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

DavidH@citysolicitors.org.uk
www.citysolicitors.org.uk

David Hobart
Chief Executive

4 June 2014

Andrea Leadsom MP
Economic Secretary to the Treasury
HM Treasury
1 Horse Guards Road
London, SW1A 2HQ

Dear Minister

The City of London Law Society ("CLLS") represents approximately 15,000 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.

Part I

We write to raise with you our serious concerns in respect of the significant legal uncertainty caused by the Court of Appeal decision on 20 March 2014 in *Fons HF (in liquidation) v Corporal Limited and Pillar Securitisation S.a.r.l.* (footnoted below).[1]

We set out in Part II below a legal analysis of some of the implications of the judgment. In short, the judgment creates uncertainty over the established understanding of the distinction between loans and debentures in English law. In holding that loan agreements are debentures in that, whether or not the relevant loan is drawn, the agreements acknowledge or create indebtedness, the judgment appears to have the effect of regulating loans in a manner not previously adopted. This may have serious implications for regulated and unregulated lenders, borrowers and loan intermediaries and cannot, we suggest, be consistent with the policy intention of HM Treasury in this area.

[1] http://www.bailii.org/cgi-bin/markup.cgi?doc=/ew/cases/EWCA/Civ/2014/304.html&query=Fons+and+HF+and+(in+and+liquidation)+and+v+and+Corporal+and+Limited+and+Pillar+and+Securitisation+and+S.a.r.l.,&method=boolean

The issue is starting to be raised in the markets and such is the potential gravity of the consequences of the judgment, we are contacting you to urge that you take action (a) immediately to clarify HM Treasury's policy intentions on this topic and (b) as soon as practicable act to provide clarity in law.

In particular, the judgment gives rise to uncertainty over the accepted view that loan agreements are not specified investments under the Financial Services and Markets Act 2000 and thereby raises doubt over the extent of the UK regulatory perimeter, given that the licensing regime under the Act extends to various activities relating to loans (such as dealing, advising and managing). Although some loan-related activities would be covered by exemptions under the Act, some significant activities do not appear to be covered by an exemption – particularly those conducted by intermediaries in the loan market and lending by unauthorised entities. There are increasing numbers of unauthorised lenders in the wholesale loan market and the judgment raises the spectre of loan unenforceability and the application of criminal sanctions to relevant parties.

The particular issues raised in the *Fons* judgment did not involve analysis and interpretation of the regulatory framework under the Act. The legislation might now be read to mean that not only lenders without authorisation, but also borrowers without authorisation may be at risk of criminal sanctions. There are some exemptions from the requirement for authorisation and most bank lenders would currently have a relevant authorisation. It is not apparent, however, that commercial borrowers and non-bank lenders would always have the benefit of an exemption. For example, peer to peer lenders and borrowers and other parties to loans not made by banks or other financial institutions regulated within the EEA would be highly unlikely to have an authorisation or be able to get one and individual loan agreements between such parties may not benefit from any exemption. This has clear policy implications for non-bank finance.

It is unlikely that such an extension of the regulatory perimeter is consistent with established policy in this area. For example, there is no single definition of debenture in the Act and where it is used it is clear that it is intended to apply in respect of transferable instruments. Further, the current draft UK bank ring-fencing legislation restricts a relevant bank from trading in debentures issued by third parties (and defines debentures by reference to the Act). If the definition of debentures in the Act should, in light of the *Fons* judgment, include loans, this restriction would place serious (and surely unintended) restrictions on the lending function of UK retail banks.

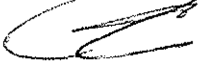
The uncertainty created by the judgment in such an important part of the UK's financial services sector has the potential to damage the perception of the UK as a safe place to do business, and will act as a deterrent to certain forms of valuable economic activity, given the potential criminal sanctions for breach of the Act (for lenders and borrowers) and the implications of loan agreements being unenforceable.

Although there is an argument that the implications of the judgment should be confined to the facts of the case, there is significant doubt, and we anticipate that this may shortly start to be reflected in legal risk assessment (such as in legal opinions), thereby undermining confidence in the UK loan market.

