council's approach. In addition to the differences between the lists of pre-defined SFTs (the Parliament includes collateral swaps, while the Council includes margin loans), the Commission's subsequent ability to include other types of transaction is significant. While the Council had previously proposed a similar approach in an earlier draft of the SFT Regulation, this was removed in its most recent proposal. If it is to remain in the final text, the key question that market participants will consider is whether transactions such as total return swaps or other derivative transactions may in time be brought within the scope of the SFT Regulation.

"Reuse" is defined as the use by a receiving counterparty of financial instruments delivered in one transaction in order to collateralise another transaction. Again, this reflects a key difference from the Council's definition, with the Parliament appearing to have taken a narrower approach in two respects. First, the Parliament refers to financial instruments delivered "in one transaction", which appears to suggest that reuse relates only to financial instruments delivered in an SFT (as opposed to the Commission's proposal, as accepted by the Council, referring to financial instruments received under a collateral arrangement without specific reference to SFTs). Secondly, the Parliament refers to the use of those financial instruments to collateralise another transaction (rather than the broader concept of the receiving party using those financial instruments on its own account in any manner). It remains to be seen whether these distinctions are deliberate attempts by the Parliament to limit the scope of the prohibition on reuse (and, in particular, to tie it to reuse under SFTs), although it is difficult to see a policy justification for doing so.

Type and jurisdiction of the parties

The SFT Regulation has a broad scope of application within the EU, with some extraterritorial effect similar to EMIR. In broad terms, it applies to the institutions shown in Table 1 (note that an institution might fall within two or more categories of person).

"Counterparties" are defined as financial counterparties, non-financial counterparties and CCPs (each as defined in EMIR) and CSDs (as defined in the CSD Regulation), in each case provided that they are either established in the EU, or are carrying out the relevant activity through a branch in the EU or, in the case of reuse, the reuse relates to financial instruments provided as collateral by a counterparty that satisfies the foregoing.

The application of the notification requirements to credit institutions and undertakings admitted to trading on a regulated market or an MTF again marks a difference between the approaches of the Parliament and the Council.

There are certain exceptions from the above including, amongst others, the European System of Central Banks.

What are the key requirements?

The SFT Regulation aims to improve the transparency surrounding SFTs and reuse and limit the perceived risks of SFTs and reuse by (i) requiring central reporting of SFTs, (ii) requiring disclosure of SFTs and reuse to investors, (iii) imposing minimum requirements for reuse and (iv) imposing minimum requirements relating to the haircuts applicable to SFTs.

Reporting obligations (Art 4)

- The details of any SFT are to be reported to a central trade repository no later than the working day after that SFT is entered into, modified or terminated. This obligation applies equally to new SFTs and those that are outstanding when the reporting obligation comes into force.
- Counterparties must keep a record of their SFTs for five years from the termination of the transaction.
- Counterparties may delegate the task of reporting.

Transparency towards investors (Arts 13 and 14)

- Management companies of UCITS, UCITS investment companies, AIFMs, credit institutions and undertakings admitted to trading on a regulated market or MTF must provide disclosure to their investors of their use of SFTs and their reuse of financial instruments on an annual and half-yearly basis and (in the case of UCITS and AIFMs) in pre-investment documentation.

"The scope of the definition of SFTs reflects a key difference from the Council's approach..."

Minimum requirements for reuse (Art 15)

- The SFT Regulation restricts the instances in which counterparties are permitted to reuse financial instruments received as collateral.
- The conditions that must be satisfied in order for reuse to take place are:
  - the collateral provider must be made aware of the risks and legal consequences of granting its consent to reuse;
  - the collateral provider must have provided prior express consent in writing (which is deemed to be satisfied if the parties have entered into a title transfer financial collateral arrangement); and
  - the financial instruments received under a collateral arrangement must be transferred from the account of the collateral provider to an account of the collateral receiver.

As noted above, there remains some uncertainty as to whether these limitations apply just to financial instruments received as collateral under an SFT, or whether they apply equally to

financial instruments received as collateral under any collateral arrangement, with the Parliament's definition of reuse being inconsistent with the restrictions in Art 15 itself.

Minimum requirements for haircuts (Art 15)

- The SFT Regulation proposed by the Parliament also introduces requirements relating to the calculation and receipt of haircuts, as proposed by the Financial Stability Board in its regulatory framework of 14 October 2014, which are seen as necessary to mitigate the perceived systemic risks associated with SFTs and reuse.
- The SFT Regulation requires all counterparties to follow methodologies to calculate haircuts on an individual asset basis or a consolidated portfolio basis, depending on the nature of their trading activities.
- With certain exceptions (as seen in Table 1), counterparties are also required to collect minimum haircuts for SFTs where the collateral does not comprise government securities.
- ESMA shall develop draft regulatory technical standards to address these points further, which is expected to follow the completion of the FSB's work.
- Interestingly, there is not currently a requirement to offer the segregation of haircuts (as there is for OTC derivatives under EMIR), so the imposition of a minimum haircut may have the unintended effect of increasing the extent to which a collateral provider is taking credit risk on the collateral receiver under a title transfer arrangement.

IMPACT AND CHALLENGES

The impact of the SFT Regulation will be felt by front-office and back-office functions alike. The structuring and pricing of SFTs will likely be impacted by the requirements relating to minimum haircuts, and market participants will need to put in place appropriate measures for disclosure and reporting, with similar challenges to those faced in the reporting of OTC derivatives under EMIR. In particular, there will be questions as to whether non-financial counterparties such as commodities firms have the necessary infrastructure to report on their own behalf and how best to allocate risk of non-compliance in any delegated reporting arrangements.

As noted above, how the Parliament and the Council manage to reconcile their differences in a final text remains to be seen, and even then we await much of the detail in draft technical standards. Until then, market participants are faced with the challenge of trying to anticipate the answers to some of the questions raised above, including the critical question as to the scope of the limitations on reuse. ■

Biog box

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In Practice

Authors Bruno Basuyaux and Emilie Haroche

The 2014 French Insolvency Law reform: a missed opportunity?

This article highlights how the recent Ordinance reforming French insolvency laws has introduced some measures to enhance creditors' rights in formal insolvency proceedings.

The draft of the ordinance reforming French Insolvency laws released a little more than a year ago contained a provision to enable creditors to cram down shareholders. Unfortunately, that provision did not survive the *Conseil Constitutionnel* review which declared it unconstitutional on the grounds that it infringes the fundamental right of ownership (*droit de propriété*).

The Ordinance eventually enacted on 12 March 2014 ("the Ordinance"), which came into force on 1 July 2014, is thus regarded by some as a missed opportunity to correct for the benefit of creditors what is commonly seen as a statutory imbalance in favour of debtors and shareholders.

Be that as it may, the Ordinance has nonetheless enhanced creditors' rights in formal insolvency proceedings, perhaps a bit more significantly than is *prima facie* apparent. Particularly relevant to creditors are the provisions improving the priority rights afforded to new money providers, the amendments made to the proof of claims process and the introduction of a right for creditors to present a rescheduling plan to the vote of creditors in safeguard and reorganisation proceedings.

