LEGAL OPINION

from the Legal High Committee for Financial Markets of Paris (HCJP) to the French Prudential Supervisory and Resolution Authority (ACPR) further to its request of 19 October 2015

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On 19 October 2015, the ACPR has sought the opinion of the HCJP in relation to the extraterritorial contractual recognition of its power to suspend early termination rights of derivatives, securities lending and repurchase agreements. A comprehensive memorandum from the ACPR's Resolution Directorate was attached to such request. The reader is referred to such memorandum for further details on the background and issues surrounding the request. Pursuant to the request the HCJP was asked to answer two questions, which have later been supplemented by a third one.

After consulting (in restricted session) the ACPR, the French Treasury, the French Financial Markets Authority (AMF) and a number of industry bodies representing both the interests of institutions subject to resolution and the buy-side (notably, the French Banking Federation and the French Financial Management Association (*Association française de la gestion financière*)), the HCJP adopted the following opinion.

I. First question: What are the advantages/disadvantages of the various possible types of rules for promoting such extraterritorial contractual recognition, i.e. a law, an administrative order, a regulatory rule or interpretation from the resolution authority (bearing in mind that such promoting rule should be binding not only on GSIBs but also on other banks, and indirectly their (buy side) counterparties)?

In our opinion, the question requires an examination of the justifications, the possible legal bases and the desirability of the requirement that ACPR intends to so impose.

Re justifications. For reference, Article 71 of the Directive of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms (BRRD)[1] provides that Member States must ensure that resolution authorities have the power to suspend the rights of any party to terminate a contract with an institution under resolution throughout a period that runs until midnight at the end of the business day following the initiation of the procedure[2]. This power is usually referred to on the markets as a «stay».

The difficulty faced by the ACPR in assessing the «resolvability» of French institutions lies in the absence of any international instrument ensuring the extraterritorial and immediate effect of such a stay outside the Union. Since resolution powers are of an administrative nature, none of the currently applicable treaties dealing with mutual cross border recognition of court judgments or arbitral awards is applicable. There are therefore serious concerns on whether any third country

[1] Article 71 of the BRRD is transposed into French law in Article L.613-56-4 of the Monetary and Financial Code, as amended by the Ordinance of 20 August 2015.

[2] The BRRD extends this stipulation to the termination rights of any party to a contract with a subsidiary of such an institution, under certain conditions.

jurisdiction would recognise and give effect to a stay decided by the ACPR. We obviously do not ignore that, under the principles of comity – i.e. courtesy between States – such a court might decide to give effect to such a stay. But in practice the application of the rules of comity often reveals a difficult issue and remains subject to numerous conditions, among which is compliance of such a stay with public order rules of the relevant jurisdiction where recognition is sought.

Having said so, we also note that the concern expressed by the ACPR does not appear to be identical on all markets concerned by the request for opinion. On the derivatives markets, we understand that most dealers, which constitute the main participants of such markets, have already to a large extent amended their contractual documentation to ensure such extraterritorial effect to a decision of stay, mainly by way of adhesion to the 2014 Resolution Stay Protocol published by the International Swaps and Derivatives Association (ISDA). On the other hand, we gather that amending existing documentation on the securities lending and repos markets, proves to be more difficult. The reason for this difference is said to be that such later transactions are usually entered into with a much larger number of counterparties types (*i.e.* not only dealers or financial institutions, but funds managers, insurance companies or unregulated buy side counterparties). Such buy side counterparties face a number of legal challenges for agreeing to amend their existing contractual documentation and waiving their rights to early termination the relevant agreements. Such legal challenges vary from one counterparty type to another. But the first challenge seems to be grounded on the fact that such requirement to amend contractual documentation is not expressly stated in the BRRD. Indeed, in a sharp contrast to Article 55 of the BRRD relating to the «bail-in», Article 71 which relates to the «stay» does not expressly provide Member States to require supervised institutions to include in their contracts, when governed by the law of a third country, such a contractual provision ensuring the precedence of stay decisions taken by a resolution authority of the Union. A second legal challenge lies in the possible conflict of such an amendment with other mandatory requirements of some other sector / specific legislations, including the European legislation governing the asset management industry.

