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BY EMAIL ONLY

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Dear Sirs

EU Framework for Cross-Border Crisis Management in the Banking Sector

The City of London Law Society ("**CLLS**") represents approximately 13,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response has been prepared by the CLLS Regulatory Law Committee (the "**Committee**"). Members of the Committee advise a wide range of firms in the financial markets including banks, brokers, investment advisers, investment managers, custodians, private equity and other specialist fund managers as well as market infrastructure providers such as the operators of trading, clearing and settlement systems.

Introduction

We set out below our comments on the Commission paper, "An EU Framework for Cross-Border Crisis Management in the Banking Sector" issued on 20 October 2009 (the "**Paper**"). The Paper makes certain proposals in relation to the crisis management, resolution and winding up of failing cross-border banks. Among other things, the Paper proposes establishing early intervention steps to reduce the risk of bank failure, and changing existing insolvency frameworks to make them more relevant to banks.

The Committee agrees with the central tenet of the Paper, namely that there is need for greater harmonisation of supervisory powers and practices across European Member States insofar as they relate to the crisis management of systemic financial institutions, and commends the Commission for opening the debate with an early stage consultation rather than rushing to legislate in this complex area. Notwithstanding this, we are concerned that a number of the proposals in the Paper, if enacted as contemplated, could pose significant risks to legal certainty in the United Kingdom. The overriding of private law rights under intra-group transfer and/or resolution regimes, in particular, are potentially very dangerous developments which merit deeper and careful analysis.

Our comments in this note are ordered such that they follow the format of the Paper.

Early intervention by supervisors

Living wills

While the Committee agrees that there is merit in requiring banks to create information packs to assist the authorities and/or insolvency practitioners in managing their failure, we are of the view that there are a number of significant issues raised by the proposals in the Paper that still need to be addressed.

In particular, the Committee believes that the living will proposals, as set out in the Paper, raise important corporate governance issues and could undermine legal certainty. Domestic corporate and insolvency law in most Member States typically provide that the management of a company must act in the best interests of that company while it is solvent, but in the interests of their creditors on, and following, insolvency. A requirement for the management of a financial institution to commence limiting risk and/or prepare for failure in the interest of the wider financial system pursuant to its living will, could place them in a conflict between their duties to the institution or creditors on the one hand, and their duties to the wider financial system on the other. As such, it is possible to conceive of situations where it would not be certain from a legal standpoint to whom management of a financial institution owed their primary legal duties. That conflict could carry potential legal liability for the management of the institution if shareholders or creditors challenged the implementation of a wind-down plan.

We are of the view therefore that living will proposals must properly delineate the boundaries and scope of the responsibilities of senior management to various stakeholders at all stages of a bank failure.

Intra-group asset transfers

The Paper raises the possibility of permitting intra-group transfers of assets in financial institutions to assist groups in managing liquidity positions and, in some cases, to help stabilise entities in a developing crisis. The Paper suggests that this might be achieved by introducing a new concept of "group interest" for banking groups.

The Committee believe that there are a number of questions raised, but not answered, in the Paper. These include:

(a) who should have power to undertake the proposed transfers (firm; lead regulator; other regulator);

(b) in what circumstances such powers should arise – i.e. triggers to intra-group transfer;

(c) what process should be undertaken to effect such transfers;

(d) the objectives of the process;

(e) how the competing interests of stakeholders in each entity (eg shareholders, creditors, holders of security and collateral interests) are to be balanced; and

(f) what compensatory rights should arise in respect of the exercise of such powers.

The Committee is of the view that the proposals in the Paper on intra-group transfers are likely to raise a number of significant legal issues which need to be addressed. These include:

(a) corporate benefit (failure to act in the best interests of the shareholder are likely to give rise to questions as to whether such transfers are in the interests of shareholders) and/or capital maintenance requirements (which prohibit the return of capital);

(b) preferences and transactions at an undervalue (the principle that non-arm's length transactions may be unwound, or management be liable for them, if the parent subsequently goes into insolvency);

(c) personal liability for management (management are typically liable for breach of fiduciary duties to a corporate, for example, acting other than in the best interests of the company, or providing a preference);

(d) conflicts of law (to the extent transfer relates to non-Member State governed contracts);

(e) human rights (to the extent that the exercise of powers encroaches on private law rights, compensation may be expected);

(f) private law rights – impact of the transfer of assets on:

(i) the asset itself – eg contractual restrictions on assignment, termination rights

(ii) proprietary rights in the asset (security interests, other encumbrances)

(iii) other contractual commitments (eg negative pledges) of the transferor.

Legislation permitting intra-group transfers, as contemplated by the Paper, would clearly override established legal principles of limited liability. This could have significant impact on the ability of counterparties to assess creditworthiness, with corresponding negative impacts on the ability of affected institutions to raise capital and/or use subsidiaries to ringfence assets and/or provide credit enhancement. The difficulties associated with overriding limited liability should not be underestimated.