ENHANCED CREDITORS' RIGHTS

Article L 626-20 I 3° of the French commercial code, as amended by the Ordinance, provides that the claims of new money providers may not be rescheduled as a result of safeguard or reorganisation proceedings. This provision closes a long debate within the restructuring community on the effects of the priority rights afforded to new money. As a result, a debtor in conciliation proceedings will no longer be able to raise new money with a short term maturity, to immediately thereafter apply for safeguard proceedings and petition the court to reschedule the new money over a maximum of ten years. This is generally seen as a measure that will facilitate the granting of new money and will benefit both creditors and debtors.

The proof of debt process has also been enhanced. Before the Ordinance, creditors had to file a proof of debt within two months following the publication of the insolvency order.[1] Failure to do so resulted in being barred from participating in the distributions. Article L 622-24 of the French commercial code, as amended by the Ordinance, provides that the proof of debt is deemed to be made if it features on the list of claims that the debtor must submit to the office holder for the purposes of the insolvency filing. Creditors may ratify the deemed proof of claim until the date on which the judge rules on the admission of the claim. While it remains to be seen how this provision will work in practice, it is definitely a step forward for creditors as it reduces the effect of the time bar.

The third measure is expected to change the approach of negotiations between creditors and the debtor in pre-insolvency situations and in safeguard proceedings. Article L 626-22 of the French commercial code, as amended by the Ordinance, now provides that, as an alternative to the plan proposed by the debtor, creditors have a right to propose their own plan(s) to the vote of the creditors' committees. While this may apply primarily to purely financial restructurings (eg in situations where LBO bank and/or bond debt or high-yield debt need to be restructured), it is likely to tip the balance back in favour of creditors and, in principle, help them to negotiate a more creditor friendly plan. While, it also remains to be seen how this provision is applied in practice, and, in particular, whether it will prompt substantial litigation, it is generally regarded as a material step in favour of creditors.

In reforming insolvency proceedings, in 2014, the French government thus seems to have chosen evolution over revolution. In spite of a number of improvements, French insolvency laws continue to be seen as debtor oriented and value destructive. However, recent restructuring transactions have, nonetheless, demonstrated that creditors can, in fact, force their way into the equity.

DISPUTE RISKS

But further regulatory changes are expected, such as a revised provision to cram shareholders down featuring in the draft Macron bill to be discussed before the parliament within the coming weeks. According to the draft, the courts will have the authority to order the transfer of shares held by the incumbent shareholders, if such transfer is "necessary for the adoption of a viable continuation plan in respect of a company subject to reorganisation proceedings whose demise is likely to cause significant harm to the local employment situation". This revised proposal has yet to be cleared by the *Conseil Constitutionnel*. However, assuming it is enacted, it is likely to create significant dispute risks, if only as to the assessment of the likely harm to the employment situation that the company's demise would cause. ■

1 Subject to extension in certain situations eg where the creditor is located outside of France.

Biog box

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Financial Crime Update

Author **Paul Bogan QC** of 23 Essex Street

Criminal sanction in the UK for money laundering abroad

R V ROGERS

A fraud is committed in the United Kingdom and the proceeds are transferred to an account held in the name of a third party abroad. The third party knows or suspects the funds represent the proceeds of the fraud. Does his or her conduct in allowing the banking facility abroad constitute a crime justiciable in the UK?

According to *R v Rogers*[1] the answer is likely to be "yes". In that case the Court of Appeal was concerned with two advance fee frauds committed in the UK. The victims were resident in the UK and the fees of which they were dishonestly relieved were sent to UK bank accounts. Thereafter some £715,000 was transferred to a bank account in the appellant's name in Spain. He acknowledged that he had permitted the principal fraudster to use that account.

He was acquitted of both conspiracies to defraud with which he had been charged. Hence the only issue was the extent of his criminal liability for dealing with their proceeds abroad. Initially he was accused of an offence under s 327(1)(e) of the Proceeds of Crime 2002, namely removing criminal property from England or Wales by arranging for its transfer to his account in Spain. However, during the course of the evidence it became clear that there was no evidence that he had been involved in the transfers from the UK to the Spanish bank accounts and accordingly the count could not succeed. A substitute count was allowed, alleging the s 327(1)(c) offence of converting criminal property by permitting its receipt into and subsequent withdrawals from his Spanish accounts. In other words, unlike the underlying fraud offences which created the criminal property, or the subsequent transfer of the swindled funds abroad, the activity of which he was accused had occurred exclusively in Spain.

Extra-territorial jurisdiction

The court ruled that the Crown court in the UK had jurisdiction to try the offence on two bases. First, the Act itself allowed it. It was held that the combined effect of s 327 and the definition section, s 340, in particular s 340(11)(d) whereby money laundering is an act which would constitute an offence under s 327 if done in the UK, operated to confer jurisdiction on courts in the UK.[2]

In the alternative it was held that the modern approach to jurisdiction was to allow offences to be justiciable in the UK "where a substantial measure of the activities constituting a crime take place in England [unless] it can seriously be argued on a reasonable view that these activities should, on the basis of international comity, be dealt with by another country".[3] Here the funds converted in Spain had become "criminal property" as a result of the fraud in the UK. They did not lose that characteristic and the victims continued to be deprived of their funds because of the transactions in Spain. There was accordingly no reason to withhold jurisdiction or to conclude that the Spanish authorities would have an interest in prosecuting.

In reaching that conclusion the court appears to have been much influenced by the dicta of Rose LJ in *R v Smith (No 1)*,[4] cited with approval by the Woolf LCJ in *R v Smith (No 4)*:[5]

> "The reliance of international banking on ever developing and advancing communications technology had added new weapons to the armoury of fraudsters, especially those whose purpose is to perpetrate fraud across national boundaries. If the issue of jurisdiction in cases of obtaining[6] to depend solely upon where the obtaining took place it is likely that the courts, and especially juries, will be confronted with complex and, at times, obscure factual issues which have no bearing on the merits of the case. This court must recognise the need to adapt its approach to the question of jurisdiction in the light of such changes."

If, in *R v Rogers*, one strips away the otiose facts that the appellant had originally been accused of involvement in the fraud itself and that he was a UK national, the Court of Appeal has in effect given the green light to the prosecution of any foreign national living abroad, dealing with property exclusively abroad, who is thought to know or suspect that the property with which he is dealing represents the proceeds of a crime committed in the UK. There would be no reason of principle not to continue the tracing exercise if the property moves on. Had the money in Rogers'

Spanish bank account been transferred, say, to the South African bank account of a citizen of that country, provided he had the requisite state of knowledge, the latter too would have committed an offence triable in the UK.

Ramifications for extradition and confiscation

While the judgment in *R v Rogers* may have a considerable impact on the power to prosecute foreign money laundering, it will also provide prosecution agencies with the corresponding ability to seek extradition of those dealing abroad with the fruits of criminal activity in the UK. European arrest warrants can be issued and extradition proceedings commenced in respect of foreign nationals who have never set foot in the UK, let alone had any financial dealings with any UK person or institution.