We are keen to discuss with you as soon as possible the issues raised in this letter. The availability of exemptions under the Act is by no means comprehensive, and so positive

action is required to address the situation. Our view is that the uncertainty created by the judgment should not be permitted to continue, and would wish to discuss the potential method of addressing that uncertainty, including a clarificatory statement from HM Treasury in the short term and legislative clarification in due course.

Yours sincerely



p.p. David Hobart
Chief Executive, CLLS

cc
Stephen Parker, HM Treasury
Ian Searle, HM Treasury
Graham Nicholson, Bank of England
Rob Price, Prudential Regulation Authority
Sean Martin, Alasdair Callum, Financial Conduct Authority
Clare Dawson, Chief Executive, Loan Market Association

Part II

Introduction

1. Loan agreements (outside the context of consumer credit and regulated mortgage contracts) have generally not been regarded as regulated investments for the purposes of UK financial regulation.

2. In the *Fons* decision, the Court of Appeal held that a loan agreement is an instrument which creates and acknowledges debt and is thereby a debenture. The decision was not given in the context of the UK's financial regulation framework. However, the decision means that it is now arguable that loan agreements could be regulated investments under the UK financial regulation framework. This is causing significant legal uncertainty among market practitioners.

3. A situation in which loan agreements are regulated investments for the purposes of UK financial regulation raises a number of anomalies and difficulties which suggest that such an outcome would be inconsistent with the nature of the financial regulatory framework and might be unintended. The scope of the regulatory perimeter would also be significantly widened to cover activity which has to date not been considered to be regulated activity. This also seems an unintended consequence.

4. The remainder of this note considers these legal matters in more detail.

Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (the "RAO")

5. The RAO sets out specified "*investments*", certain activities in respect of which are regulated for the purposes of the RAO and the Financial Services and Markets Act 2000 (**FSMA**). Loan agreements are not specifically referenced under the RAO as a specified investment. Article 77 RAO sets out a wide list of such investments which are described in general terms. Article 77 is set out in the Schedule to this note.

6. Such investments include:

   "*debentures...*" (paragraph 1(a) of Article 77); and

   "*...any other instrument creating or acknowledging indebtedness*" (paragraph 1(f) of Article 77).

7. Loan agreements have generally been regarded as falling outside the scope of these paragraphs. This is because the prevailing view has been that loan agreements do not create or acknowledge debt but simply create a contractual framework under which loans might be advanced. They are therefore neither debentures nor other instruments which create or acknowledge indebtedness.

Relevance of the *Fons* case

8. The *Fons* case concerned the interpretation of a security agreement. A security provider had granted security over its assets, including its "*Shares*" in a company. "*Shares*" was widely defined in the security agreement to include "*debentures*". The Court had to determine whether the definition of "*Shares*" included the security

provider's rights as lender under two loan agreements that it had made with that company.

9. The Court of Appeal considered that those two loan agreements fell within the definition of "*Shares*" because they were debentures for the purposes of that definition. Crucially, this was because the Court considered that the loan agreements either created or acknowledged debt. As part of its judgment the Court stated that it considered that even a loan agreement which is undrawn at the time it is signed creates and acknowledges debt. One of the Court of Appeal judges, LJ Gloster, went as far as stating that an undrawn loan agreement could also constitute a debenture in that it created or acknowledged a debt on execution.

10. The Court expressly dismissed as "*wrong*" the orthodox view that loan agreements which are undrawn at the time of signing do not create or acknowledge debt but simply create a contractual framework under which loans might be advanced.[2]

11. Although the *Fons* case did not concern interpretation of the RAO or the application of FSMA to loan agreements (and Lord Justice Patten does appear to acknowledge that the term "debenture" may not have a single, fixed meaning), the Court's express statement that loan agreements create or acknowledge debt has caused widespread concern. It has become difficult to advise conclusively that loan agreements fall outside the scope of paragraph 1 of Article 77 RAO.

Implications of loan agreements falling within Article 77 of the RAO

12. The RAO sets out a number of "*regulated activities*". Any person carrying out these activities in relation to a specified investment is required to be authorised or exempt under the FSMA framework.

