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Ladies and Gentlemen

Possible EU Framework for Bank Recovery and Resolution

The International Swaps and Derivatives Association (**ISDA**) is grateful for the opportunity to comment on the Working Document of DG Internal Market and Services of the European Commission on "Technical Details of a Possible EU Framework for Bank Recovery and Resolution" issued by the Commission for consultation on 6 January 2011 (the **Working Document**). ISDA has followed closely this consultative process since its inception.[1] The issues considered in the Working Document are of great importance to the financial markets, including the privately negotiated derivatives markets.

1. Information about the Respondent

ISDA is the global trade association representing leading participants in the privately negotiated derivatives industry, a business that includes interest rate, currency, commodity, credit and equity swaps, options and forwards, as well as related products such as caps, collars, floors and swaptions. The address of our European office appears above and our registration number in the relevant EU register is **46643241096-93**. The addresses of our other offices, including our head office in New York, may be found on our website at http://www.isda.org through the "Contact us" link at the top of the home page.

[1] See, for example, our letter to the Commission of 20 January 2010 commenting on the Commission's Communication "An EU Framework for Cross-Border Crisis Management in the Banking Sector" issued on 20 October 2009, a copy of which is available on the ISDA website at: http://www.isda.org. We understand that this consultative process incorporates the Commission's required review of Directive 2001/24/EC of 4 April 2001 on the reorganisation and winding up of credit institutions.

ISDA has 800 member institutions from 54 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

More than half of ISDA members are based in the European Union and neighbouring countries and most of the other members are active participants in the European financial markets as dealers, service providers or end users of derivatives. Promoting legal certainty for cross-border financial transactions through law reform has been one of ISDA's core missions since it was chartered in 1985.

Many of ISDA's members are credit institutions or investment firms likely to fall within the scope of an eventual EU framework for bank recovery and resolution. ISDA's other members active in the European financial markets are likely to have dealings from time to time with those European credit institutions and investment firms. Accordingly, ISDA members take a close interest in the proposals.

ISDA's membership encompasses members carrying out European regulated activities, including banking and investment services, as well as many end-users of derivatives, who are not themselves regulated[2] but are protected by financial regulation. Further details of ISDA's membership structure, including a list of the names of its primary, associate and subscriber members, is available from our website at http://www.isda.org through the "Membership" link on the left side of the home page.

2. Scope of our response

We welcome the Commission's continued engagement with industry on these issues. We are aware that a number of other financial market trade associations and other professional bodies will be responding in detail to the Working Document, as we have participated in industry discussions concerning the Commission's current consultation process on these issues.

Given our focus on the privately negotiated derivatives markets, we will comment principally on the aspects of the proposals that will have a direct impact on derivatives transactions, in particular:

- resolution powers, in particular:
    - the power to transfer specified rights, assets and liabilities and ancillary provisions
    - the power to impose a stay on or suspension of rights to terminate transactions early in the event of a whole or partial property transfer

[2] i.e, not regulated in relation to their derivatives activities, although many end-users may be regulated as to part or all of their other business activity, for example, insurance companies, pension fund trustees and administrators, licensed public utilities and so on. Many end-users are, of course, large industrial and commercial corporations using derivatives to manage interest rate, currency and other business-related risks.

    - the power to reduce or write off the claims of unsecured creditors in connection with a resolution (generally referred to as "bail-in")

- the scope and detail of the proposed safeguards for financial contracts in relation to the resolution powers

Our comments will therefore principally be concerned with issues raised in Part 4 of and the first Annex to the Working Document. In particular, we adopt the perspective of a market counterparty transacting derivatives transactions with a failing financial firm and consider the extent to which the proposals, if implemented, could negatively affect the integrity of and legal certainty regarding the enforceability of existing transactions and related netting and collateral arrangements

While the issues raised in the remainder of the Working Document are of great importance, we believe that other financial market trade associations and professional bodies with a less sector-specific focus and mission than ours are better placed to comment in detail on these aspects, in particular, in relation to matters concerning the architecture of the European regime, supervision, recovery planning, intra-group financial support, resolution plans, early intervention, group resolution and financing arrangements for the resolution regime.

We expect that other respondents will be better placed to comment in detail from the perspective of the failing firm itself, in terms of the potential impact on its operations and its ability to carry on its activities in a commercially successful, safe and cost-effective manner. And, of course, respondents representing other stakeholders, for example, those who operate financial infrastructure, such as clearing and settlement systems, or who provide other services to financial firms, such as custody and safekeeping, will be better placed than we are to comment on the potential impact of the proposals on those stakeholders and their activities.

Finally, we do not comment in this response in detail on the proposals in the Working Document regarding compensation of third parties where (a) the exercise of a power puts that party in a worse position than the position it would have been in had there been an insolvent liquidation or (b) there has been an unjustified or wrongful exercise of a resolution power, particularly one entailing a breach of a safeguard. As to the mechanic of compensation in such circumstances, we believe that there are other respondents who are better placed to comment in detail.

Also, as already noted, we are principally concerned in our response with the direct impact of the proposed resolution powers on the rights of a market counterparty under its derivative transactions with a failing firm and under related netting and collateral arrangements. In particular, we are concerned with legal uncertainty created by the possibility that resolution powers, if not adequately defined and circumscribed, may be exercised or by uncertainty as to the scope or effect of any related safeguards. A failure, for example, adequately to protect close-out netting arrangements or related financial collateral arrangements from the possible operation of the resolution powers will have a material and adverse impact on the ability of supervised firms to obtain robust legal opinions as to the enforceability of those arrangements. This will, in turn, negatively affect their regulatory capital requirements. In relation to these concerns, the possibility of eventual compensation, however fairly determined, is of little assistance.