The Committee believes that it would be imperative for the Commission to draw a proportionate balance between the competing interests of private law rights and certainty, against the need for financial stability when legislating in this area. A number of safeguards would be likely to be necessary to protect the legitimate interests of stakeholders, including protections for netting and set-off, collateral, security interests, and capital markets transactions. Questions are also likely to arise as to the impact of a regime on the position of individual Member States where assets are transferred across borders. There is a clear interrelationship here with the question of burden sharing between Member States, on which the proposals may founder.

This is likely to be a highly complex area: the Committee questions whether, in light of the complexity of the area and the diverse nature of Member State corporate and insolvency laws, it is feasible to create an asset transfer regime. In any event further consultation with detailed proposals would be necessary to enable analysis of the possible impact and safeguards which would be needed.

Bank resolution

Devising a resolution framework

The Committee agrees with assertion that systemic financial institutions must be able to fail regardless of their size. However, whether a resolution regime has as its purpose the function of protecting depositors or preserving systemic stability, or both, needs to be clarified, as it is clear that the interests of depositors and stability do not necessarily coincide.

It is essential that a resolution regime strikes a number of balances. These include the balance between the importance of prevention of systemic failure (and if applicable depositor loss) on the one hand with the adverse consequences that taking powers to deal with those events could have (i) on private law rights and

(ii) as a result, on the wider markets and investor confidence. A regime which does not give clarity to stakeholders – particularly shareholders and creditors – would be likely to impair the ability of affected institutions to raise capital and funding. In order to protect the interests of such stakeholders, the Committee believe that the following additional principles must underlie a resolution framework, as well as its practical operation:

(a) A resolution regime should have predictable outcomes: a stakeholder in a bank (whether as shareholder, creditor, collateral holder, employee or pension trustee) should be able to assess the effect each resolution regime option will have on its stake.

(b) A resolution regime should not prejudice legal and regulatory certainty as to contractual and property rights. In particular it should not prejudice close-out netting or the existence or enforceability of property rights (including in collateral). Moratoria on the exercise of rights should be kept to a minimum.

(c) A resolution regime should not disturb the rights and *pari passu* treatment of creditors arising on an insolvency.

(d) A resolution regime should operate on the basis of procedural fairness, making the authorities accountable for their actions and giving adequate rights to stakeholders to be heard and obtain recourse through an appropriate forum.

All of these principles are, we believe, sufficiently fundamental to require enshrinement in law.

Powers and safeguards

The Paper contemplates powers in connection with bank resolution which far exceed those powers under the Banking Act 2009 in the United Kingdom (the "**Act**").

The Act restricts the making of partial property transfers under the Act in a variety of circumstances, including as they relate to:

(a) set-off and netting arrangements;

(b) title transfer financial collateral arrangements;

(c) security interests;

(d) capital market arrangements (securitisations, covered bonds etc); and

(e) market contracts and rules (including default rules) of recognised investment exchanges or clearing houses.

We believe that, at a minimum, safeguards for these types of claim must also be safeguarded under any regime introduced by the Commission.

The Committee is of the view that the principle set out in the Paper of "no creditor worse off" on transfer of bank assets following exercise of a resolution tool is correct, but the same approach, we believe, should apply to shareholders as well as creditors. Rights to compensation are critical to market confidence so it is essential that such rights are clearly stated, objective, transparent and established by an independent person. Moreover, authorities must also be accountable for their actions, and affected persons must be given rights to appeal the outcome of any compensation to the courts.

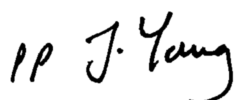
Insolvency

The Paper suggests two possible approaches: integrated (European) and national approaches to resolution. The paper acknowledges the difficulty of an integrated or consolidated approach to failure, but does not analyse the legal issues associated with such an approach. The Committee would welcome further analysis by the Commission on this point.

However, as a general point, if one accepts that a resolution regime along the lines of that described in the Paper is desirable, the provisions of domestic insolvency law will not be a viable option for managing bank failure. As such, resolution regimes must therefore be accompanied by amended insolvency regimes in domestic law to enable the resolution regime to operate as intended. The Committee notes that any change to Member States' insolvency regimes is likely to be highly controversial and complex, and also carries potential fiscal ramifications for Member States on the failure of a cross-border institution. In addition, any amendments are likely to need to be highly complex and to take account of the diversity of law and practice across Member States. We would question whether, in light of this, any such regime is workable.

We would be delighted to discuss the above observations and suggestions with you. You may contact me on +44 (0)20 7295 3233 or by e-mail at margaret.chamberlain@traverssmith.com.

Yours faithfully,



Margaret Chamberlain

Chair CLLS Regulatory Law Committee

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