13. If a loan agreement is an investment specified by Article 77 RAO then it will be a specified investment for the purposes of the FSMA regime.

14. In turn this means that any person carrying on a regulated activity in relation to a loan agreement in the UK will be required either to be authorised or exempt under FSMA.

15. Obtaining a regulatory licence in the UK means, amongst other things, compliance with regulatory capital requirements, conduct of business rules, client documentation requirements, organisational requirements (including for systems and controls, risk management and outsourcings) and separate approvals in respect of certain individuals within the entity.

16. This would be a significant change for the loan market, which has always operated on the basis that many activities in respect of loan agreements are not regulated for FSMA purposes.

17. For persons who are already regulated, certain regulatory obligations may for the first time directly apply to their activity in the loan market. For example, some of the

[2] The judgment is also problematic for agreements which govern drawn loans. The established English law view to date has been that the loan agreement is not a debenture, regardless of whether loans made by reference to the agreement are drawn or undrawn. It is also noteworthy that the key problematic dicta in the judgment were made by only one of the three judges (Lady Justice Gloster).

FCA/PRA Principles for Businesses (such as in respect of proper market and conduct and systems and controls) apply directly to regulated activities. Individuals involved in regulated activities in respect of loans may need to be FCA/PRA approved persons.

Consequences of loan agreements being regulated investments for FSMA purposes

18. Characterising loan agreements to be specified investments for FSMA purposes would have a number of unexpected (and in some cases, odd) consequences.

Borrowers and borrowing

19. A borrower under a loan agreement would be carrying on the regulated activity of "*dealing as principal*" under Article 14 RAO. Borrowers would therefore need to be regulated in respect of borrowing.

20. This is because "*selling*" has an extended meaning under the RAO, including issuing or creating the relevant investment, which would be likely to cover borrowing if loan agreements are specified investments.

21. Corporate and other borrowers might be able to rely on the exemption under Article 18 RAO for the issue of a company of its own shares, which includes the issue by a person (not only companies) of own debentures. However, this is not completely certain. It is unclear if a loan agreement can be "*issued*", as this seems to mean something different from "*become a party to*".

Key impact: loan market intermediaries and non-bank lenders

22. Intermediaries in the loan market (i.e. persons engaged in arranging and advising on loans) are unlikely to be covered by relevant exemptions in respect of all of their functions (an exemption under Article 31 may apply in respect of "arranging" but there is no apparent exemption in respect of advising). Persons administering loans would need to consider whether they are conducting the regulated activity of "safeguarding and administering" debentures (and so need to become authorised to provide custody services).

23. While established lenders (such as banks) are likely already to be authorised under FSMA to deal as principal in debentures, non-bank lenders (such as corporate providers of vendor financing in supply chains) are unlikely to be authorized and would need to rely on the exemption in Article 17 of the RAO (available only if the lender could be said to "accept an instrument" in respect of a loan made). But it is not clear that the transfer of loan participations, in particular in respect of a non-bank lender/transferor, would be covered by an exemption. We have noted in Part I the serious implications of this uncertainty for the operation (and growth) of the non-bank lending market in the UK, particularly if there are concerns over loan enforceability.

Financial promotions

24. Promotions to individual borrowers in respect of a loan would be financial promotions for which no obvious exemption under the UK financial promotions regime is available (the "one off" exemption in Article 28 of the Financial Promotion Order may be available, but is not often comfortably relied on).

25. Promotions to borrowers which are businesses should be permitted where the borrower is a regulated entity or a high net worth company. Promotions to other business borrowers may also be permitted if it is possible to regard such borrowers as conducting the controlled activity of "*dealing*" for the purposes of their business because the exemption under the UK financial promotions regime for "*investment professionals*" covers any person "*who it is reasonable to expect will carry on [the controlled activity to which the promotion relates [issuing or creating the loan agreement] for the purposes of a business carried on by him*".

26. However, there are no similar exemptions for individual borrowers, which would mean promotions to individual borrowers would need to be approved by a regulated entity.