In light of the foregoing, we will not answer every numbered question set out in a "Question Box" in the Working Document or even every such question in Part 4 of or in the first Annex to the Working Document. Where possible, however, we will indicate where our response relates to a specific numbered question.

3. General comments on the Working Document

We note that some of the proposals, as currently formulated, have the potential to increase legal uncertainty in the market and therefore to run against the purported aim of these proposals to increase financial stability. We therefore encourage and commend the Commission's openness to dialogue with industry as well as other stakeholders to ensure that any ultimate European legislation in this area achieves the optimal balance of effectiveness and predictability.

We note that the Working Document contemplates the evolution of a comprehensive EU framework for troubled and failing banks and certain investment firms, that will encompass at least three steps: first, the development of a common set of resolution tools and reinforcement of cooperation between national authorities; secondly, further harmonisation of bank insolvency regimes; and thirdly, the creation of an integrated resolution regime, possibly based on a single European Resolution Authority. The Working Document is intended to present technical details only in relation to the first step. We therefore express no view on the need for or feasibility of the second and third steps. We do note, however, that some of the proposals in relation to the first step do not seem to us likely to be achievable within the proposed timeline of a legislative proposal during the summer of this year. In particular, we are sceptical that the various difficulties that must be overcome to articulate a workable proposal for an effective "bail-in" regime can be achieved within that timeframe. We comment further on this below.

We welcome the Commission's acknowledgement of the importance of legal certainty. It is essential to the safety and integrity of the financial market and therefore to financial stability. We also therefore welcome the Commission's proposals in relation to appropriate safeguards for third parties in relation to the proposed resolution powers and acknowledgement of the principle that interference with "property rights" (and, we would add, private law rights more generally) should be restricted "to what is necessary and justified in the public interest".[3] It is difficult to judge from the Working Document alone, ahead of more detailed legislative proposals, whether the proposed safeguards will be effective to achieve the necessary level of legal certainty. We indicate below where we believe the dangers potentially lie, and we look forward to continued dialogue with the Commission in relation to these issues.

[3] Page 7 of the Working Document

4. Importance of co-ordination with international work on financial firm resolution

The Working Document refers to the work being undertaken at international level, specifically by the Financial Stability Board and the G20, in relation to cross-border resolution of financial institutions in crisis and refers to the involvement of the Commission in this work. The Working Document also states that the ideas in the Working Document are consistent with the recommendations being developed by the FSB. We strongly endorse the principle that European work in relation to these issues should be consistent with the work being done at the international level.[4] Indeed, we believe that this is of critical importance, given the global nature of the financial markets.

5. Early intervention

As noted above, we focus in our response on aspects of the proposals in the Working Document with actual or potential direct impact on derivatives transactions, meaning therefore principally Part 4 of and the first Annex to the Working Document, however we do wish to make one general comment on the early intervention proposals in Part 3 of the Working Document. Part 3 sets out proposed powers that financial supervisors could exercise against supervised firms at an early stage to prevent a trouble firm from deteriorating, with the aim of securing recovery ideally without the need for resolution.

From the perspective of a market counterparty to a troubled firm, it would appear that the exercise of most of these powers would not directly impact its contractual arrangements with the troubled firm. One possible power, however, is the power to require a troubled firm to divest itself of activities that are deemed to pose excessive risks to the soundness of the troubled firm.

We assume that this would not involve the authorities having the power directly to affect (by cancelling, writing down or otherwise modifying) existing contractual arrangements between the firm and a market counterparty. We also assume that any divestment by the firm would be via a winding down of the affected activities and related contractual arrangements by negotiation with the relevant market counterparties in an orderly and non-coercive manner.

If those assumptions are correct, then we have no further comment on this power. If those assumptions are not correct, we would have serious reservations regarding this power. Appropriate safeguards would need to be crafted to protect property and private law contractual rights of affected market counterparties and to ensure that the possible exercise of the power did not increase legal uncertainty.

6. Resolution powers generally

As would most respondents to this consultation, at least those who represent financial market participants, we emphasise the need for certainty, clarity and transparency in relation to the operation of the triggers for the application of the resolution tools and

[4] Page 9 of the Working Document.

resolution powers. Beyond that, we do not comment on the conditions, objectives and general principles in Part 4F of the Working Document (questions 28-30).

We also do not comment on the resolution tools set out in sections G1 – G4 of Part 4G (questions 31-34) of the Working Document, other than to notice that this set of resolution tools, leaving aside the debt-write-down ("bail-in") tool, appears to be broadly consistent with the set of tools currently available in jurisdictions with modern bank resolution regimes, for example, the US, the UK and Germany.

From a derivatives market perspective, the critical issue is how the resolution tools are applied through the resolution powers, and the impact of the exercise of those powers on derivatives transactions and related netting and collateral arrangements. From the perspective we adopt in this response (see "Scope of response" above) this is the critical aspect of the Working Document as a whole. The resolution powers are dealt with in the remainder of Part 4G of the Working Document (questions 35-45) and safeguards against the exercise of those powers are considered in Part 4H.

Not all of the proposed resolution powers would directly affect the contractual or property rights of a derivatives market counterparty dealing with a failing firm or entering into a derivatives transaction referenced to the equity price or credit risk of the failing firm. For example, the resolution powers set out in G5 of the Working Document in clause (a) (power to take control of the affected credit institution) and clause (i) (power to remove or replace senior management) would have no direct impact on contractual or property rights of a derivatives market counterparty, unless specific provision for such events was made in a particular contract (in which case, no policy issue is raised and no safeguard against the exercise of the power is needed).