Additionally the judgment will add weaponry to the confiscation armoury. Whereas the proceeds of UK crime have always been at least nominally traceable overseas, by imposing criminal liability on those whose conduct takes place abroad prosecutors will be better equipped to achieve a sequestration of their assets, both in the UK and abroad. In the *Rogers* situation for example, where a conviction will inevitably lead to a confiscation order, the available amount will include assets in both jurisdictions. That in turn will enable prosecutors to seek restraint orders at an early stage of the proceedings or, as is often the case, pre- charge. Such orders may accordingly prohibit the disposal by a foreign national located abroad of his assets also located abroad. Moreover restraint orders can include a direction for the repatriation of overseas funds to the UK in order to ensure they are not dissipated.

Conclusion

In a 21st century world with unprecedented access to global travel, communications, banking and other financial services, *R v Rogers* will give considerable confidence to those investigating and prosecuting transnational crime in which the benefit of a fraud in the UK is laundered in foreign jurisdictions. Launderers with no connection to the UK, or for that matter no connection with a fraud in the UK beyond later possession abroad of some of its proceeds, may now be liable to prosecution in the UK for money laundering. And in order to give effect to the ability to prosecute such persons, prosecution agencies will be armed with corresponding powers of extradition and confiscation. ■

1 [2014] EWCA Crim 1680 [1 August]; [2014] 2 Cr App R 32.
2 See *Criminal Law Week* [2014] 31/14 for a trenchant criticism of the court's reasoning on this first basis.
3 Per La Forest J in *Libman v R* (1985) 21 CCC (3d) 206, adopted by Rose LJ in *R v Smith* (No 1) [1996] 2 Cr App R 1 and cited with approval by Woolf LCJ in *R v Smith* (No 4) [2004] EWCA Crim 631, [2004] 2 Cr App R 17 and Treacy LJ in *R v Rogers supra*.
4 *Supra*.
5 *Supra*.
6 In these proceedings, *inter alia*, for obtaining by deception, the funds obtained were deposited into a bank account located in New York, but whose ownership and control was English.

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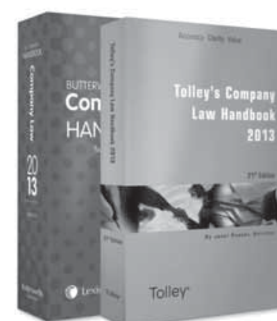

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Case Analysis

Sam O'Leary of One Essex Court reports on a recent decision of the Privy Council

ANTI-SUIT INJUNCTIONS IN INSOLVENCY

Stichting Shell Pensioenfonds v Krys

[2014] UKPC 41

SUMMARY

This was an appeal by Shell against an order of the British Virgin Islands (BVI) Court of Appeal restraining it from pursuing proceedings it had commenced in the Netherlands against a BVI company which had subsequently been ordered by the BVI court to be wound up. The appeal was dismissed. Shell had submitted to the BVI court by proving in the insolvency of the BVI company. The court has an equitable jurisdiction to restrain the acts of persons amenable to the court's jurisdiction calculated to violate the statutory scheme of distribution.

FACTS

Stichting Shell Pensioenfonds ("Shell") had invested in Bernard Madoff's funds through Fairfield Sentry Ltd ("FSL"), a BVI-incorporated feeder fund. Shell, like other investors in FSL, acquired shares in FSL and were entitled to withdraw their funds by redeeming their shares, in both cases on the basis of a price based on the net asset value per share published from time to time by the directors of FSL.

On 12 December 2008, the day after Mr Madoff's arrest, Shell applied to redeem its shares. However, no redemption payment was received and, six days later on 18 December, the directors of FSL suspended determinations of net asset value per share.

Shell obtained pre-judgment garnishment and conservatory attachment orders in the Netherlands over assets of FSL held by its custodian, Citco Bank Nederland BV, in bank accounts in Ireland, totalling about US$71m. These orders were made in support of proceedings Shell had commenced in the Dutch courts for alleged breaches of representations and warranties contained in a letter given by FSL to Shell in advance of its initial investment.

On 21 July 2009, FSL was ordered by the High Court of the British Virgin Islands to be wound up. On 5 November 2009, Shell submitted a proof of debt in the liquidation for US$63,045,616.18.

The effect of the attachments was that if Shell succeeded in its claim in the Dutch courts it was likely to be able to satisfy its judgment debt in full out of FSL's balance in its account with Citco Bank.

The joint liquidators of FSL unsuccessfully challenged the attachments in the Dutch courts. They subsequently applied in the High Court of the British Virgin Islands for an anti-suit injunction restraining Shell from prosecuting its proceedings in the Netherlands and requiring it to take all necessary steps to procure the release of the attachments. The application was heard *inter partes* in July 2011 by Bannister J, who rejected it. His main reason, in summary, was that the BVI court would not, as a matter of principle, prevent a foreign creditor from resorting to his own courts.

The liquidators appealed successfully to the BVI Court of Appeal. The Court of Appeal reasoned that Shell was subject to the personal jurisdiction of the BVI court by virtue of having lodged a proof in the liquidation; that the jurisdiction of the Dutch court was exorbitant; and that Shell should not be allowed to avail itself of that jurisdiction so as to gain a priority to which it was not entitled under the statutory rules of distribution applying in the British Virgin Islands.

HELD (LORD SUMPTION AND LORD TOULSON DELIVERING THE OPINION OF THE BOARD DISMISSING THE APPEAL):

Distribution of the worldwide assets of an insolvent company

The making of an order to wind up a company divests it of the beneficial ownership of its assets and subjects them to a statutory trust for their distribution in accordance with the rules of distribution provided for by statute. The general rule is that only the jurisdiction of a person's domicile can effect a universal succession to its assets.

The *lex situs* remains relevant to the question of which assets form part of the insolvent estate. Thus if execution is levied on an asset within the territorial jurisdiction of a foreign court before the company is wound up, it will no longer be regarded by the winding-up court as part of the insolvent estate.

In the present case, however, the effect of the attachments was not to charge them or otherwise transfer a proprietary interest in them to Shell (in either case, such an order would have ranked prior to the winding-up order).

Anti-suit injunctions in insolvency cases

Where it has jurisdiction, the court may act personally upon a defendant by restraining him or her from commencing or continuing proceedings in a foreign court where the ends of justice require. In the context of insolvency, the court has an equitable jurisdiction to restrain the acts of persons amenable to the court's jurisdiction calculated to violate the statutory scheme of distribution: *Carron Iron Company Proprietors v Maclaren* (1855) 5 HLC 415; *Re Oriental Inland Steam Company, Ex p Scinde Railway* (1874) 9 Ch App 557; *Re North Carolina Estate Co Ltd* (1889) 5 TLR 328; *Mitchell v Carter* [1997] 1 BCLC 673; and *Societe Nationale Industrielle Aerospatiale (SNIA) v Lee Kui Jak* [1987] AC 871 considered.

The conduct of a creditor or member of a company in invoking the jurisdiction of a foreign court so as to obtain prior access to an insolvent estate might also be vexatious or oppressive, in which case an injunction might also (or alternatively) be justified on that ground: *Bloom v Harms Offshore AHT Taurus GmbH & Co KG* [2010] Ch 187 considered.

However such vexatious or oppressive conduct was not a necessary part of the test for the exercise of the court's discretion to grant an anti-suit injunction (see paras 15-16, 18-24 of judgment) in a case where foreign proceedings are calculated to give the litigant prior access to assets subject to the statutory trust.