It hence appears that all relevant banking regulators are calling for the adoption of a rule unambiguously granting them the effective power to suspend termination rights of any party to a contract with an institution under resolution (the «Rule»). This will enable resolution authorities to ensure the resolvability of supervised institutions and will provide the institutions in question with a basis to justify requests to their counterparties. As for buy-side participants, the rule would give them a solid basis for contractual acceptance of the stay likely to protect them from any action for damages for breach of their fiduciary obligations.

Re possible legal bases for such Rule. The above mentioned different wording of Articles 55 and 71 of the BRRD raises a question – which precedes the question of which status / nature the Rule should have – and that is whether such a rule is at all legally possible.

Indeed, the issue appears to us not being whether the ACPR has the power to suspend termination rights – this is a given and, pursuant to the law of any Member State, any conflicting clause

should be considered null and void. But rather, whether the ACPR can restrict the contractual freedom of institutions under its supervision – and that of their counterparties –to ensure that its administrative powers / decisions are in practice given extraterritorial effect, *i.e.* in situations where, from a strict legal standpoint, no such effectiveness is currently ensured or guaranteed by any treaty.

The HCJP believes that such a Rule should be legally possible. Such possibility is supported by a number of solid legal arguments.

First, while Article 71 of the BRRD is not drafted the same as Article 55, it nevertheless requires France to ensure that the ACPR has the power to suspend the termination rights of «*any party*» to «*a contract*» entered into with an institution under resolution. In our opinion, the generality of such terms commands to read Article 71 as being not limited to counterparties established within the Union, or to contracts governed by the law of one Member State, only. Within our hierarchy of legal norms, the requirement set forth by Article 71 of BRRD ranks higher than law. Such provisions must therefore be implemented in France and being given effect. We note that that other Member States – in particular the United Kingdom and Germany – have recently taken an similar approach and have adopted, on the same legal basis of Article 71, rules allowing their relevant resolution authorities to require institutions under their supervision to amend their contractual documentation so that to include a provision ensuring precedence of a their power to declare a stay.

From a strictly functional point of view, while BRRD does not provide any specific sanctions for breaching any of its requirements, it gives resolution authorities in the Union the power to assess the «resolvability» of institutions under their supervision. In the context of such an assessment, the ACPR is therefore authorised to consider that the ineffectiveness of its stay decisions vis-a-vis non-European counterparties under contracts governed by non-Union law, is a predicament that legitimately prevents the ACPR from considering the relevant institution as being properly «resolvable». In practice, for French institutions, which are among the most international operators in the banking market, scenarios in which a stay would be so ineffective in practice, are far from being theoretical. This would, for instance, be the case for any contract entered into by such French institutions governed by the law of the State of New York or the law of any State of Asia, counting now major financial places.

Finally, BRRD is a minimum harmonisation Directive. This means that it leaves Member States the freedom, not only to grant their resolution authorities with more powers that those provided in the Directive, but also, to decide, while implementing the Directive, the legal means through which – each, depending of the constraints of its own legal domestic framework –the Directive's objectives should be met and resolution measures being effective.

On such basis, and considering the above discussed legal issues raised by the buy side, considering also the importance of having a proper and effective resolution regulation for our financial

institutions, considering further the importance for the financial markets and, more generally, the stability of our economy, of having orderly and efficiently resolvable French institutions, and finally considering the provisions of Article 71 of BRRD, the HCJP considers that such the Rule is not only legitimate but legally possible.

Having said so, the HCJP acknowledges that such a Rule would amount to a limitation of the principle of contractual freedom. Pursuant to the provisions of Article 34 of the French Constitution, any issue relating to the principles of civil and commercial obligations may only be dealt with by mean of a law voted in Parliament. This constitutional principle is confirmed by the consistent doctrine of the French Constitutional Council which, while accepting that contractual freedom may suffer certain «*limitations linked to constitutional requirements or requirements justified by the general interest*», requests such limitations not to have a «*disproportionately adverse effect given the objective pursued*». The Constitutional Council confirms that the power to restrict the principle of contractual freedom should exclusively reserved to the Parliament alone (cf. 14 May 2012, *Association Temps de Vie*, no. 2012-242 QPC, paragraph 6; 13 June 2013, no. 2013-672 DC, paragraph 6). In a similar way, the consistent doctrine of the Council of State considers that «*only legislative provisions may, in certain circumstances, limit the principle of contractual freedom*» (cf. 5 May 2010, M.A. and *Société* ICD-Vie, no. 307089). For these reasons, the HCJP believes that the Rule could only take the form of a law voted by the French Parliament.