The remaining resolution powers fall broadly into two categories:

(1) resolution powers that affect the nature, ownership and/or value of equity or debt securities issued by a failing firm; and

(2) resolution powers that affect the rights, assets or liabilities of a failing firm.

The first category includes the resolution powers set out in clauses (b), (c), (e), (f), (g), (h) and (j) of section G5 of Part 4 of the Working Document.[5] The second category includes the resolution powers set out in clauses (d) and (f) of section G5.

We note that the resolution power in clause (f) falls into both categories. This is the power to reduce or write off the claims of unsecured creditors of a failing firm, sometimes referred to as "bail-in".

In relation to each resolution power involving the power to transfer securities of the failing firm or to transfer other assets, rights or liabilities of the failing firm, there are ancillary provisions, discussed in section G6, intended to ensure the effective application

[5] Page 56 of the Working Document.

of the primary transfer power. We discuss these ancillary provisions, where appropriate, below in relation to the relevant transfer power.

Leaving aside, for the moment, the debt write-down power, which straddles the two categories, it is the second category of resolution powers that raises the greater potential difficulties for derivatives market counterparties. In relation to these, therefore, safeguards are critical to preserve legal certainty and to protect as far as possible property and private law contractual rights. The Working Document acknowledges this, of course, and discusses proposed safeguards in Part 4H (questions 46-51).

In the remainder of our response to the Working Document, we:

- first consider the resolution powers within the first category (including ancillary provisions), apart from the debt write-down power;
- then consider the resolution powers within the second category (including ancillary provisions), apart from the debt write-down power (in other words, we deal with the resolution power in clause (d) of section G5, namely, the power to transfer assets, rights or liabilities of the failing firm);
- then consider the proposed safeguards, and
- finally, consider the debt write-down (bail-in) resolution tool and power.

In relation to the last point, the debt write-down resolution tool and power is briefly considered in Part 4G of the Working Document,[6] but is principally dealt with in the first Annex to the Working Document.

7. Resolution powers in relation to securities of a failing firm

As already noted in part 6 of our response above, a number of the proposed resolution powers set out in section G5 of Part 4 of the Working Document[7] affect the nature, ownership and/or value of equity or debt securities issued by a failing firm. In this part 7 of our response, we consider only the proposed securities-related resolution powers set out in clauses (b), (c), (e), (g), (h) and (j) of section G5.

Some of these involve the power to transfer securities issued by a failing firm, namely, the powers in clauses (b) and (c). As noted above, section G6 of the Working Document sets out ancillary provisions relevant to the exercise of the resolution powers permitting the authorities to transfer securities of a failing firm (as well as other assets, rights and liabilities).

The other proposed securities-related resolution powers, namely, the powers in clauses (c), (e), (g), (h) and (j), involve the power to write off or cancel shares of a failing firm, to convert certain debt instruments of the failing firm or require the conversion of

[6] Page 55 of the Working Document.
[7] Page 56 of the Working Document.

its debt instruments under a relevant contractual term or to issue new shares in the failing firm.

As a derivatives transaction entered into by a failing firm is not a security for this purpose, the exercise of any of the securities-related resolution powers is only directly relevant to a derivatives transaction that relates to that security. Although it is possible that a failing firm may be a party to such a derivatives transaction, the vast majority of these transactions will be between third parties. Such transactions would include swaps, forwards and options written on the shares of the failing firm and swaps (including credit default swaps), forwards and options written on the debt securities[8] of the failing firm.

The principal need of derivatives market participants in relation to the possible exercise of any of the securities-related resolution powers, including the transfer powers, is certainty, clarity and transparency as to the conditions under which such powers may be exercised and the effect of the exercise of the power. This is important so that market participants entering into derivatives transactions that refer to the securities of a financial firm are able to draft their contractual arrangements in a manner that adequately addresses the risk of such an event occurring, clearly allocates the risk of such event and provides for the consequences of the event as between the parties.

It is also important, in relation to any actual exercise of such a power by a resolution authority, that there is clarity and transparency as to the timing and effect of the exercise. So, market participants should be notified promptly of the exercise via an appropriate market information mechanism with details of the terms of the exercise so that parties to a transaction referring to the securities of the failing firm are quickly in a position to assess the impact of the exercise, determine their rights under the relevant contact setting out the terms of the transaction and take any and all appropriate actions, for example, in relation to any hedge positions to protect their financial and commercial interests.

This clarity and transparency is important not merely to the individually affected market counterparties but to the market as a whole, as any shock caused by uncertainty as to the timing or effect of the exercise could have contagion effect and/or could result in market counterparties taking unnecessary actions (for example, liquidating hedge positions or establishing new ones) based on inaccurate or incomplete information.

Beyond these considerations, we do not believe that the securities-related resolution powers and, where relevant, ancillary provisions raise the need for special safeguards.

One additional issue, which is not directly discussed in the Working Document in relation to the securities-related resolution powers (although foreign law issues are considered elsewhere in the Working Document), is the difficulty and uncertainty that would be caused by the failure of a foreign court to recognise the effect of the exercise of a securities-related resolution power.

[8] These could be senior, subordinated or convertible debt securities. In effect, a derivative transaction may be written on any security of a firm falling within the spectrum of possible capital instruments from ordinary shares, at one end, to senior debt securities at the other end.