Jurisdiction

Shell had submitted to the jurisdiction of the BVI courts for the purpose of being amenable to an anti-suit injunction by participating unconditionally in the injunction proceedings and also by proving for the debt alleged to arise under their redemption notice of 12 December 2008.

Application to foreign litigants

There is no principle that an anti-suit injunction will not be issued so as to prevent a foreign litigant from resorting to the courts of his own country or some foreign court. The true principle is that the English and BVI courts will not as a matter of discretion grant injunctions affecting matters outside their territorial jurisdiction if they are likely to be disregarded or would be "*brutum fulmen*": *Carron Iron* considered; *In re Vocalion (Foreign) Ltd* [1932] 2 Ch 196 not applied.

Discretion

There was no place for deference to the Dutch court. The question did not turn on the relevant convenience or appropriateness of litigation in the courts of the Netherlands and the BVI: both courts could adjudicate on the substantive dispute but the BVI was the only forum in which priorities could be determined. The Dutch courts had no regard to foreign insolvencies so far as they conflict with Dutch domestic law or limit the recovery of local creditors. Furthermore, given that the relevant accounts were in Dublin, the jurisdiction of the Dutch court was exorbitant. This was a case where the judicial or legislative policies of the BVI (and England, for that matter) were so at variance with those of the Dutch court that comity was overridden by the need to protect British national interests or prevent what it regards as a violation of the principles of customary international law.

COMMENT

The Privy Council distinguished the rationale for an anti-suit injunction in the context of insolvency proceedings from the logic of vexation and oppression which justify such injunctions in other contexts. The concept of vexation or oppression as a ground for intervention is directed to the protection of a litigant who is being vexed or oppressed by his opponent. Where a company is being wound up in the jurisdiction of its incorporation, other interests are engaged. The court acts not in the interest of any particular creditor or member, but in that of the general body of creditors and members.

Moreover, as the Privy Council recently observed in *Singularis Holdings Ltd v PricewaterhouseCoopers* [2014] UKPC 36, paras 17-23 there is a broader public interest in the ability of a court exercising insolvency jurisdiction in the place of the company's incorporation to conduct an orderly winding up of its affairs on a world-wide basis, notwithstanding the territorial limits of its jurisdiction. In protecting its insolvency jurisdiction, the court is not "standing on its dignity". Rather, it intervenes because the proper distribution of the company's assets depends upon its ability to get in those assets so that comparable claims to them may be dealt with fairly in accordance with a common set of rules applying equally to all of them.

It is also notable that the Privy Council confirmed that formal submission of a proof of debt to the insolvency administration will generally be adequate to support a conclusion that the court supervising the administration thereafter has jurisdiction to make orders in matters connected with the administration against the creditor who has proved. The decision of Lord Collins to this effect in *Rubin v Eurofinance SA* [2013] 1 AC 236 has been criticised, notably by Professor Briggs who described that decision as "astonishing" because no proof had been admitted and no dividend had been paid. The Privy Council concluded that Lord Collins was correct. A submission may consist in any procedural step consistent only with the acceptance of the rules under which the court operates. It does not matter whether or not the proof is subsequently admitted or a dividend paid. A submission of a proof for claim A does not in itself preclude the creditor from taking proceedings outside the liquidation on claim B. But the creditor may not take any step outside the liquidation which will bring direct access to the insolvent's assets in priority to other creditors. This is because, by proving for claim A, he has submitted to a statutory scheme for the distribution of those assets *pari passu* in satisfaction of his claim and those of other claimants. ■

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Regulation Update

A round-up of regulatory changes by **Norton Rose Fulbright**

ESMA REVIEWS CCP COLLEGES UNDER EMIR	On 8 January 2015, the European Securities and Markets Authority (ESMA) published a report which presented the findings of its first peer review pursuant to Art 21(6)(a) of EMIR. Article 21(6)(a) of EMIR provides that ESMA shall at least annually conduct a peer review analysis of the supervisory activities of all member state national competent authorities (MS NCAs) in relation to the authorisation and the supervision of central counterparties (CCPs). The report provides an overview of ESMA's contribution to the work of CCP colleges and presents an assessment of the degree of convergence reached by MS NCAs in the authorisation of CCPs, as well as identifying best practices developed by some MS NCAs in this context.
EBA UPDATES LIST OF CET 1 CAPITAL INSTRUMENTS	On 23 December 2014, the European Banking Authority (EBA) published an updated list of capital instruments that MS NCAs have classified as common equity tier 1 (CET1) capital under Art 26(3) of the Capital Requirements Regulation (CRR).
EBA GUIDELINES ON MATERIALITY, PROPRIETARY AND CONFIDENTIALITY AND ON DISCLOSURE FREQUENCY UNDER CRR	On 23 December 2014, the EBA published three sets of final guidelines related to the information that institutions in the EU banking sector should disclose under Pillar 3. The guidelines, condensed into a single document, cover how institutions should apply the concepts of materiality, proprietary nature and confidentiality in relation to disclosure requirements, as well as how they should assess the frequency of disclosures. The EBA expects all MS NCAs and financial institutions to whom the guidelines are addressed to comply with the guidelines. MS NCAs to whom the guidelines apply should incorporate them into their supervisory practices as appropriate, including where the guidelines are directed primarily at institutions.
FINAL DRAFT RTS ON RISK CONCENTRATION AND INTRA-GROUP TRANSACTIONS UNDER FICOD	On 23 December 2014, the Joint Committee of the European Supervisory Authorities (the Joint Committee) published final draft regulatory technical standards (RTS) on risk concentration and intra-group transactions under Art 21a(1a) of the Financial Conglomerates Directive.
DISCUSSION PAPER ON THE USE OF CREDIT RATINGS BY FINANCIAL INTERMEDIARIES	On 23 December 2014, the Joint Committee published a discussion paper on the use of credit ratings by financial intermediaries. The aim of the discussion paper is to: • establish a preliminary overview of MS NCAs' supervisory activities and experiences concerning contractual reliance on ratings; and • allow supervised entities to provide feedback to the Joint Committee on their degree of contractual reliance on credit ratings and on their recourse to alternative means of creditworthiness assessments. The deadline for responses to the discussion paper is 27 February 2014.
BCBS CONSULTS ON CAPITAL FLOORS	On 22 December 2014, the Basel Committee on Banking Supervision (BCBS) published a consultation paper on capital floors and the design of a framework based on standardised approaches. The proposed framework will replace the current transitional floor, which is based on the Basel I standard, with a revised capital floor framework based on the Basel II/III standardised approaches, which allows for a more coherent and integrated capital framework. The deadline for responses to the consultation paper is 27 March 2015.

