The City of London Law Society

4 College Hill
London EC4R 2RB

Tel +44 (0)20 7329 2173
Fax +44 (0)20 7329 2190
DX 98936 - Cheapside 2

mail@citysolicitors.org.uk

www.citysolicitors.org.uk

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Cross Sectoral Prudential Policy
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS
[Submitted via email cp12_01@fsa.gov.uk]

Re: Large Exposures Regime – Groups of Connected Clients and Connected Counterparties – Response to Consultation Paper 12/1

The City of London Law Society ("CLLS") represents approximately 14,000 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.

This response to Consultation Paper 12/1 (CP12/1) published by the Financial Services Authority (FSA) in January 2012 and proposing certain changes to the large exposure rules which apply in the UK has been prepared by The City of London Law Society Regulatory Law Committee (the "Committee"). Members of the Committee advise a wide range of firms across Europe who operate in or use the services provided by the financial markets. European clients include 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.

Although we welcome those elements of the proposals which will conform the UK rules to those in the CRD and the CEBS guidelines, we wish to raise the following serious concerns:

(a) we have concerns with respect to those proposals which go beyond, or do not adequately reflect, CRD and the CEBS guidelines: the guidance proposed in chapters 2 and 3 of the consultation presents interpretative difficulties, is confusing and in places inconsistent with CRD and/or the CEBS guidelines. As the FSA is an active participant in the EBA, the correct way to deal with perceived deficiencies

would be through amendments to the CEBS guidelines rather than by creating additional and inconsistent requirements;

(b) the intended interaction of the proposals in CP12/1 (including the proposed guidance on structured finance vehicles) with the coming new CRD4 regime and the proposed move to a 'single rulebook' is also of concern. There seems to be little point in introducing new rules and guidance between now and finalisation of CRD4. We encourage the FSA to take proper account of the coming harmonised regime which is intended to apply under CRD4 and to avoid pushing ahead with (independent) rule changes now which may lead to confusion and/or the need for further conforming changes. To the extent that changes to the large exposures regime are considered necessary and appropriate, these should be made through harmonised action as part of the current and ongoing EU process.

Our response to certain questions raised in CP12/1 is set out below.

Chapter 2 – Connected Counterparties and groups of connected clients (Q1 to Q5)

In general, we support changes to the large exposure rules which are intended to remove provisions which operate in a manner which is super-equivalent to related CRD provisions.

Accordingly, we support a move to rules which more closely follow the CRD provisions by placing increased emphasis on the concepts of 'connected clients' and 'group of connected clients' (GCC), removing provisions which provide for an automatic connection (e.g. as a result of a participating interest) and clarifying the circumstances in which institutional waivers may be granted.

However, that the focus in the proposed changes on a GCC also including entities deemed to be 'connected' to the reporting firm, and on the determination of whether entities are economically interconnected with each other based on their (independent) interconnection with the firm, is not clearly supported by the CRD provisions and/or the CEBS guidelines on the implementation of the revised large exposures regime and we consider that it should not be presumed to achieve an appropriate outcome under the large exposures rules. On the basis that the concept of economic interconnection and, in turn, the large exposure rules, are intended to protect against idiosyncratic risks in bilateral relationships and to guard against undue concentration of risks in any one counterparty or group of counterparties, rather than focusing on counterparty risks arising as a result of links to the reporting firm itself, the key factor should be whether the requisite 'single risk' exists between the relevant entities/clients in question, consistent with the GCC definition in the CRD.

Further, the case for further guidance on the relationships which might be considered to constitute single risk for the purposes of the definition of GCC over and above the CEBS guidelines has not been made. The proposed guidelines in paragraph 2.2 of the consultation are unhelpful insofar as they diverge from the CEBS guidelines and give no clarity as to how

they should be assessed in practice. We would urge that they not be included in any amendments to the rulebook.