We would expect that the equity securities issued by a failing firm would normally be governed by the law of the EU Member State where the failing firm is organised, headquartered and principally supervised. But that might not be the case for all of the debt securities issued by that firm.

As far as the European Union is concerned, we understand that this issue will be addressed in the legislative proposal by providing for mutual recognition of the exercise of resolution powers by a relevant Member State resolution authority in relation to a firm for which it is the home state by the authorities and in the courts of all other Member States.

In relation to jurisdictions outside the EU, it will be necessary to agree such mutual recognition of resolution measures in an appropriate international instrument. This underlines the importance of continued coordination of the European work on financial firm resolution with the international work currently under way.

8. Resolution powers in relation to assets, rights and liabilities of a failing firm

Power to transfer specified rights, assets and liabilities and ancillary provisions

We now turn to the proposed resolution powers affecting rights, assets or liabilities of a failing firm. These are:

- principally, the power set out in clause (d) of section G5 of the Working Document (the power to transfer to another undertaking or person specified rights, assets and liabilities of a credit institution to which resolution tools are applied); and

- the ancillary provisions set out in clauses (a), (d) and (e) on page 57 of the Working Document, in particular, the power to provide that a transfer takes effect from any liability or encumbrance (subject to appropriate compensation of third parties) and in clauses (a) and (b) on page 58 of the Working Document, in particular, the power to provide for the continuity of contracts transferred from a failing firm to a third person

We do not dispute the need for such powers, which appear to be necessary in order to give effect to the sale of business, bridge bank and asset separation resolution tools. Nonetheless, as we have already stated, these proposed powers are of the ones of most concern to derivatives market participants (apart, perhaps, from the debt write-down tool and power, discussed below) and raise the most significant issues of potential legal uncertainty.

It is therefore of utmost importance that the scope and effect of the proposed resolution powers, including ancillary provisions, and of the related safeguards are clear and certain. It is also important that any actual exercise of such a power be notified effectively and promptly to the market, both as to timing (when the transfer takes effect) and as to the precise scope and effect of the exercise of the power (detailing, for example, the specific rights, assets and/or liabilities transferred).

We are therefore pleased to see that the Commission has considered these issues in section G10 of the Working Document, and we agree, **in response to Question 40**, that the proposals there, as far as they relate to the property transfer resolution power, do seem generally appropriate. We would also suggest, however, that in addition to publishing a statement or notice relating to the exercise of the powers (including the terms of the relevant order or instrument) on the official website of the relevant resolution authority or of the European Banking Authority,[9] the relevant statement or notice should be published on the official website of the failing firm itself. Retail depositors and other retail customers of the failing firm are more likely to look there if seeking information about the firm than on the website of any national or European authority.

Transfers of foreign property

In relation to the securities-related resolution powers, we have already discussed the potential difficulties caused by lack of recognition by foreign courts of the effect of the exercise of such powers by the authorities in a particular member state. This issue arises, perhaps more acutely, in relation to the proposed property transfer resolution power, where the relevant rights, assets or liabilities of the failing firm are governed by a foreign law. This is discussed in section G8 of Part 4 of the Working Document.

We agree that it is fundamental that there should be mutual recognition of the exercise of resolution powers by a resolution authority in one Member State by the relevant authorities and courts of other Member States.

Subject to the foregoing, **in response to Question 38 in the Working Document**, the suggested provisions appear sufficient to achieve the objective that where a transfer includes assets located in another EU Member State or rights and liabilities are governed by the law of another EU Member State, the transfer cannot be challenged or prevented by virtue of provisions of the law of that other Member State.

As regards third countries, the position is more difficult unless and until there is agreement on mutual recognition of financial firm resolution measures at the international level through an appropriate international instrument. In other words, the proposals of the Commission in section G8 are appropriate and necessary but not sufficient fully to address this potential difficulty. It is important, therefore, that the European Union remains fully engaged in international work relating to financial firm resolution and that an international agreement on mutual recognition of resolution measures is reached as part of that process.

We revert below to the foreign property issue in relation to the proposed safeguards.

Power to suspend payment and delivery obligations

In response to Question 42, we do not believe that there is any justification for a general suspension, even on a strictly limited and temporary basis, of a failing firm's payment

[9] We note that, on page 61 of the Working Document, the proposal is that the relevant statement or notice should be published on the official website of the resolution authority "or" on the website of the EBA, however it would clearly be better to publish on both websites, maximising the availability of the information to all potentially affected market participants and other stakeholders.

and delivery obligations. At most, subject to the following discussion, there should merely be a temporary suspension of the right to terminate transactions early as the result of the imposition of the resolution regime on a failing firm. The case even for this limited power of suspension is, however, weak.

Power to suspend close-out netting rights

In response to Question 43, the Working Document, in section G11 of Part 4 and as elaborated in section G13, proposes a “short, temporary suspension of rights [to] enforce obligations against a credit institution under resolution and rights to close out netting”. This is said to be for the purpose of giving resolution authorities time to decide which assets or liabilities should be transferred and to effect the transfers. The Working Document stresses that this should be understood in conjunction with the proposed safeguards for partial transfers.

The first point to note, which is essentially a technical point in relation to the scope of the proposed suspension, is that the suspension should only relate to the right of a counterparty under a derivatives master agreement, such as the ISDA Master Agreement, with a failing firm to terminate transactions early as a result of the triggering of the resolution regime against the failing firm. Early termination of transactions is the essential first step in the process of close-out netting, the other steps being valuation of the terminated transactions and then determination of the net balance owing by or to the defaulting party under the close-out provisions. Every master netting agreement operates on this basis, even if the details of the close-out mechanism vary.

