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KEY POINTS

- Contracts involving only the payment of differences (and not delivery) are wagers.
- In accordance with Lord Mansfield's "equal ignorance or equal knowledge" concept, for one party secretly to manipulate the "uncertainty" at the root of any wager is clearly not acceptable.
- The statutes contain no statement that the common law of wagering is altered, replaced or superseded.
- Enforcing this well-established principle would do much to benefit the financial markets generally.

Spotlight

Author Professor Julian Roberts

Swaps, betting and the law

In this article Professor Julian Roberts finds an answer in the common law that could offer redress to buyers of loss-inducing "hedging swaps".

Derivatives play a central role in the modern financial markets. Although, in the hands of the unwary, they can lead to ruinous losses, provisions exist to limit such dangers. Principally, this is done by regulating the duties of originators towards their more vulnerable customers. The current Financial Conduct Authority (FCA)-sponsored review of interest rate hedging products (IRHPs) is an aspect of this regulatory intervention.

It is apparent, however, that administrative regulation can only go so far. The FCA review is guided by a generalised concern for the public's confidence in the retail market rather than by any clear legal principles. The banks – who are taxed with carrying out the individual reviews themselves – have felt comfortable taking a restrictive view of the review's terms.

Many buyers of loss-inducing hedging swaps have, as a result, been denied redress, and the FCA review has been followed by a penumbra of litigation.

Two main difficulties face intending litigants. One is that because the rules for marketing financial services are essentially administrative, they cannot, as a matter of principle, be invoked in a private damages action for breach of statutory duty. Parliament did create a right of action for certain "private persons", and this can also extend to corporates, but only as long as the disputed derivative agreement was not entered "in the course of business of any kind" (Financial Services and Markets Act (FSMA) 2000, s 150; SI 2001/2256 r 3(1)(b)). So far, the courts have always found that agreements were entered in the course of business (see eg *Grant Estates v RBS* [2012] ScotCS CSOH_133 (Scottish Court of Session 2012)).

The second difficulty is that almost all IRHP contracts were sold subject to extensive exclusion clauses. These throw upon the customer the entire burden of deciding whether a financial product is suitable. The English courts' concern for legal certainty has, by and large, led them always to uphold exclusion clauses of this sort (see eg *Springwell Navigation v JP Morgan Chase CA* [2010] EWCA Civ 1221).

THE *NEXTIA* CASE

In a recent case, however, the claimant has attempted to take the issue back to first legal principles (*Nextia Properties Ltd v Royal Bank of Scotland* [2014] EWCA Civ 740).

The facts of this case were that Nextia, a property developer, bought from the defendants a five-year interest rate swap as a hedge, in order to "fix" the rate payable on its loans. Unfortunately, however, the loans themselves all had much shorter maturities. When the defendants refused to renew them except at significantly higher rates of interest, Nextia not only lost on the swap (because interest rates fell), but also had to pay more on the loans. The "hedge" thus failed to materialise, instead becoming a serious burden.

Initial market value and risk

It was accepted that, on signature, the swap had a substantial market value to the benefit of the defendants. The market value of a derivative is based on the expected future cash flow under the deal. Although derived from statistical techniques, this value is not theoretical, but returns a price at which the instrument can be traded in the market. It forms the basis, *inter alia*, for calculating the "break costs" charged to customers who wish to exit before maturity.

As one is dealing with statistical expectations, the actual outcome will almost certainly be different. However, market value is not a "forecast", it is an empirical valuation elicited from present market data. A non-zero market value indicates that – given current expectations – the chances have shifted to the benefit of one side. The higher the value, the more extensive the shift.

Market value varies continuously throughout the life of the deal. At inception, market value will be zero if the expected cash-flow on both sides is the same; in that case the deal is described as "fair". But, of course, the risks of the instrument can be shifted so that the expected cash-flow is higher on one side. In effect, the value to the party which is "in the money" is directly proportional to the risk borne by the party which is "out of the money".

It was not disputed that Nextia was unaware of the swap's risks having been structured to its disadvantage.

The swap "not a wager"

On this basis, Nextia argued two points of law. First, the interest rate swap was a wagering contract. Second, as a wagering contract, it was subject to the incidents of such contracts, which included an interdict on one side secretly improving its own chances of winning at the expense of the other.