EBA FINAL GUIDELINES ON COMMON SUPERVISORY PROCEDURES AND METHODOLOGIES	On 19 December 2014, the EBA published its final guidelines for common procedures and methodologies for the supervisory review and evaluation process (SREP) under Art 107(3) of the Capital Requirements Directive IV (CRD IV). The guidelines introduce methodologies for the assessment of risks to both capital and liquidity, and for the assessment of capital and liquidity adequacy. The guidelines will apply from 1 January 2016, at which point a number of earlier Committee of European Banking Supervisors/EBA guidelines on the SREP and wider Pillar 2 related topics will be repealed.
EBA OPINION AND REPORT ON SECURITISATION RETENTION, DUE DILIGENCE AND DISCLOSURE REQUIREMENTS	On 22 December 2014, the EBA published a report and an opinion on securitisation retention, due diligence and disclosure requirements under the CRR. The opinion contains advice from the EBA in the form of: • nine recommendations on the overall appropriateness of requirements related to exposures to transferred credit risk as specified in Arts 405 to 409 of the CRR; and • one recommendation on the convergence of the retention rules regulatory frameworks.
EBA FINAL DRAFT RTS AND ITS ON SUPERVISORY COLLEGES	On 19 December 2014, the EBA published final draft RTS and implementing technical standards (ITS) on the functioning of colleges of supervisors in accordance with Arts 51 and 116 of the CRD IV. The draft RTS specify the general conditions for the establishment and functioning of colleges of supervisors. The draft ITS establish procedures to structure and facilitate the interaction and co-operation between a consolidating supervisor and relevant MS NCA.
EBA FINAL DRAFT RTS ON COUNTERCYCLICAL BUFFER DISCLOSURE	On 23 December 2014, the EBA published its final draft RTS on disclosure of information related to the countercyclical capital buffer. The draft RTS specify what information institutions must disclose in relation to their requirements for a countercyclical capital buffer. The draft RTS provide two tabular disclosure templates that harmonise the information available to the general public on the institution specific countercyclical capital buffer and the geographical location of the exposures determining that buffer. The first disclosure using the specifications set out in the draft RTS must take place at the earlier of the following two dates: six months following the date of its publication in the Official Journal of the EU or 1 January 2016.
ESMA PUBLISHES LATEST PAPERS ON MIFID II AND MIFIR	On 19 December 2014, ESMA published a final report containing its technical advice to the European Commission (the Commission) on the possible content of the delegated acts under MiFID II and MiFIR. It also published a consultation paper seeking stakeholders' views on certain RTS and ITS. The delegated acts should be adopted by the Commission so that they enter into application by 30 months following the entry into force of MiFID II and MiFIR, taking into account the right of the European Parliament and the Council of the EU to object to a delegated act within 3 months (which can be extended by a further three months). The deadline for comments on the consultation paper is 2 March 2015. In addition, an open hearing was held in Paris on 19 February 2015. ESMA will use the input received from the consultation to finalise the draft RTS which will be sent for endorsement to the Commission by mid-2015, the ITS by January 2016. MiFID II/MiFIR and its implementing measures will be applicable from 3 January 2017.
ESMA CONSULTS ON IMPLEMENTING MEASURES FOR NEW SETTLEMENT REGIME UNDER CSDR	On 18 December 2014, ESMA published three consultation papers concerning implementing measures for the new settlement regime set out under the Regulation on improving securities settlement and regulating central securities depositories. The deadline for comments to the consultation papers was 19 February 2015.
EBA PUBLISHES FINAL DRAFT TECHNICAL STANDARDS ON JOINT DECISIONS FOR APPROVAL OF INTERNAL MODELS	On 18 December 2014, the EBA published final draft ITS which specify the joint decision process to be followed by MS NCAs when deciding on whether to grant permissions to institutions to use the internal-ratings based approach for credit risk, the internal model method for counterparty risk, the advanced measurement approach for operational risk and the internal models for market risk. The ITS also detail the joint decision process for the approval of material model extensions or changes.

Regulation Update

LETTER FROM THE COMMISSION – ANNEX WITH AMENDED DRAFT RTS ON CLEARING OBLIGATION FOR IRS	On 1 October 2014, ESMA sent the Commission draft RTS on the clearing obligation for interest rate swaps (IRS) pursuant to Art 5 of EMIR. The draft RTS lay down the classes of IRS that will be subject to mandatory clearing as well as the different dates from which the clearing obligation will take effect for the four different categories identified, for which different phase-in periods are laid down. The draft RTS also set out the minimum remaining maturities determining which contracts concluded or novated before the clearing obligation takes effect will have to be cleared when the clearing obligation takes effect. On 19 December 2014, ESMA published a letter it had received from the Commission, in which the Commission stated that it intended to endorse, with amendments, the draft RTS submitted. In the letter the Commission covered certain important issues that the draft RTS raised. These issues were set out under the following headings: - postponing the start date of the frontloading requirement; - clarifying the calculation of the threshold for investment funds; and - excluding from the scope of the clearing obligation non-EU intragroup transactions.
EBA CONSULTS ON AMENDING ITS ON LCR AND LR REPORTING	On 16 December 2014, the EBA issued two consultations on the draft ITS amending the Commission's Implementing Regulation on supervisory reporting with regard to the liquidity coverage ratio (LCR) and the leverage ratio (LR). The draft amendments follow the Commission's delegated acts specifying the LCR and the LR respectively. The consultation on the amendments to LCR reporting closed on 10 February 2015 and the consultation on the amendments to LR reporting closed on 27 January 2015.
EBA PUBLISHES CRITERIA TO ASSESS OTHER SYSTEMICALLY IMPORTANT INSTITUTIONS	On 16 December 2014, the EBA published its final guidelines setting out the criteria that MS NCAs will use to identify institutions that are systemically important either at the EU or member state level (O-SIIs).The final guidelines have been developed in accordance with Art 131(3) of the CRD IV. In line with the provisions of the CRD IV, MS NCAs can require O-SIIs to hold an additional capital buffer of up to 2% of CET1.
COMMISSION IMPLEMENTING DECISION ON THIRD COUNTRY EQUIVALENCE FOR THE PURPOSES OF TREATMENT OF EXPOSURES UNDER CRR	On 17 December 2014, there was published in the Official Journal of the EU the Commission Implementing Decision on the equivalence of the supervisory and regulatory requirements of certain third countries and territories for the purposes of the treatment of exposures according to the CRR. The Implementing Decision, which covered jurisdictions such as Brazil, Canada, China, Singapore, South Africa and the United States, entered into force on 1 January 2015.
EBA FINAL TECHNICAL ADVICE ON CRITERIA AND FACTORS FOR INTERVENTION ON STRUCTURED DEPOSITS UNDER MIFIR	On 11 December 2014, the EBA published its final technical advice to the Commission laying out criteria and factors for exercising intervention powers on structured deposits. The technical advice, which was developed in accordance with MiFIR requiring the EBA to monitor the market for structured deposits, takes into consideration, where appropriate, comments received during an earlier public consultation.
COMMISSION ADOPTS IMPLEMENTING REGULATION TO EXTEND TRANSITIONAL PERIOD FOR CAPITAL REQUIREMENTS FOR EXPOSURES TO CCPS	On 11 December 2014, the Commission adopted an Implementing Regulation which extended the transitional period relating to own funds requirements for exposures to CCPs under the CRR and EMIR. The Implementing Regulation extended the transitional periods to 15 June 2015.
BCBS CONSULTS ON NSFR DISCLOSURE STANDARDS	On 9 December 2014, the BCBS published a consultative document on disclosure standards for the Net Stable Funding Ratio (NSFR). Like the disclosure standards for the LCR, these new standards are intended to improve transparency of regulatory funding requirements, reinforce the BCBS' *Principles for Sound Liquidity Risk Management and Supervision*, enhance market discipline and reduce uncertainty in the markets as the NSFR is implemented. The deadline for comments on the consultative document is 6 March 2015. The NSFR will become a minimum standard by 1 January 2018.