It is not necessary, in other words, to suspend a counterparty’s “right to enforce” or “rights to close-out netting”. We appreciate that the Working Document is not intended to set out precise drafting, but we make this point in response to this consultation to aid the Commission in formulating its eventual legislative proposal and to ensure that the suspension is drafted no more widely than necessary.

During the period of temporary suspension, the market counterparty’s rights and the failing firm’s obligations (and, of course, vice versa) under the master agreement should not otherwise be affected. Throughout this period, the counterparty should (bearing in mind, as the Working Document invites us to do, the safeguards) be permitted to consider its exposure to the failing firm to be fully net. In that important sense, the proposed suspension should not “suspend” close-out netting. At most, it should simply stay temporarily the initiation of the close-out netting process, namely, the early termination of transactions following an event of default.

There is no need for the power to suspend early termination rights to have any effect other than that. As noted in our response above to Question 42, the payment and delivery obligations of each party, and any related obligations, should continue to be owed and any breach of any such obligation (for example, a failure to make a payment or delivery) falling due during the brief suspension period should have the consequences specified in the master agreement between the parties, including, at the end of the brief suspension period, the right to close out all transactions, by terminating and valuing the transactions and determining a net close-out amount due between the parties.

We should note that many financial market participants, including many (perhaps most) of our members, oppose any suspension of early termination rights and believe that a suspension even for a limited period of 24 or 48 hours would create unacceptable market uncertainty.

Moreover, we do not believe that the case has yet effectively been made by the Commission for such a suspension (or by the FSB or the Basel Committee's Cross-border Resolution Working Group, which are considering the same idea in an international context). The Working Document provides no evidence and little in the way of argument in support of the need for such a suspension. Instead, the Working Document appears to assume that the need for such a suspension is obvious. However, any interference with freely agreed contractual rights between sophisticated professional counterparties needs to pass a high threshold of justification.

The need for the resolution powers generally (subject to appropriate safeguards), including the partial property transfer power, appears to pass the necessary high threshold. The need for the suspension of early termination rights, however, is not obvious, and we note that the United Kingdom has successfully implemented its own bank resolution regime under its Banking Act 2009 without including a provision to this effect.[10]

Nonetheless, we also note that there is considerable momentum behind this idea, partly inspired by the inclusion of a 24-hour suspension period in the US FDIC regime (and, more recently, in the Dodd-Frank Act). This proposal was also included as Recommendation 9 of the Report and Recommendations of the Cross-border Bank Resolution Group of the Basel Committee on Banking Supervision, published in March 2010.

Accordingly, if such a power to suspend early termination rights is to be included in the European financial firm resolution regime, we believe that it must be made subject to certain conditions, namely that:

- the ability of the resolution authority to suspend early termination rights is strictly limited in time (ideally for a period not exceeding 24 hours, but in any event not more than 48 hours)

- the relevant master agreement and all transactions under it are transferred to an eligible transferee as a whole or not at all, together with any related collateral (there is no possibility of "cherry-picking" of transactions or parts of transactions or divorcing the collateral from the obligations secured or supported by it)

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10 The Banking Act 2009 includes analogous provisions permitting an override of early termination rights in certain circumstances under the so-called continuity powers, but there is no provision of the Banking Act 2009 or the related subordinate legislation that corresponds directly to the suspension of early termination rights proposed in the Working Document.

- the proposed transferee is a financially sound entity with whom the counterparty would prudently be able to contract in the normal course of its business
- the early termination rights of the counterparty are preserved as against the transferee in the case of any subsequent default by the transferee
- the counterparty retains the right to close out immediately against the failed financial institution should the authorities decide not to transfer the relevant master agreement during the specified transfer window

On the positive side, we note that the existence of a limited power of the US resolution authority, the FDIC, to suspend early termination and close-out netting has not prevented supervised institutions from obtaining, in relation to US banks subject to the FDIC regime, legal opinions that are sufficiently robust to comply with current requirements for recognition of close-out netting for regulatory capital purposes. But we stress that any regime implementing such a power must clearly limit the power if the necessary legal certainty is to be maintained.

Question 43 also asks whether certain classes of counterparty, specifically, central banks, central clearing counterparties (CCPs) or payment and securities settlement systems falling within the scope of the Settlement Finality Directive should be exempted from the effect of the temporary stay. We can see no policy justification for exempting a central bank. If such a stay would be harmful to the central bank's position as a counterparty to the failing firm, then that would appear to undermine the case for applying the suspension to any other market counterparty. We believe, however, that the case is somewhat stronger for exempting CCPs and payment and securities settlement systems, to protect their unique, role, function and structure as part of financial market infrastructure. The better position, however, is simply not to have any such power.

Apart, of course, from our suggestion that the case is weak for including the power to suspend early termination rights in the proposed resolution regime, it appears that the Working Document has taken into account most of the above points regarding the need to circumscribe strictly the proposed suspension of early termination rights. The legislative detail will be important, and we will consider carefully the Commission's eventual legislative proposal in this regard.

Relationship to proposed EU netting instrument

We understand that the Commission is currently studying the possibility of a European instrument to set out the fundamental principles that should underlie a legal framework for close-out netting, as well as the personal and material scope of such a framework. As you know, we have advocated such an instrument for a number of years, as have others,[11] to increase legal certainty within the European Union in relation to close-out netting, promote convergence of the existing netting regimes in most Member States and to provide a framework for those few Member States that have either no current legal

[11] See, for example, the letter dated 14 April 2008 co-signed by ISDA and the European Financial Markets Lawyers Group, setting out our joint proposal for a European Netting Directive.

framework or an inadequate one for close-out netting. It is important that this work be co-ordinated with the proposal for a temporary suspension of close-out netting rights for at least two reasons: first, to ensure that the proposed suspension power, if implemented, operates on the same basis across Europe (because applying to a common European framework for close-out netting) and secondly to strengthen the safeguard for close-out netting proposed in the Working Document (discussed in part 9 of our response below).

