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Supplemental note on amendments recommended by the City of London Law Society to clause 48(1) of the Banking Bill 2009

The City of London Law Society (CLLS) represents over 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 supplemental note on amendments recommended by the City of London Law Society to clause 48(1) of the Banking Bill 2009 has been prepared by the CLLS Financial Law Committee. The Committee is made up of a number of solicitors from City of London firms who specialise in financial law. The Committee's purpose is to represent the interests of those members of the CLLS involved in this area of law.

The amendments recommended below are to the Banking Bill published on 4th December 2008 and take into account the amendments to clause 48 to be moved at Committee Stage in the House of Lords by Lord Myners.

1. We consider that the amendments proposed by Lord Myners are helpful and improve the original text. However, given the fundamental importance of adequately and precisely defining the arrangements to be protected through clause 48, we recommend that legal certainty be improved even further. We also consider that there is clear and strong logic for making the definitions in clause 48(1) consistent with those in regulation 3 of the Financial Collateral Arrangements (No 2) Regulations 2003 (the "FCA Regulations") and, where relevant, regulation 2 of The Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (the "Settlement Finality Regulations"). A further benefit is that consistency will assist in ensuring that the UK continues to comply with its obligation to implement the Directives from which both Regulations derive (see paragraph 8 below). Our suggested modifications are set out below.

2. We suggest that the proposed definition of "set-off arrangement" be amended to read:

> "set-off arrangement" is an agreement or arrangement between two or more parties under which Obligation 1 can be set off against Obligation 2

to discharge or reduce the amount of Obligation 2, whether by contract, operation of law or otherwise.

3. We suggest that the proposed definition of "netting arrangement" be amended to read:

> "netting arrangement" is an agreement or arrangement between two or more parties under which a number of claims or obligations can be converted into a net claim or obligation (including under a close-out netting provision or a title transfer collateral arrangement), whether by contract, operation of law or otherwise, whether on a bilateral or multilateral basis and whether through the interposition of a clearing house, central counterparty, settlement agent or otherwise.

4. We suggest that the following new definitions be added:

> "close-out netting provision" has the meaning given to that expression in regulation 3 of the Financial Collateral Arrangements (No 2) Regulations 2003 but with "arrangement" being substituted for "financial collateral arrangement" and with the words "or an arrangement of which a financial collateral arrangement forms part" being deleted.
>
> "title transfer collateral arrangement" has the meaning given to the expression "title transfer financial collateral arrangement" in regulation 3 of the Financial Collateral Arrangements (No 2) Regulations 2003 but with "collateral" being substituted for "financial collateral" and with sub-paragraph (c) of that definition being deleted.

5. The reasons for our amendments to the definition of "set-off arrangement" include the following:

   (a) It is important to reflect the fact that set-off arrangements often operate between more than two parties. An example is where a bank provides cash management services to a group of companies on the basis explained in our paper to HM Treasury of 11th December 2008.

   (b) It is important to make clear that the definition includes the situation where contractual set-off rights are superseded by automatic, self-executing and mandatory set-off in cases where Rule 2.85 or 4.90 of the Insolvency Rules 1986 comes into play.

6. The reason for our amendments to "netting arrangement" include the following:

   (a) It is important to make clear that netting under a "close-out netting provision" is included and to ensure that this expression is construed consistently with the FCA Regulations. (The original text which refers to "theoretical debts" being calculated during the course of a contract for the purpose of enabling them to be set-off against each other is not entirely accurate and is also incomplete).

   (b) The definition of "netting arrangement" should be consistent with the definition of "netting" in regulation 2(i) of the Settlement Finality Regulations.

(c) It should be made clear that netting under the rules of a recognised clearing house, recognised investment exchange or designated system are covered.

(d) It should be made clear that the points set out in paragraph 5(a) and 5(b) above are also covered.

7. The point made in paragraph 6(c) above is part of a much wider point. As stated in our paper of 17th October 2008 in response to HM Treasury's consultation document on proposals to reform Part VII of the Companies Act 1989 ("Part VII"), care must be taken that the Banking Bill (when enacted) will not undermine the special statutory regime created to ensure certainty, efficiency and stability in the financial markets by the combination of the following:

(a) Part VII and its secondary legislation, which provide protection for recognised investment exchanges, recognised clearing houses, recognised overseas investment exchanges and recognised overseas clearing houses;[1]

(b) The Financial Markets and Insolvency Regulations 1996, which provide protection for settlement banks such as CREST settlement banks;[2]

(c) The Settlement Finality Regulations, which implement Directive 98/26/EC and provide protection for designated systems;[3] and

(d) The FCA Regulations which implement Directive 2002/47/EC and provide protection for financial collateral-providers and takers.