BCBS AND IOSCO CONSULT ON CRITERIA FOR IDENTIFYING SIMPLE, TRANSPARENT AND COMPARABLE SECURITISATIONS	On 11 December 2014, the BCBS and International Organization of Securities Commission issued a joint consultative document which identifies 14 criteria for simple, transparent and comparable securitisations. The purpose of the criteria is to provide a basis for the industry and the regulatory community to identify certain features of securitisations which may indicate those securitisations that lend themselves to less complex analysis and therefore could contribute to building sustainable securitisation markets. The criteria is not intended to serve as a substitute for investor due diligence but rather to identify and assist the financial industry's development of simple and transparent securitisations. The criteria are non-exhaustive and non-binding. The deadline for comments on the proposed criteria was 13 February 2015.
BCBS ISSUES REVISION TO BASEL SECURITISATION FRAMEWORK	On 11 December 2014, the BCBS published a revised securitisation framework which aims to address a number of shortcomings in the Basel II securitisation framework and strengthen the capital standards for securitisation exposures held in the banking book. The framework comes into effect in January 2018 and forms part of the BCBS' broader agenda to reform regulatory standards for banks.
BCBS ASSESSMENTS OF BASEL III IMPLEMENTATION IN THE EU AND US	On 5 December 2014, the BCBS published a report assessing the implementation of the Basel III capital framework in the United States and the nine EU member states which are members of the BCBS.

Butterworths Insolvency Law Handbook, 15th Edition

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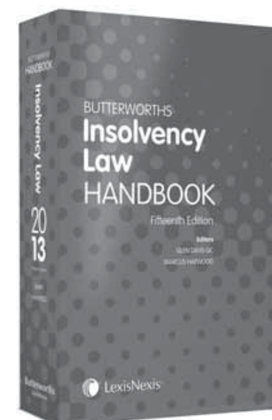

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Market Movements

DLA Piper UK LLP reviews key market developments in the banking sector

Domestic banking

New proposals from the **Bank of England** could leave those banks not meeting regulatory risk management standards facing the prospect of having to raise more capital than their "better-run" brethren. The Prudential Regulation Authority (PRA) is considering making banks which are deemed "weak" when it comes to governance and risk hold more of a buffer against future losses, possibly between 10 and 40% more – *Times.co.uk, 20 January 2015*

The PRA is expected to publish a paper before the end of March setting out how it will work with auditors to keep an eye on the secret internal models used by banks to establish how much capital they must keep in reserve against potential losses – *Times, 6 January 2015*

Barclays is offering an all-time low rate of 2.99% on its ten-year fixed rate home loans, a drop of 0.46%, signalling the start of increased competition between banks offering long-term mortgages – *FT.com, 9 January 2015*

HSBC has sent out offers of compensation payments to thousands of its customers totalling £350m following an internal check on loans taken out between October 2010 and July 2014. The bank said that it had failed to tell its loan customers that they could repay part of the debt early and has decided to rectify the error even though it does not believe any of its customers lost money as a consequence – *Independent, 12 January 2015*

HSBC is stepping up its efforts to widen its business operations in Greater China. Helen Wong, chief executive of **HSBC**'s Chinese operation, will take over the running of **HSBC** Hong Kong for three months after the current head, Anita Fung, stepped down, and will then become the head of **HSBC** in Greater China in March once a successor for **HSBC** Hong Kong has been appointed – *Financial Times, 9 January 2015*

Small British businesses will be given better access to finance by **The Royal Bank of Scotland (RBS)** after it struck a deal with Assetz Capital and Funding Circle. The alliance will see the lender direct certain smaller businesses which it is unable to finance to the peer-to-peer lending platforms – *FT.com, 22 January 2015*

RBS has conducted an internal investigation into a government scheme to encourage lending to small businesses, the Enterprise Finance Guarantee scheme, which has uncovered concerns that some loans may have been mis-sold. The bank has promised to carry out a comprehensive review of loans granted and to compensate any customers who are found to have been mis-sold loans – *Times, 15 January 2015*

The US Federal Reserve has granted **RBS** a waiver which means it will not have to comply with new rules imposed on foreign banks with over $50bn of assets in the US – *Financial Times, 14 January 2015*

RBS is looking to sell the majority of its corporate banking business in Asia – *Telegraph, 12 January 2015*

Investec has entered the race to buy **Coutts**' international division which is being sold by **RBS** – *Telegraph, 5 January 2015*

Domestic general

A study by the Financial Conduct Authority (FCA) into the cash savings market, has found that a lack of proper understanding of the products available and concern that switching accounts will go wrong, means that over a fifth of savers have accounts that are earning interest at, or below, the current **Bank of England** base rate – *Times, 21 January 2015*

The Financial Reporting Council, which looks after the City's stewardship code, has expressed its intention to examine which signatories to the code are actually taking steps to follow its guidance on being an involved investor and which are only paying it lip service. Those who fall into the latter category could find themselves banned from identifying as signatories – *Financial Times, 15 January 2015*

Hampden & Co is planning to start accepting new clients before the end of March. **Hampden** is the first private bank to come through the new, quicker, route to a banking licence put in place by the FCA and the PRA. It obtained its licence in March 2014 – *Telegraph, 15 January 2015*

Tens of millions of customers might have to change their bank sort codes as a result of incoming new rules which are designed to "ring-fence" the retail operations of banks. If banks are not given enough time to sort the situation out then payment systems could be disrupted.

The British Bankers Association has called on the **Bank of England** to finalise the new rules ahead of the expected early 2016 deadline – *Telegraph, 8 January 2015*

Barclays, **HSBC**, **Lloyds**, **RBS**, **Santander**, **TSB** and **Virgin Money** will submit formal ring-fencing plans to the **Bank of England** in early January, setting out their responses to new rules aimed at protecting consumers from banks' riskier investment banking arms – *Sunday Telegraph, 4 January 2015*

European banking

An interim ruling by the European Court of Justice on the legality of the 2012 **European Central Bank (ECB)** bond-buying plan, could lead to the dismantling of the "troika" which has supervised a number of Eurozone bailouts. Whilst the ruling gave the go-ahead for full-blown government bond purchases, the advocate-general also said that the **ECB** "must refrain from any direct involvement in the financial assistance program that applies to the state concerned" if it ever initiates Outright Monetary Transactions – a bond-buying scheme created to assist Eurozone bailout countries – *Financial Times, 15 January 2015*

The **ECB** has set new additional capital targets for the largest banks in the Eurozone. Banks have until mid-January to appeal against the figures they have been given – *Financial Times, 12 January 2015*

European general

Following the decision by the Swiss government to abandon its currency floor between the Swiss franc and the euro, which caused the Swiss franc to appreciate by 15%, the Swiss central bank faces a state rescue after its current provisions were lost. The head of foreign exchange currency at ING, Chris Turner, predicted that "recapitalisation from the government now looks likely" – *Times, 16 January 2015*