9. Safeguards in relation to the partial property transfer resolution power

Part 4H of the Working Document sets out proposals regarding safeguards for market counterparties against the exercise of the partial property transfer resolution power and relevant ancillary provisions.

In response to Questions 46a to 46d, our views are as follows:

(1) **Question 46a**: We agree that the classes of arrangement suggested in the section should be protected by the suggested safeguards in the case of partial property transfers.

Although our focus is principally on the impact of the partial property transfer power on derivatives transactions and related netting and collateral arrangements, we note that the protection of structured finance arrangements (which are not derivatives transactions, of course, but generally involve derivatives transactions for hedging and sometimes for structural purposes) has proven to be difficult under safeguards set out in subordinate legislation to the UK Banking Act 2009. Careful further work will be necessary in relation to structured finance arrangements to ensure that they are adequately protected.

(2) **Question 46b**. This is a very important question. We are strongly of the view that the European legislative proposal should <u>not</u> be limited to merely suggesting a set of outcomes. Instead, it should prescribe, at least in principle, (a) how that should be done and (b) the consequences if a transfer contravenes the safeguards.

Of course, some flexibility should be left to each EU Member State to ensure that the proposed safeguards (and, indeed, the rest of the resolution regime) are appropriately adapted to the general legal and regulatory framework governing the activities of financial firms in that EU Member State. <u>However, the remedy for a breach of a safeguard is absolutely crucial to legal certainty</u>. It is important, therefore, that there be a common and robust approach to the appropriate remedy across Europe. This means that this issue should not be left entirely to the individual EU Member States to determine.

If, for example, a resolution authority deliberately or, perhaps more likely, inadvertently breached the safeguard protecting the integrity of a netting agreement from "cherry-picking" by transferring some but not all transactions (or some, but not all, individual rights and liabilities under certain transactions) under a master agreement to a transferee while leaving others behind in the failing firm, then if the sole remedy for that were an administrative remedy under which an aggrieved creditor applied to the resolution authority to reverse the transfer or pay compensation, the close-out netting arrangement would have been effectively disrupted, possibly for weeks.[12]

While the creditor might eventually be restored (more or less) to the economic position it would have been in had the breach of the safeguard not occurred, there is no guarantee that this would be the case and it is highly likely that there would be significant period of time where the outcome of the aggrieved creditor's application for a remedy would be in doubt. Such a remedy would therefore fail to give the legal certainty necessary to obtain a robust legal opinion satisfying the requirements for recognition of close-out netting for regulatory capital purposes.

It is for this reason that the netting safeguard[13] under the UK Banking Act 2009 does not provide for an administrative remedy but instead provides that a netting agreement shall take effect in relation to all obligations covered by the netting agreement, notwithstanding any breach of the safeguard purporting to transfer some but not all of the rights and/or liabilities governed by the netting agreement.[14] The same remedy applies in relation to a set-off arrangement.[15]

In other words, the transferee takes any obligations received by way of transfer subject to the netting agreement or set-off arrangement. This is comparable to the general position of an assignee of a debt claim under English law, who takes the assignment subject to a contractual set-off previously agreed between the obligor of the debt claim and the assignor. More generally, this is an example of the principle *nemo dat quod non habet*, which of course is sometimes subject to exceptions but is otherwise a common feature of commercial law across the European Union.

(3) **Question 46c.** See our answer to Question 46a above.

(4) **Question 46d.** First, we assume that the reference to "non-related derivatives" in this question is intended to refer to arrangements which are <u>not</u> derivative transactions rather than to derivatives transactions that are, in some way, not "related" to other derivative transactions under the same master netting agreement. There is no reason in principle why there should be any restriction on the nature of the derivative transactions that may be included under a single master netting agreement. And it would be extremely difficult to define what

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12 See note 14 in relation to the UK administrative remedy for breach of the UK Safeguards Order (as defined in note 13).

13 Set out in The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 (the **UK Safeguards Order**).

14 Article 11 of the UK Safeguards Order sets out this remedy. By way of contrast, Article 12 sets out an administrative remedy for other breaches of the UK Safeguards Order by a partial property transfer order, but it was accepted by the UK authorities that this would not provide sufficient legal certainty in relation to netting agreements and set-off arrangements. It is worth noting that Article 12 provides for a period of up to 180 days (that is, six months) within which the resolution authority may consider, decide upon and, if so decided, effect a remedy under that provision.

15 In brief, the distinction between a netting agreement and a set-off arrangement is that the former involves provisions setting out the three stage process necessary for close-out netting, namely, (i) early termination of transactions, (ii) mark-to-market valuation of the terminated transactions and (iii) determination of the net balance due by one party to the other party. That third stage may be effected by a contractual set-off provision, but other legal approaches are possible (for example, a so-called "flawed asset" approach). Not every netting agreement therefore involves contractual set-off. Conversely, a set-off arrangement that does not provide for early termination and mark-to-market valuation of the terminated transactions would not be considered a netting agreement.

constitutes the "relation" of one derivative transaction to another derivative transaction beyond the fact that they are each entered into between the same two parties.