On an application by the defendants to strike out under CPR 24, the court at first instance (HHJ Behrens) held, on the authority of *Morgan Grenfell v Welwyn* (QBD, AER [1995] 1 (QBD 1993)) that the disputed swap was not a wagering contract. The judge said:

> "I do not accept that this was a wagering contract. It is excluded from being a wager by s 10 of the Gambling Act. Furthermore it is plain that both parties intended that the Swap would act as a hedge against increased interest rates for the five-year

> period that Mr Flavin envisaged that he would have outstanding loans of £2 million. As is made clear in Morgan Grenfell interest rate swaps are not usually treated as wagers. There is no reason to do so in this case." (para 74)

He also said that even if the swap had been a wager, there was no basis for implying a term that it was "fair", ie with a zero initial market value:

> "To my mind it would be contrary to normal expectations to imply such a term. NatWest is a commercial organisation offering a service. It would expect to cover its costs and make a profit. If the Day 1 MTM was zero it would not do either." (para 76)

THE COURT OF APPEAL

On an application for leave to appeal, Nextia pressed the point that contracts for differences, at common law, are invariably wagers. To the extent that he departed from this position, the judge in *Morgan Grenfell* had been at odds with higher authority. It should not be forgotten that Lord Goff, in the later case of *Westdeutsche v Islington LBC* [1996] 2 All ER 961, 961j (HL 1996), reiterated that interest rate swaps are, in law, wagers.

In the oral hearing, the Court of Appeal agreed with Nextia that the swap would indeed have been a wager at common law, and that it would not have conformed to the requirements thereby imposed. Nonetheless, said Vos LJ, it was plain that the common law had been superseded by statute. Financial "wagers" such as the swap would now be governed by a new regime contained in the financial services legislation of 1986 and 2000, and in the Gambling Act 2005. He said:

> "Those pieces of legislation have, as it seems to me, established an entirely new and separate regime for the regulation of financial contracts. The fact that a contract for differences of the kind that is in issue in this case would have been regarded as a wagering contract at common law with all of the consequences that might flow from that must, as it seems to me, have been superseded by the modern legislation and in particular by ss 10 and 335 of the Gambling Act 2005." (para 22)

Thus, although Vos LJ refused permission to appeal, he adopted an entirely different tack from the High Court: in his view, at common law swaps were indeed wagers, and it was only in the recent past, following statutory reform, that they had ceased to be so.

Procedurally, this decision is questionable. It rests on the premise that the common law has been altered by statute – something which, as every law student knows, confronts the venerable presumption that no statute alters the common law unless it says so in clear terms. It is, of course, possible to rebut such a presumption, but the burden of doing so would in this case have lain on the defendants, who, however, had said nothing about it at the strike-out stage and were not represented in the permission hearing.

Judgments in applications for permission to appeal may not be cited as authorities (*Practice Direction (Citation of Authorities)* [2001] 1 WLR 1001). Nonetheless Vos LJ's argument leaves the law in a rather uncertain state. As the defendants pointed out at trial, legal opinion has generally assumed (despite Lord Goff's comment) that *Morgan Grenfell* was correct, and that swaps, at least in the banking context, are – at common law – not wagers. In the light of Vos LJ's judgment, this would seem, at least, to need revisiting.

WAGER OR COMMERCIAL CONTRACT? "BOTH PARTIES" TEST

The background to these arguments, in summary, is as follows. In *Morgan Grenfell*, Hobhouse J seems to have approached the matter on the footing that "wagers" were on principle suspect. If, on the other hand, a deal had a "commercial" purpose – such as hedging a risk – moral reservations were clearly misplaced. So even if a deal could, in itself, be used for speculation, it was only a wager *if both parties intended this*. The test for "wagering", according to Hobhouse J, was therefore a subjective one.

However, as Lord Goff evidently noticed, this is a misreading of the authorities. English law, unlike, say, the civil law tradition, is morally neutral with regard to wagers. It invests them with certain structural characteristics (set out, classically, in *Carlill v Carbolic Smoke Ball Company* [1892] QBD 484 (QBD 1892)), and possesses a clear objective test for distinguishing wagers from other superficially similar contracts.

Superficially similar contracts: futures and CFDs

The "superficially similar" contracts in question are futures on the one hand, and "contracts for differences" (CFDs) on the other. The difference can be illustrated in commodities deals. For example, A agrees on 14 February to supply B with 1,000 tons of wheat for delivery on 10 August, at a price of $292 per ton. By 10 August, as a result of disturbances in the Ukraine, the price has risen to $330. A delivers and receives $292,000, which represents a loss of $38,000 with respect to what she might otherwise have made on the spot market. B sells onwards on the spot market for $330,000, making a profit of $38,000. This contract is called a "futures" contract.

The same economic effect – loss to A, profit to B – can be achieved without delivery. In such a contract, A and B would, on 14 February "fix" a price, and on maturity (10 August), instead of delivery, the parties would merely make a payment reflecting the difference in price between the price fixed in February and the current spot price. In this example, A would pay B $38,000. This contract is a "contract for differences".

