

HM Treasury Consultation Document

on

Major Operational Disruption

Set out below are some general comments, followed by some specific observations in relation to certain of the particular questions raised in the Condoc.

Annexed to this document is an example, to illustrate some of the points we wish to make.

General

Speed and certainty

Participants in the financial markets will want, as much as anything, to know where they stand as soon as possible.

Any procedure established by the Contingency Powers legislation needs, therefore, to be capable of being applied very rapidly.

There also needs to be a procedure for notifying interested parties promptly if it is **not** going to be applied.

As the Condoc acknowledges, co-ordination and consultation is critical, but could be problematic at the time. We assume that there is a separate, practical, exercise being conducted of ensuring that records are maintained of as many alternative methods as possible of contacting those who would need to be involved in consultation.

We also assume that there is one or more contingency planning groups in existence, even if only on a shadow basis.

International dimensions

Given the globalisation of the markets and the existence, for example, of global settlement institutions, we wonder how effective Contingency legislation by any single jurisdiction could be.

It would be interesting to know what other EU or major financial jurisdictions are doing.

The worst result would be a web of inconsistent legislative powers with no organised co-ordination process.

Nor is it clear to us that UK legislation to suspend contractual effects would be effective if the contract is governed by the laws of a jurisdiction other than England and Wales.

Similarly, if an English law contract requires performance in another jurisdiction, an English law suspensory provision may not be adequate.

Would Government action lead to inaction by the private sector?

It seems unlikely that the existence of the Contingency Powers would appreciably reduce the efforts made by participants in the financial markets to do what they can, both operationally and contractually, to prepare for a Contingency. At least in the case of regulated institutions, any perceived reluctance to plan adequately could presumably be addressed by regulatory influence.

Financial system contracts/obligations

The Condoc refers in various places to “financial system contracts” or “financial system obligations” (e.g., 4.23 and 6.1).

Whilst we can understand the reason for making a special case for the financial markets, it must be recognised that financial system transactions are often part of a chain which begins or ends outside them. Suspending the financial system obligation may simply shift the problem (or the consequences) to the non financial customer. The Example provides a potential illustration of this.

“Purely financial crises”

We understand the reasons for seeking to exclude the application of any Contingency legislation to the consequences of a purely financial crisis. There may, however, be difficulty in defining this clearly enough.

Intra day (“Herstatt”) issues

Particularly delicate issues could arise if the Contingency were to arise in the middle of a day, when some settlements or nettings had already taken place, at least on a provisional basis, or when (for example) payments in Euros had completed but corresponding payments in dollars had not. A number of the multilateral settlement systems have of course been established primarily to mitigate this sort of risk.

Suspension of all or part?

A contract may contain a number of different provisions. In particular, it may contain important but ancillary protective provisions such as covenants or information rights. It is not immediately clear that these should be suspended.

A particular category of provision which may deserve addressing is margin requirements. Given that liquidity may be constrained and that valuations may be impacted in the short term, there may be merit in at least suspending the consequences (in terms of default or termination triggers) of failure to provide margin.

Force Majeure/Frustration

It is suggested in the Condoc that these existing legal doctrines may provide some relief in the event of a major catastrophe.

We consider that it would not be prudent to put too much confidence that these concepts would provide a breathing space. These are notoriously difficult issues and, at least as a matter of English law, force majeure is ultimately a question of interpretation of the particular words used by two counterparties. The English courts, quite rightly, have been reluctant to create any general principles to exonerate people from their contractual commitments.

The example provides an illustration of a difficult case. The London branch of a German bank agreed to deliver Euros to A. Even assuming a force majeure provision in the contract, A might be able to resist a claim by G invoking force majeure by pointing out that the bank could have performed in Frankfurt. This argument might not ultimately succeed, but it illustrates the scope for uncertainty.

Chain effects

Again, this is best illustrated by the Example.

If the Contingency occurs, the bank may be off the hook (at least in terms of payment on the exact date), but A is still in breach and may be liable in damages to the vendor. Alternatively, his vendor may have termination rights.

- **Cross default**

One particular “chain effect” relates to cross default.

This is where A’s contract with B provides that, in addition to A’s other remedies, A may terminate/accelerate/declare B in default if B is in “breach” of B’s contract with C. Depending on the drafting of the cross default clause, A may have default rights even when C has decided not to take any action.

One concern we have is that a corporate borrower might become in default of his obligations to a third party because of the failure of a financial institution to perform its obligations to the corporate borrower.

We could see merit in a power to declare that third party rights to rely on defaults and cross defaults ultimately occasioned by the consequences of a Contingency should be suspended. Clearly, any such power should be framed so as to be no broader than absolutely necessary.

- **Consequential losses**

This again is a complex and in some ways uncertain area of the law, in England at least.

There might be merit in any Contingency legislation containing powers to ensure that affected institutions (as well as those impacted by their inability to perform) are not caught by claims of consequential losses.

- **Mitigation**

A question which may need to be addressed is whether participants should be under any obligation or pressure to find another way of performing.

Competitiveness of London as a financial and legal centre

There is continuing competitiveness between London and other financial centres (notably New York). One area where the “rivalry” manifests itself is in relation to anything which might constitute an area of legal uncertainty. It is desirable to avoid any legislation being capable of being characterised as allowing Government to undo or rewrite contracts (except in extreme circumstances). So this argues in favour of circumscribing the use of the powers or couching them as regulatory rather than political.

Legal opinions

If any Contingency legislation is introduced, thought will need to be given to how its potential application will be addressed in legal opinions, particularly with a view to avoiding alarmist conclusions being drawn.