International banking

Citigroup has reported a fall in profits in its fourth quarter after $3.5bn restructuring and legal charges. The bank reported a profit of $350m, down from $2.46bn for the same period in 2013. The bank has also reduced its bonus pool, indicating that traders could expect bonuses to be 5-10% lower than last year – Times, *16 January 2015*

In the recent Dealogic league table for 2014, **JP Morgan** came out as the top investment bank for investment fees, beating rival investment banks **Goldman Sachs** and **Bank of America**, which came second and third respectively – *Telegraph, 5 January 2015*

Acenden, Lehman Brothers' UK mortgage business, has been sold by the bank's administrators to private equity firms Blackstone and TPG – *Telegraph, 8 January 2015*

International general

The International Monetary Fund (IMF) has warned that the largest potential threat to the US financial system is from the country's shadow banking sector. Whilst much of the global banking system has been cleaned up by regulators since 2008, the excesses have moved off books and are again at significant levels, according to the IMF deputy chief Zhu Min – *Telegraph, 22 January 2015*

US and UK market watchdogs predict that more charges will be brought against people for financial crimes as a result of international co-operation, as bribery and other financial crimes are made a priority. Stephanie Avakian, the deputy director of enforcement at the US Securities and Exchange Commission, said there will be a renewed focus on accounting fraud and bribery violations. Jamie Symington, the FCA's head of investigations, said financial crimes such as bribery and sanctions will be targeted by the FCA, with potential criminal matters referred on to the Serious Fraud Office – *Financial Times, 21 January 2015*

Unpicking the Dodd-Frank financial reform act is a high priority for the US House of Representatives' new Republican leadership. In the second week of its new term, the House has voted to delay part of the Volcker rule from 2017 to 2019. The delay concerns a ban on banks holding securitised debt which has been packaged up into collateralised loan obligations – *Financial Times, 15 January 2015*

China Construction Bank has become the second Chinese bank in less than six months to be awarded a branch licence by regulators in Britain. The licence will give the bank more opportunity to offer wholesale banking services in the UK – *Financial Times, 9 January 2015*

China has launched its first online-only bank, **WeBank**. The government hopes that a new crop of privately owned lenders will expand access to finance for small-scale borrowers – *Financial Times, 6 January 2015*

Russia's third-largest bank, **Gazprombank**, has received an almost 40bn rouble (£430m) bailout from the ministry of finance, as international trade sanctions, the oil price crash and the collapse of the rouble, continue to impact the country's banking sector and wider economy – *Times, 1 January 2015* ■

This publication is a general overview and discussion of the subjects dealt with. It should not be used as a substitute for taking legal advice in any specific situation. DLA Piper UK LLP accepts no responsibility for any actions taken or not taken in reliance on it. Where references are made to external publications, the views expressed are those of the authors of those publications or websites which are not necessarily those of DLA Piper UK LLP, and DLA Piper UK LLP accepts no responsibility for the contents or accuracy of those publications.

QUOTE OF THE MONTH:

"The era of credit ratings being used in bank regulation could be slowly coming to an end globally."

Gerald Podobnik, head of capital solutions at Deutsche Bank; FT 23/12/14

Deals

Our monthly round up of industry news, major transactions, their significance and the players involved

Ashurst advised HSBC, Lloyds, Société Générale and Unicredit on the financing of the acquisition of the German web hosting supplier Intergenia by the British Host Europe Group, a portfolio company of private equity investor Cinven. The vendor of Intergenia is Oakley Capital. The Ashurst team advised out of Frankfurt and London and was led by Frankfurt banking partner Anne Grewlich.

Global law firm **White & Case LLP** has advised the lenders, including international financial institutions International Finance Corporation, European Bank for Reconstruction and Development, DEG, Proparco and Korea Development Bank, and a syndicate of commercial banks including BBVA, SMBC, HSBC, Siemens Bank and Deutsche Bank, on the €550m financing of an integrated healthcare campus public-private partnership (PPP) in Adana, Turkey. The White & Case team which advised on the transaction included partners Jacques Bouillon, Victoria Westcott (both Paris) and Çağdaş Evrim Ergün (Ankara) with support from associates in Paris and Ankara.

Global legal practice **Norton Rose Fulbright** has advised Crédit Agricole Corporate and Investment Bank (CA-CIB) on the establishment of Sea Bridge Finance, a joint venture with Sumitomo Mitsui Trust Bank (SMTB). Sea Bridge Finance is a 50-50 joint venture between CA-CIB and SMTB and has been formed to invest up to US$1bn in senior secured ship mortgage loans over the next three years. Corporate partner Jill Gauntlett, ship finance partner Simon Hartley and tax partner Matthew Hodkin led the team advising CA-CIB, supported by associates Charles Bremner and Juliet Huang.

Herbert Smith Freehills has advised China Merchants Bank Co Ltd. Hong Kong Branch on the second drawdown of its US$5bn Medium Term Note (MTN) Program established in 2014. The second drawdown consisted of RMB1bn Formosa bonds, issued and listed in Taiwan, and another RMB1bn worth of Lion City bonds, issued and listed in Singapore. The net proceeds of the drawdown notes will be used for working capital and general corporate purposes. The Herbert Smith Freehills team on the deal was led by Hong Kong partner Kevin Roy, who was assisted by consultant Cindy Kao in Hong Kong, and senior associate Gareth Deiner and associate Nupur Kant in Singapore.

International law firm **Clifford Chance** has advised the leading Dutch energy-from-waste and water treatment facility operator AVR-Afvalverwerking BV on the establishment of a structured secured debt issuance platform pursuant to which AVR has raised €130m of senior term and revolving credit facilities from its relationship lenders, US$75m, £16m and €197m of US private placement notes and €23m of institutional term debt by way of a European private placement. The senior debt has been rated BBB+ by Fitch and is supported by a five-year dedicated liquidity facility. The London team was led by structured debt partner Steve Curtis and senior associate Amer Siddiqui.

Allen & Overy LLP has advised Sartorius AG, a leading laboratory and biopharmaceutical equipment provider based in Göttingen, on a €400m long-term syndicated loan with a term of five years. The loan agreement with an international syndicate of banks led by BNP Paribas, Commerzbank AG and LBBW was signed on 17 December 2014. The Allen & Overy team comprised partner Thomas Neubaum, counsel Bianca Engelmann and associate Dr Alexander Schilling (all banking and finance, Frankfurt).

Shearman & Sterling advised Ares Management Ltd as arranger, and funds managed by Ares Management Ltd as subscribers, on a €40m unitranche bond financing provided for refinancing the indebtedness of the Frial Group, a European leader in premium frozen meals. The Frial Group was acquired in 2008 by Alpha Investment Funds to develop the company internationally. The Shearman & Sterling team was led by partner Arnaud Fromion (Paris-Finance) and included associates Adrien Paturaud and Laurent Bonnet (both Paris-Finance).

International law firm **Freshfields Bruckhaus Deringer** has advised the joint lead managers in relation to the US$750m tap issue by the Republic of Kenya of its debut issue of US$500m 5.875% Notes due 2019 and US$1.5bn 6.875% Notes due 2024. The Freshfields team advising on the deal was led by capital markets partner Duncan Kellaway, US securities partners Stuart Grider and Ashar Qureshi and senior associate Nick Hayday.