The ISDA Master Agreement, for example, may be used to govern any form of derivatives transaction that may be entered into between the parties, regardless of the underlying reference asset, price, index or other measure of value and regardless of whether such transactions are cash-settled or physically-settled.

Subject to the foregoing, we agree that it is legitimate to consider the appropriate material scope of this safeguard, just as it is appropriate to consider the appropriate material scope of a common European legal framework for netting, as discussed above at the end of part 8 of this response to the Working Document. We are doubtful, however, whether, apart from the exclusions from the netting safeguard already proposed in section H2 of Part 4 of the Working Document, there are any other types of transactions that need, for any policy reason, to be excluded from the scope of the netting safeguard.

If there is a suggestion that financial firms might seek to put service or supply contracts or other non-financial contracts under netting agreements in order to avoid the effect of the partial property transfer power, we think that the risk of this occurring is extremely low and, subject to more detailed consideration, we believe that any such potential abuse of the netting safeguard could probably be dealt with using existing regulatory powers.

In response to Question 47a, we believe that the safeguards for title transfer financial collateral arrangements and set-off and netting arrangements suggested in section H2 of Part 4 of the Working Document are broadly appropriate, as they relate to derivatives transactions under a master netting agreement, a related set-off arrangement (for example, a contractual set-off clause permitting a close-out amount due under a master agreement to be set off against a deposit or loan) and a related title transfer financial collateral arrangement.

We know that some respondents to the consultation have significant concerns about the nature and scope of some of the exclusions, and so it is clear that further consultation and dialogue with industry on those issues is important. We leave it to other respondents to raise those concerns to the extent that they do not relate to derivatives transactions.

We are grateful for the proposed clarification that the inclusion within a netting arrangement of rights or liabilities that are not protected by the safeguard will not affect the safeguard in relation to the otherwise protected rights and liabilities. This avoids an uncertainty that has sometimes arisen in the past in relation to netting legislation (sometimes referred to as "bad apple" risk), although this difficulty has normally been eliminated by legislative amendment, once it has been clearly identified.[16]

[16] For example, this risk appeared to arise (at least arguably) under the original drafting of the UK Safeguards Order, as in effect from 21 February 2009, which was the effective date of the UK Banking Act 2009, but the risk was eliminated by an amendment to the UK Safeguards Order that came into effect in July 2009.

We note that section H1 of Part 4 of the Working Document states that the proposed safeguard for netting should be subject to proposed temporary stay on early termination for the purpose of close-out netting. We have, of course, already commented on this, but clearly if such a power to suspend early termination is included within the resolution regime, then it should apply notwithstanding the safeguard, subject to the strict conditions we have already mentioned.

Foreign property and the safeguards

Section H1 of Part 4 raises once again the difficult issue of foreign property. The Working Document proposes that a transfer involving foreign property should not be considered a partial transfer and therefore should not be protected by the proposed netting and collateral safeguards. With respect, we submit that such an approach would be wrong and would create unnecessary legal uncertainty.

A netting agreement, for example, should be fully protected by the netting safeguard under a national resolution regime whether or not any right or liability under the netting agreement is governed by local or foreign law. This is the current approach under the netting legislation in the US, and it was the approach also taken by the UK when it implemented its own resolution regime under the UK Banking Act 2009 and the related netting safeguard set out in subordinate legislation.[17]

We realise, given the current lack of mutual recognition of statutory transfers under bank resolution regimes, that if a property transfer power were applied by a resolution authority to a netting agreement so that it were purportedly transferred as a whole to a bridge bank or other transferee, there is a risk that a court in a jurisdiction whose law governs some of those rights and liabilities might not recognise that transfer as legally effective.

While this issue can be addressed, as between EU Member States, by providing for mutual recognition as discussed in section G8 of the Working Document, the issue remains extant as between an EU Member State and a third country until such time as there is an international agreement between the EU Member State and that third country providing for mutual recognition. This risk currently therefore exists in relation to the US and UK resolution regimes. Nonetheless, it remains possible to obtain a sufficiently robust legal opinion in relation to netting and financial collateral against US and UK banks, respectively, because each legal opinion addresses the issues solely from the perspective of local law. For the time being, therefore, the issue is addressed as a practical matter in the manner described in the final paragraph of section G8 of the Working Document (just before Question Box 38). While this is not a perfect solution, there is currently no better one.

One approach, not adopted in the US or the UK, would simply be to exempt all foreign property, rights and liabilities from the property transfer resolution power. That would certainly address the issue, and would therefore be satisfactory from the point of view of our members. It may be considered, however, that such a rule would mean a failing firm

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17 See Article 3(4) of the UK Safeguards Order.

and its counterparty could effectively put a netting or collateral agreement beyond the reach of the property transfer resolution power by including a single foreign law governed transaction (or even just a single foreign law governed right or liability) under the netting or collateral agreement.

It might be that this would be done deliberately by the parties (although the motivation for doing so would not be obvious), but it seems equally, if not more, likely that this would occur inadvertently, given that cross-border financial agreements typically involve a range of rights and liabilities and it would be difficult, and also unduly constraining commercially, for the parties to ensure that all rights and liabilities under a master netting agreement and/or related financial collateral arrangement are governed by the law of the jurisdiction of the financial firm's resolution authority.[18] Indeed, it would be bad policy to craft a rule that would force such a result.

In response to Question 48, we believe that the proposed safeguards are appropriate.

10. The debt write-down resolution tool and power

As already noted above, the Working Document proposes the inclusion in the European financial firm resolution regime of a debt write-down resolution tool and power, often referred to as "bail-in". This is briefly mentioned on page 55 of the Working Document, where the international streams of work relating to this issue by the Financial Stability Board and the Basel Committee on Banking Supervision are also mentioned, but the proposals in this regard are principally set out in the first Annex to the Working Document.