8. Although arrangements protected by the above legislation will be capable of being protected through clause 48 of the Bill to the extent that those arrangements rely on security interests, set-off arrangements, netting arrangements or title transfer collateral arrangements within the meaning of clause 48(1), it is essential that all such arrangements be protected. For instance, at present "market contracts", "default rules" and "default proceedings" protected by Part VII, and "default arrangements", "transfer orders" and contracts for the purpose of realising "collateral security" protected by the Settlement Finality Regulations, fall outside the scope of clause 48. We recommend that

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1 The UK has the following Recognised Investment Exchanges: EDX London Ltd, ICE Futures Europe, LIFFE Administration and Management, London Stock Exchange plc, PLUS Markets plc, The London Metal Exchange Ltd, and SWX Europe Limited. The UK has the following Recognised Clearing Houses: Euroclear UK & Ireland Ltd, LCH.Clearnet Ltd, ICE Clear Europe Ltd the European Central Counterparty Ltd. The UK has the following Recognised Overseas Investment Exchanges: Cantor Financial Futures Exchange (CFFE), Chicago Board of Trade (CBOT), Eurex (Zurich), ICE Futures US Inc, National Association of Securities Dealers Automated Quotations (NASDAQ), New York Mercantile Exchange Inc (NYMEX), NQLX LLC, Sydney Futures Exchange Limited (SFE), The Chicago Mercantile Exchange (CME), The Swiss Stock Exchange (SWX) and US Futures Exchange LLC. The UK has the following Recognised Overseas Clearing Houses: SIS x-clear AG, Eurex Clearing AG, The Chicago Mercantile Exchange (CME) and ICE Clear US Limited: see the FSA Register at http://www.fsa.gov.uk/register/exchanges.do

2 CREST settlement banks are key providers of the intra-day liquidity to CREST members (including market makers) required to enable the CREST system to function. The daily average value of securities moving through the CREST system is in the order of £1,537 billion, while the daily average value of cash moving through CREST is in the order of £960 billion, including self-collateralising repo transactions: CREST Newsletter Issue No. 130, October 2008. Such cash payments are only possible as a result of the credit and liquidity facilities which are provided by CREST settlement banks to CREST participants.

3 Systems designated under the Settlement Finality Regulations include CHAPS Sterling, CHAPS Euro, the Continuous Linked Settlement (CLS) System, BACS, the Cheque Clearing System, the Credit Clearing System, LCH.Clearnet Ltd and CREST.

clause 48(2) provides that the making of partial property transfers be restricted in cases that involve, or where they might affect, arrangements protected by the existing legislation referred to in paragraph 7 above. Further, substantial parts of that legislation were enacted in fulfilment of the UK's obligation to implement EU Directives. Any UK national legislation which had the effect of overriding the terms of implementation of those Directives would seem to be a breach of European Community law.

9. The reasons for amending the definition of "title transfer collateral arrangement " include the following:

   (a) It is highly desirable to ensure consistency with the FCA Regulations.

   (b) It is helpful to include a purpose.

   (c) It is important to clarify that the obligation is to transfer "equivalent" collateral. If the obligation were to re-transfer "those assets" (ie the same actual collateral), the arrangement might be recharacterised as a security arrangement. Equally, no title transfer arrangement provides for the transfer of "other" collateral: during the duration of, say, a stock lending agreement, there may be substitution, but the obligation at the end is always to transfer securities equivalent to those held at the end of the "loan" as collateral.

10. We should point out that there is a gap, from the Scots law perspective, in the definition of "title transfer financial collateral arrangements" in the FCA Regulations, which refers to transfers of "legal and beneficial ownership". This overlooks the fact that equitable transfers are not possible under Scots law and that trusts are commonly used to achieve the same result: see Dr. Hamish Patrick's paper of 9th January 2009. We therefore suggest that the words "and any arrangement which achieves substantially the same effect wholly or partly by use of trust" be added at the end of the definition of "title transfer collateral arrangement" suggested at paragraph 4 above.

The City of London Law Society
Financial Law Committee
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