Chapter 3 – Treatment of structured finance vehicles (Q6 to Q10)

We note that CP12/1 indicates that the FSA perceives there to be a current "regulatory failure" related to the application of the current large exposures regime to sponsored structured finance vehicles given certain inconsistencies in the application of the CEBS guidelines to such vehicles. In response, it is proposed in CP12/1 that such guidelines should be expressly stated to apply in respect of entities which are connected to the firm and that further specific guidance would be provided on the treatment of sponsored structured finance vehicles.

Concerns have been raised with respect to these proposed changes. In particular, we would note that the justification for the proposed extension of the CEBS guidelines is not clearly made. The GCC considerations in the CEBS guidelines focus generally on connections between entities that are not necessarily connected with the reporting firm and it is not clear that the same principles should apply in all contexts (i.e. it is not clear that the same principles should apply in circumstances where the relevant entities are connected with the reporting firm).

In addition, in keeping with our comments on Chapter 2 above, there is some question as to the level of focus which should be placed on the interconnections with the reporting firm when determining single risks between entities for GCC purposes. As noted above, the underlying CRD provisions do not place emphasis on the identification of single risks between entities via an assessment of interconnections with the reporting firm. Indeed it is arguably circular to assess a reporting firm's exposure for the purposes of the large exposures regime based on connections between entities derived from links to the reporting firm itself. We encourage the FSA to maintain a level playing field with respect to the large exposures regime and not to adopt a different approach in this regard.

Concerns have also been raised with respect to the proposed further guidance on the treatment of sponsored structured finance vehicles. While it appears that such guidance is intended to assist reporting firms in their large exposure determinations and assessments and this intention is welcomed in general, various aspects of the proposals as drafted are unclear and unduly complicated, and may give rise to unexpected and/or difficult outcomes in certain circumstances.

In particular, we note that the guidance with respect to the establishment of vehicle-to-vehicle contagion is difficult to follow (including the scenario analysis diagrams). The complexity of this section seems to be acknowledged in paragraph 26 of the guidance itself, i.e. in the note indicating that firms may wish to assume the presence of a single risk between each vehicle which has a single risk with the firm "to avoid having to undertake deeper analysis to demonstrate the differences in scenarios that may cause different

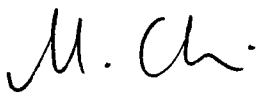
vehicles to encounter financial distress". Given that intended importance of the presence of a single risk between entities under the GCC definition in general, it would seem to be an odd result if the proposed changes contemplated by CP12/1 effectively resulted in a reduction in focus on this and in greater importance being attached to the connection between the vehicle and the firm.

It is indicated in CP12/1 that the proposed changes would result in consequences for ABCP conduits due to the single risk arising as a result of the credit and liquidity support provided by the reporting firm. Based on the comments set out above, concerns have been raised with respect to an approach which would result in 'single risk' assessments between vehicles based on connections to the reporting firm alone.

Moreover, we note that it is not clear that the cost-benefit analysis in CP12/1 has fully taken into account the significant implications for sponsor firms and/or the extent of the potential resulting market disruption which would arise from the proposed conclusions in a conduit context. We encourage the FSA to ensure that the full extent of such implications is factored in before any changes are made.

Lastly, we note that the proposed guidance for structured finance vehicles does not refer to the provisions within Article 106 of the CRD and in the CEBS guidelines which allow reporting firms to look-through to the underlying exposures, or the effect of on-balance sheet treatment of securitisation structured in which no significant risk transfer is achieved. For example, in the context of RMBS transactions, it seems counterintuitive to assess an SPV which step-up and call date arrangements and corresponding investor expectations in circumstances where the assets and liabilities of the vehicle are reported on the regulatory capital balance sheet of the firm. The guidance, if retained, should reflect these very important elements of the regulatory capital framework.

If FSA would find it helpful to discuss any of these preliminary comments then we would be happy to do so. Please contact me in the first instance by telephone on +44 (0) 20 7295 3233 or by email at margaret.chamberlain@traverssmith.com.



Margaret Chamberlain
Chair, Regulatory Law Committee
CLLS

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