II. Second question: What should be the scope of such a rule (which contracts, which covered entities, which exemptions, in light notably of similar rules enacted by other Member States)?

This question is about the material and personal scopes of the Rule.

Re its material scope. Directive 2001/24/EC of 4 April 2001 on the reorganisation and winding up of credit institutions provides that decisions relating to the reorganisation and the winding up immediately take effect in all Member States. The BRRD has amended the winding up Directive to add resolution measures to the list of «reorganisation measures». As a result, the beginning of any resolution procedure shall immediately be effective throughout the Union (cf. second paragraph of Article 3.2 of the winding up Directive). However, the first paragraph of the same Article 3.2 provides that: «*The reorganisation measures shall be applied in accordance with the laws, regulations and procedures applicable in the home Member State, unless otherwise provided in this Directive*». And Article 25 of the winding up Directive then provides that: «*Without prejudice to Articles 68 and 71 of [BRRD], netting agreements shall be governed solely by the law of the contract which governs such agreements*». It is therefore pursuant to the combined provisions of the winding up Directive, on the one hand, and of Article 71 of BRRD, on the other hand, that the impacts of a resolution proceeding are to be determined in relation to netting arrangements. Pursuant thereto Member States are required to give full effect to a stay issued by any resolution authority of any Member State, within the conditions provided by BRRD.

On such basis, and assuming that the above mentioned two EU Directives have been properly implemented in all Member States, the HCJP considers that the provisions of Article 71 of the BRRD are immediately applicable in all countries within the Union. In other words, there is no need to provide the ACPR with any special additional mean or legal tool to ensure, within this scope, the efficiency of any stay issued by it. Its decisions to suspend termination rights shall be effective vis-a-vis any buy-side counterparties established in the Union and agreements governed by the laws of a Union Member State.

Furthermore, providing any additional mean or legal tool dealing with some Member States only (e.g. on the basis of whether they are or not members of the European Monetary Union) does not seem possible to the HCJP. This would constitute an unjustified and irrelevant discrimination among Member States.

Finally, the HCJP recommends that the scope of the Rule does not extend beyond «financial contracts» within the meaning of paragraphs (a) to (d) of Article 2(1)(100) of the BRRD, including, for the sake of clarity, such contracts entered into by subsidiaries of the relevant institutions, where conditions set forth in Article 71(2) of the BRRD are met[3].

Re its personal scope. The question arises as to whether the Rule should create obligations not only on institutions subject to BRRD, but also on buy side or other entities. This is admittedly only a technical issue. Indeed, in practice, submitting all institutions to an obligation to amend their contractual documentation, including that entered into with the buy side, should produce identical results whether the buy side itself is or not submitted to such an obligation when trading with one of such relevant institutions. However, from a legal standpoint, the issue warrants attention. For the same reasons as those referred to above in respect of the constitutionality review and compliance with the principle of proportionality, insofar as the purpose of the Rule is to ensure the effectiveness of an administrative decision that relates solely to supervised institutions, the HCJP expresses concerns on whether a law could goes beyond limiting the sole contractual freedom of such supervised institutions. The HCJP therefore recommend that the personal scope of the Rule is limited to such legal entities falling with the scope of BRRD.

Similarly, the HCJP has examined the issue of whether the Rule should go as far as to place a general prohibition upon supervised institutions on guaranteeing the obligations of their subsidiaries under any contracts which, assuming the conditions of Article 71(2) are met, would not contain an express recognition of the effectiveness of a stay. Based on the same reasoning as that set out above, the HCJP considers that the desired result can, in practice, be achieved without any such general prohibition, and thus does not recommend to provide for such a general prohibition.