SPECIFIC COMMENTS

Question 3(b)

Almost certainly there are exercises to be done. Presumably, the authorities will encourage this. Should new contractual formulations be devised to address contingencies, there will clearly be a role for the authorities in encouraging the adoption of the new formulations.

The pervasive use of master contracts may mean that new transactions would continue to be written under old style contracts (without the new formulations) even after the introduction of new formulations.

Question 3(c)

As already indicated, this is not necessarily just a market problem.

Clearly there is a significant and perhaps preponderant role for market based approaches, but these will never deal with every element of linked transactions.

Inevitably, the draftsman of contractual provisions will tend to frame any contractual suspensory provisions quite narrowly, so as to avoid giving participants the right to invoke them in unsuitable circumstances. This leads to the risk that the particular Contingency which occurs may not (or may arguably not) be covered.

Question 4(a)

We certainly consider it is worth carrying out the exercise of drafting new legislation to see what it would look like and how it would operate. We do not believe that market solutions could cover all potential problems, although we are prepared to

believe that, if there were a Contingency and no legislative solution, market participants would generally seek to work co-operatively to devise practical solutions.

Question 4(c)

As already indicated, apart from suspension provisions, we think it may be worth considering enabling provisions to limit the potential knock-on effects of inability to perform.

We express no views on the direction powers.

Procedure for Exercise (5(a))

Whilst there may be constitutional issues surrounding the triggering of the contingency powers by someone other than a government minister, one could see merits (particularly in terms of avoiding any suggestions of political interference) in the exercise being by FSA/BoE.

At the very least, we would see merit in a “double signatory” role, i.e., both regulator and government being seen to support the initiative.

Question 5(d)

This may need further thought, depending on the sort of power contemplated.

It seems to us that there are at least two possible approaches to the formulation of the powers. They are not necessarily exclusive of each other.

One would “target” the contract and its effect (for example by implying/imposing/extending a force majeure provision). In principle, it would be possible for such a provision to apply to any contract governed by English law (irrespective of place of performance).

Another would be to target the parties themselves, either by giving the performing party a moratorium or restraining the beneficiaries. Clearly, such an approach would have to be limited to those in, or actions in, the UK.

Question 5 generally

In principle if contingency legislation is thought desirable, it should, at least in theory, be capable of applying to the broadest range of contingencies.

Retail obligations (6(b))

This is clearly a less important issue in systemic terms. One possibility might be to extend the suspension to any payment (including retail) which would otherwise have been made using a payment system itself affected by the suspension (and by the circumstances giving rise to the suspension) and to exclude any default or penalty provisions.

We see no reason at this stage to exclude all retail transactions. If for example the legislation would remove the requirement to pay penalty/default rates of interest, there seem no policy reason to excuse banks but not (say) credit card holders.

We share the concern hinted at in 6.13 about the difficulty of distinguishing readily between wholesale and retail.

Drawing the distinction could in any event be difficult.

Conveyancing transactions may need to be protected, especially any where time is of the essence of the contract.

Question 6(d)

Whilst we agree that insurance contracts are generally less time sensitive, there are in the wholesale markets contracts to which insurers are party which are time sensitive.

Given that there is a degree of uncertainty as to what constitutes an insurance contract, excluding them could simply lead to litigation as to the status of a particular transaction.

“Performance in the UK” (6(f))

We draw your attention to the need to understand, and define clearly, what is meant by this. A payment by SWIFT, or a payment settled by an international netting system, may involve steps in a number of jurisdictions including the UK.

It may be necessary to adopt a test of initiation of the action in the UK or of one or more steps taking place there.

Question 6(h)

Logically, suspension should only apply to the particular obligations rendered impossible or impracticable as a result of the Contingency.

Question 6(i)

Whilst it would make sense to draft any Contingency Powers legislation in as broad a fashion as possible (to avoid the situation where the Contingency which occurs is not covered), it should also contain on its face a clear requirement that any action taken pursuant to it should be as focussed (and time limited) as possible.

Question 6(j)

We have made some observations in our general comments above. There is a danger that the risk is simply shifted to another commercial counterparty.

Question 6(k)

Some thought may be needed about the process of bringing any suspension to an end, with a view to it being a gradual process. If, for example, a large build up of foreign

currency purchases had to be made on a single day at the end of the suspension, this could impact on exchange rates.

Question 6(l)

The idea of a power to suspend, coupled with a power to mitigate adverse consequential effects, is sensible provided that its existence does not prove alarmist and that there is confidence that it would only be used in an extreme situation but that in such a situation it could be used effectively.

Question 7(a)

We agree that the powers conferred by the Banking & Financial Dealings Act 1971 are largely irrelevant to the issues addressed in the Condoc.

Other points

A particular point which might be worth addressing is expiry dates in guarantees or bonds.

Freshfields (PJR)
24.4.2003

Annex

(Example)

An English industrial company, A, agrees to purchase from P a business in Continental Europe. Part of the purchase price (which is denominated in Euros) is deferred. A enters into a forward foreign currency purchase contract with the London branch of a German Bank (G) for G to deliver the requisite Euro amount on the due date.

Part of the purchase price payable on completion is funded by a loan to A by a syndicate of banks. The loan agreement, which is a bespoke document negotiated between the banks and A, contains default clauses including a cross default if A breaches the terms of its purchase agreement. On the day when the deferred purchase price falls due¹, a Contingency occurs in the London Market (but does not affect other Euro markets). The London branch of G is unable to cause the delivery of Euros and so A defaults on its obligation to P. This triggers a cross default under A's loan agreement.

¹ Technically, it may be that this should be the day on which London would have to give instructions for a Euro payment for value the due date.