Secondary loan market: portfolio sales, secondary trading etc

27. The "*buying*" and "*selling*" of loans in the secondary loan market could now be the regulated activity of dealing in investments ("*dealing as principal*" under Article 14 RAO or "*dealing as agent*" under Article 21 RAO). The loan market has operated to date on the basis that the secondary trading of loans is not a regulated activity.

28. The extended definition of "*selling*" includes disposing of the investment for valuable consideration which "*in the case of an investment consisting of rights under a contract*" includes (*inter alia*) surrendering and assigning those rights.

29. It is unclear whether this extended definition should include loan agreements, or whether it relates only to investments which are expressed to be rights under contracts (such as futures or contracts for differences). However, there is now a lack of certainty as to whether "*buying*" and "*selling*" under the RAO can cover activity in respect of loans. Non-bank lenders are significant actors in the secondary loan market, and legal uncertainty over their involvement in that market could quickly become a serious issue for the primary and secondary loan market.

Structured debt: "true sale" securitisations, loan participation notes etc

30. Discretionary management of assets where these assets include loans could now be the regulated activity of discretionary management of assets under Article 37 RAO. This would be relevant to the roles of some participants in the debt fund market, and structured debt market, such as securitisation and loan participation structures.

31. For example, under a "true sale" securitisation structure, where there is a genuine sale with title passing to the issuer SPV, a servicer entity is usually appointed to administer the underlying investment. Similarly, under a typical loan participation note structure[3], an SPV will assign its administrative rights under a loan to a trustee.

---

[3] A typical loan participation note structure involves an SPV issuing notes to investors (noteholders), with the issue proceeds used to finance a loan to a borrower. The notes are issued on a limited recourse basis where payment obligations of the SPV to the noteholders under the notes are limited to the amounts received by the SPV from the borrower under the loan. The SPV assigns its administrative rights under the loan to a trustee and grants the trustee a fixed charge over payments due under the loan as security for its payment obligations under the notes. The trustee is able to enforce the rights of the SPV under the loan against the borrower.

32. Such administering of loans or servicing of a loan book under such structures could amount to managing of investments under Article 37 RAO. It might be argued that under such structures it is the asset which is managed (i.e. the rights under the loan agreement) rather than the loan agreement itself. However, there is now a lack of certainty as to whether such administrative roles in the structured debt market are regulated or not.

RAO overlap/consumer credit and regulated mortgage contracts

33. It is commonly accepted that a regulated investment should not fall within more than one category of specified investment in the RAO. Specific regulated activities apply in respect of regulated consumer credit agreements and regulated mortgage contracts. It would be an odd result if these types of loans were to become subject to other parts of the licensing regime (for example, advising and arranging under the RAO) because such loans are characterised also as debentures, or if exemptions under the RAO were available in respect of their characterisation as regulated consumer credit agreements (see Articles 60C to 60H in the RAO) but not as Article 77 debentures.

MiFID

34. Loans are not included in the list of financial instruments in Annex 1 of the Markets in Financial Instruments Directive 2004/39 ("MiFID") The characterisation of loans as debentures under the RAO would create a further significant disparity between the lists of RAO and MiFID instruments.

Schedule

Article 77 RAO

77. **Instruments creating or acknowledging indebtedness**

(1) Subject to paragraph (2), such of the following as do not fall within article 78

(a) debentures;

(b) debenture stock;

(c) loan stock;

(d) bonds;

(e) certificates of deposit;

(f) any other instrument creating or acknowledging indebtedness.

(2) If and to the extent that they would otherwise fall within paragraph (1), there are excluded from that paragraph

(a) an instrument acknowledging or creating indebtedness for, or for money borrowed to defray, the consideration payable under a contract for the supply of goods or services;

(b) a cheque or other bill of exchange, a banker's draft or a letter of credit (but not a bill of exchange accepted by a banker);

(c) a banknote, a statement showing a balance on a current, deposit or savings account, a lease or other disposition of property, or a heritable security; and

(d) a contract of insurance.

(3) An instrument excluded from paragraph (1) of article 78 by paragraph (2)(b) of that article is not thereby to be taken to fall within paragraph (1) of this article.