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[3] *For reference, Article 71(2) of the BRRD requires that stays issued by resolution authorities apply not only to contracts entered into by supervised institutions, but also to those entered into by their subsidiaries (i) if the institution guarantees them, and (ii) if the termination rights laid down in the contract in question are based solely on the insolvency or financial position of the institution concerned.*

Re the sanction. Since none of the legislation being drawn up in other Member States on this matter appears to provide for such, and since the BRRD lays down no obligations in the matter, the HCJP recommends that the Rule is not accompanied by any sanction, other than the possibility for the ACPR, in its sovereign assessment of an institution's situation, to consider that non-compliance with the Rule has an adverse effect on the assessment of its resolvability.

As has been done in other areas of law, the HCJP recommends that the Rule expressly excludes the possibility that failure to comply with the requirements may render the relevant contracts null and void.

Re the effective date of the Rule. The HCJP recommends that the Rule enters into force at a date that will later be set by an administrative decree. We understand that, at this stage, the scheduled effective date of the United Kingdom regulation is 1 March 2016 for GSIBs and 1 January 2017 for other credit institutions and investment firms. The HCJP recommends to avoid proceeding any faster than our neighbours on this issue, and that we also adopt a phased implementation approach, depending on the legal status of supervised institutions.

The referral to an administrative decree to set the effective date of the Rule will need to be worded carefully and in a sufficiently precise and controlled manner, to avoid the Rule itself being as a result deemed of an administrative nature, as opposed to a law.

III. Additional question: Could the Rule potentially be extended to other provisions of the BRRD?

It would be advisable to study the appropriateness of extending the scope of the Rule to Articles 69 and 70 of the BRRD, which provide for the suspension of payment obligations and the enforcement of security interests, as well as Article 68 of the BRRD, which prohibits the counterparties of a supervised institution from terminating a contract with that institution (and, in some cases, its subsidiaries) solely on the basis of a crisis prevention or crisis management measure, with any conflicting clause being considered null and void.

With respect to contracts governed by the laws of a third country, the United Kingdom has adopted a broad rule covering such other provisions of BRRD. Such broad rule, save in limited cases, provides that supervised institutions may only enter into or amend a contract governed by the laws of a third country if, under the terms of that contract, the counterparty has termination and security realisation rights equivalent to those it would enjoy if the contract were subject to United Kingdom law. The ISDA protocol also covers these other provisions of BRRD, at least in respect of crisis management measures.

Although not expressly laid down in the BRRD, such an extension to such other provisions of BRRD appears, on the face of it, to be allowed by the fact that BRRD is a minimum harmonisation Directive, and should facilitate the resolvability of institutions by increasing the effectiveness of

measures that would be adopted by resolution authorities vis-a-vis counterparties whose contracts are governed to foreign law, while reducing the difficulties for the industry that might result from a difference in scope between the Rule and the provisions of the ISDA protocol.

However, further work is required on this issue to establish the terms of any such extension, its real effectiveness and any potential counter-productive effects.

In general terms, the HCJP recommends that care be taken to ensure that, in relation to all issues discussed in this opinion, French institutions are in no way subject to more stringent obligations than those applicable to their competitors in the Union's other two main financial markets, nor being required to comply with any obligations in advance to their competitors. As regards other Member States, the possibility that some do not adopt similar rule – thus encouraging buy-side counterparties to give preference to dealing with institutions domiciled in those States – cannot be ruled out. While this risk appears more moderate in respect of those Member States whose financial markets are not as developed as those mentioned above, this concern should nevertheless encourage the French Treasury, in future discussions on the revision of the BRRD, to support a proposed clarification of this question in the Level 1. In the same vein, the French Financial Management Association has drawn the HCJP's attention to the importance, when the BRRD is revised, of clarifying the relationship between the provisions of Articles 68 and 71 of the BRRD and those of the European UCITS Directives requiring any derivative entered into by a UCITS to be, at the initiative of that UCITS, be terminated, liquidated or closed out «at any time» and at fair value.

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