We know that a number of respondents will be responding in detail in relation to the debt write-down proposals. Rather than attempting to answer each of the questions posed in the Annex, many of which are beyond the scope of this response, we focus first on some general aspects of the proposal and then on aspects with a particular potential impact on derivatives transactions and the derivatives market. We would be pleased to discuss these issues with the Commission in more detail and, of course, will study any eventual legislative proposal in this regard with close attention.

Our comments are as follows:

Necessity of international co-ordination on debt write-down

First, the Working Document mentions the necessity for the EU to take proper account of the international work being done on the issue of debt write-down as a resolution tool. Not only do we strongly endorse this, but we would go further and say that given the complexity of the issues and the danger of unintended consequences for the markets and, in particular, for financial stability, if such a power is not properly defined and circumscribed, this is not an issue on which Europe should get ahead of the international process.

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18 And, indeed, what law would be chosen for an agreement between financial firms located in different jurisdictions?

Complexity of the issues means that a legislative proposal should not be rushed

Secondly, the debt write-down proposal raises a number of complex and difficult legal issues, under the corporate, property, insolvency, restructuring and other commercial laws of each Member State. Crafting a common European approach will be particularly difficult given the diversity of legal regimes within the European Union. This task will be made still more complex by the potential interaction between these proposals and other international regulatory developments such as the Basel III work and the work on cross-border resolution of financial groups.

Among the many legal and regulatory issues that will need to be addressed are conflict of laws issues, inter-relationship between the bail-in regime and the insolvency law regimes for financial firms, applicable listing and securities exchange requirements and company law issues, a number of which are identified in the first Annex to the Working Document.[19] There are, of course, also issues as to the interaction between the debt write-down resolution tool and the other resolution tools, the interaction between the statutory and contractual approaches, change of control provisions in contractual documents and regulatory restrictions on investors (for example, whether a particular debt investor, which is itself a regulated entity, hold equity in a failing firm where the debt of the firm has been converted into equity). There will inevitably also be difficult tax issues for failing firms and investors. A number of these issues are, of course, acknowledged in the first Annex to the Working Document. Additional issues will no doubt be identified as work progresses at international and European levels on debt write-down.

Current proposed timetable for European legislation on debt write-down is unrealistic

In light of this and the necessity for international coordination on these issues, we have severe doubts regarding the current legislative timetable as it relates to the proposed debt write-down tool. If it is necessary to implement some form of European resolution regime within the timetable indicated in the Working Document, namely, a legislative proposal during the summer of this year on a common set of resolution tools and a framework for improved cooperation between national regulatory and resolution authorities, we would urge that such a proposal not include debt write-down unless and until the international work on these issues is much more advanced and many of the complex issues raised by the proposals have been more thoroughly considered and addressed.

Potential impact of the proposed debt write-down power on derivatives transactions

The proposed debt write-down power has the potential, broadly, to affect derivative transactions in at least two ways.

[19] A number of the potential legal and regulatory difficulties with statutory and contractual debt write-down in a resolution context are addressed in the Report of the International Bar Association on "Legal Issues in relation to Proposals for Bank 'Bail-In' Measures" published on 29 November 2010.

First, there is the question of whether the liabilities of a financial firm under a derivatives master agreement are a class of debt that should, as a policy matter, be subject to the debt write-down power and, if so, how in practice that could be achieved, given the variable nature of derivatives exposures, the question of valuation and the impact of any such write-down on transactions hedged by those derivatives transactions and on related financial collateral arrangements for such derivatives transactions.

From both a policy and a pragmatic perspective, based on the proposals as they currently stand, we are of the view that derivatives exposures, whether or not under a master agreement, are not an appropriate form of debt to make subject to the write-down power. Given that derivatives transactions normally form part of a bank's trading book, we consider that derivatives counterparties should be treated in the same manner as a bank's other trade creditors and excluded from the debt write-down resolution tool and power. Comparable arguments would suggest that securities repurchase (repo) agreements and securities lending agreements should be similarly excluded.

Secondly, there is the impact of the debt write-down proposals on derivatives transactions[20] that are written on debt that is or may be subject to a statutory or contractual bail-in provision. Rather than rehearsing here all of the possible issues, difficulties and uncertainties that this aspect of the proposal potentially raises for the derivatives market, given that the proposal is a moving target, for the reasons mentioned above, we would be pleased to discuss these issues with you in detail on a bilateral basis, particularly once there is greater clarity regarding the scope and detail of the debt write-down proposal.

The over-arching concern is that the scope, effect and consequences of a statutory and/or contractual debt write-down regime (and, it is likely, that any regime ultimately established will have both statutory and contractual elements, since these are potentially complementary, as noted in the first Annex to the Working Document and in the international discussions relating to debt write-down) should be certain and clear. Provided that is the case, market participants can then structure their debt-related derivatives transactions and related hedging arrangements with confidence.

We would be pleased to meet with you to continue our discussions with you regarding issues raised in or arising out of the Working Document. We look forward to receiving and will study with close attention the more detailed proposals contemplated by the Working Document that are due to appear during the course of this year.

[20] For example, bond forwards, bond options, credit default swaps and other credit derivatives written on the debt of a financial firm.

Please do not hesitate to contact either of the undersigned if we can provide further information about the privately negotiated derivatives market or other information that would assist the Commission's work in relation to financial firm recovery and resolution.

Yours faithfully

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