King & Wood Mallesons has advised National Australia Bank Ltd on its first ever "green" bond issuance. This market-leading move represents the first issue by an Australian company of a "green" bond certified in accordance with the Climate Bond Standard. The bond will raise A$300m on a senior unsecured basis, with proceeds ear-marked for financing a portfolio of renewable energy assets, including wind farms and solar energy facilities across Australia. The KWM team was led by partner Anne-Marie Neagle, assisted by solicitor Kathryn Tomasic. ■

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NOTICE REQUIREMENTS UNDER THE ISDA MASTER AGREEMENT

When negotiating an International Swaps and Derivatives Association, Inc (ISDA) Master Agreement, the tendency is often to focus on the important key provisions towards the front of the Schedule, but the recent case of *Greenclose Ltd v National Westminster Bank* [2014] EWHC 1156 (Ch) has emphasised the importance of ensuring that even what might seem to be a relatively innocuous boilerplate provision (such as the notices provision) is carefully considered and reviewed periodically.

What are the notice requirements under the ISDA Master Agreement?

The notice requirements are set out in s 12 of both the 1992 ISDA Master Agreement ("1992 ISDA") and 2002 ISDA Master Agreement ("2002 ISDA"). The 1992 ISDA sets out five acceptable methods of delivering notice:

- in writing;
- by telex;
- by fax;
- by certified or registered mail; or
- by electronic messaging system.

The 2002 ISDA sets out the same five methods but also includes e-mail for certain purposes. It is then for the parties to amend these methods in the Schedule to the applicable master agreement (to the extent they wish to do so) and include the relevant details for each method.

The interpretation of s 12 in *Greenclose*

How can notice be given?

Notice must be given in strict accordance with the requirements set out in s 12 of the relevant ISDA Master Agreement, subject to any amendments made to that section in the Schedule to the ISDA Master Agreement.

Electronic transmission

In *Greenclose*, the High Court judge, Mrs Justice Andrew DBE carefully considered what methods of notification "electronic transmission" (as set out in s 12 of the 1992 ISDA) was designed to cover. In doing so, the judge referred to the User's Guide for the 2002 ISDA Master Agreement (published by ISDA) ("User's Guide") in which ISDA stated that the 2002 ISDA had been modified "to permit e-mail delivery". This indicated that e-mail delivery was not previously permitted in the 1992 ISDA. Further, she discussed the fact that in 1992 e-mail was not commonly used and so when ISDA referenced "electronic transmission" they would have been referring to SWIFT rather than to e-mail.

Even if a 1992 ISDA was entered into by parties more recently (in Greenclose's case, the ISDA was entered into in January 2007), the expression "electronic transmission" should be construed as at the time that the 1992 ISDA was drafted when e-mail was not prevalently used. In any event, in *Greenclose*, not only was s 12 not amended to include e-mail as a method of notification, no e-mail address was provided in the Schedule.

Market evidence

The judge noted that she did not have the benefit of a submission from ISDA on how they would interpret the relevant provision or any expert evidence on how this worked in practice. This would have been helpful but the judge did refer to ISDA publications when making her conclusions and so her interpretation was largely based on what ISDA had indicated in their published guidance notes, even though they did not comment directly on this particular case. She referred to:

- a document published by ISDA in 2001 entitled "the Amendments to the ISDA Master";
- the User's Guide; and
- an article published in this Journal in 2005, written by Richard Tredgett and John Berry of Allen & Overy.[1]

> "... it was clear that e-mail was a new addition to the 2002 ISDA and was not contemplated in the 1992 ISDA."

In all of these documents, it was clear that e-mail was a new addition to the 2002 ISDA and was not contemplated in the 1992 ISDA. She also considered, but did not agree with the textbook Firth on Derivatives, in which Simon Firth suggests a more permissive approach should be taken when sending notices.

What should practitioners advise amending in a 1992 ISDA Master Agreement as a result of *Greenclose*?

Parties should consider whether they want e-mail to be considered a valid method of providing notice under the 1992 ISDA, and if so:

- Check if s 12 of the ISDA Master Agreement has been amended to include e-mail as an additional method of notification. If s 12 has not been amended and still only refers to "electronic transmission" then an e-mail notification will not be deemed as giving sufficient notice, as the judge in *Greenclose* specifically concluded that this did not include e-mails.
- Including e-mail addresses and telephone numbers etc in Part 4 of the Schedule may not be sufficient to imply that such details can be used to give notices: s 12 needs to be explicitly

amended to allow such methods to be used.

- Check trade confirmations: these may include additional methods of notification that are used by parties to the 1992 ISDA which you may want to include in the Schedule.
- Check Part 4 of the Schedule in case any contact details need to be updated (eg if key contacts have left the relevant organisation and new key contacts have joined, or phone numbers and addresses changed).
- Where e-mail is a permitted method of notice under an ISDA master agreement, parties should tick the box requiring a "read receipt" to check that the recipient has opened the relevant e-mail.

Will the decision in *Greenclose* affect any other of my master agreements?

The Global Master Repurchase Agreement (GMRA) 2000 and 2011 have very similar notice provisions to those found in the 1992 ISDA and 2002 ISDA respectively. Both of the GMRA 2000 and 2011 refer to "an electronic messaging system" but it is only in the GMRA 2011 that it is specifically defined to refer to e-mail. A similar approach as that suggested above should therefore be taken when reviewing a GMRA 2000 if parties want to be able to send notices by e-mail. If it went to court, it might be that a less cautious approach would be taken if e-mail was not specifically added to a GMRA 2000 since by 2000 e-mail was used much more widely so might be construed as being included in an "electronic messaging system". However, until and unless this is raised, a cautious approach should be taken.

The Global Master Securities Lending Agreement (GMSLA) 2000 and 2010 each have similar notice provisions to those found in the 1992 ISDA. The notice provisions are the same for both 2000 and 2010 agreements except that references to "telex" have been deleted from the 2010 version. They each however refer to an electronic messaging system which is not specifically defined. Paragraph 4 of the Schedule to each version of the GMSLA requests electronic messaging system details which indicates a system such as SWIFT rather than an e-mail which would require an address. Again, a cautious approach should be taken when considering the notice provisions of a GMSLA.

Next steps

The decision in *Greenclose* may be appealed or a similar question on notices may be subject to a different interpretation in another case. It is questionable whether an agreement signed in 2007 should be subject to the meaning of a term 15 years previously. However, in the meantime, practitioners should carefully review existing and new notice provisions in any agreement they negotiate to ensure there is no ambiguity as to how to give valid and effective notices. ■

1 [2005] 5 JIBFL 197.

Further reading links in Lexis®PSL

- Practice Note: Scope of the ISDA Master Agreement part 6 – Sections 7 to 14 (the "back-end")
- News analysis: Talking Point: a look to the future (29 May 2014)
- *Greenclose Ltd v National Westminster Bank* [2014] EWHC 1156 (Ch)

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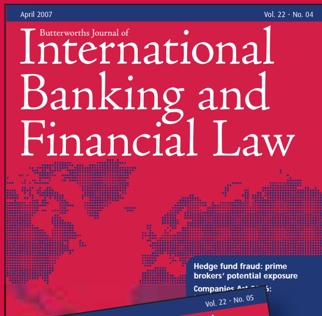

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