The same two possibilities arise in many areas of the market. Interest rates, for example, can be the subject of a forward rate agreement (the loan is delivered at a later date at a previously agreed "fixed" rate), or a swap (where only differences are paid). The former is a futures contract, the latter is a CFD.

The delivery test

Although these two types of contract are indeed superficially similar, English law makes a fundamental distinction between them. Contracts involving delivery, such as futures, are, in the eyes of the law, "real" commercial contracts of exchange. Contracts involving only the payment of differences are wagers. Both can be used for "speculation" and other morally suspect purposes, but that is irrelevant. The test for distinguishing the two is simple: is the underlying property to be delivered? If so, it is a "real" commercial contract. If not, it is a contract for differences and thus invariably a wager.

There is only one situation in which a subjective test, as to the intentions of both parties, is applied, and that is where suspicion arises that a deal which on its face provides for delivery is accompanied by a secret intention to settle by the payment of differences only. Such "colourable" contracts were the subject of much litigation in the Victorian era: because wagers were at that time unenforceable, losers could try to avoid obligations under futures contracts by claiming that both parties never, in reality, intended to deliver (see eg *Thacker v Hardy* (1878) AC 685 (CA 1878)). That, however, is the only role for the "both parties" test.

This remains the case. *City Index* reiterates that the test for distinguishing between wagering and other contracts is delivery. As Leggatt LJ said:

> "Although before the 1986 Act came into force, contracts for differences were void, other contracts which are superficially similar were not. These were contracts entered into for a commercial purpose, such as hedging. Such contracts may result in no more than the payment of a difference. But because they were made for a commercial purpose, they are not void as wagering contracts. *That in practice is determined by whether the parties intended that any stock or commodity or other property should be delivered, by reference to which the contract was made. So in para 9 of Sch 1 [of FSA 1986] the note declares:*
>
> 'This paragraph does not apply where the parties intend that the profit is to be obtained or the loss avoided by taking delivery of any property to which the contract relates.'
>
> *"From this it follows that (a) delivery of property is made the test for distinguishing between a commercial contract and a contract for differences*, (b) the intention of both parties is made relevant, and (c) the obtaining of profit is equated with securing it." (per Leggatt LJ at 190d – *author's emphasis*)

(It is significant to notice that when Hobhouse J quoted this passage in *Morgan Grenfell*, he omitted all the words italicised.)

Swaps are CFDs. On a correct reading of binding authority, therefore, swaps must, at common law, invariably be wagers.

THE STRUCTURE OF WAGERING CONTRACTS

Wagers, in English common law, are distinct sorts of contract. The accepted authority on their structure is contained in *Carlill*:

> "A wagering contract is one by which two persons, professing to hold opposite views touching the issue of a future uncertain event, mutually agree that, dependent upon the determination of that event, one shall win from the other, and that other shall pay or hand over to him, a sum of money or other stake; neither of the contracting parties having any other interest in that contract than the sum or stake he will so win or lose, there being no other real consideration for the making of such contract by either of the parties. It is essential to a wagering contract that each party may under it either win or lose, whether he will win or lose being dependent on the issue of the event, and, therefore, remaining uncertain until that issue is known." (per Hawkins J at 490)

Three things emerge from this definition. The first is that no "real consideration" flows under a wagering contract. In a wager, the only "consideration" is the mutual agreement to be bound by the outcome of a future event. Winning or losing itself is no more than a zero-sum transfer, and not to be mistaken for the consideration flowing under a commercial contract, where disparate items are exchanged and both participants benefit. This is logically equivalent to the "delivery" test we have just considered.

The second point is that the parties do not have any "interest" in the contract beyond the money won or lost. This distinguishes wagers from contracts of insurance, which are characterised by the existence of "insurable interest". Hedging swaps might well be regarded as insurance. However, this would involve additional burdens for any bank selling hedging instruments, and (as, indeed, in the *Nextia* case) they have tended to shy away from the suggestion.

Equal ignorance: the uncertainty principle

The third point emerging from the *Carlill* definition is that the future event wagered upon must be "uncertain". This obviously excludes bets on events where one party has the power of determining the wager in his own favour (*Fisher v Waltham* (1843) 114 ER 1132 (1843)). As expressed by Lord Mansfield, uncertainty also covers a situation where one party has privileged knowledge of the "uncertain" event, with the consequence that the uncertainty is not "equal" as between the parties and there is no longer a position of "equal knowledge or equal ignorance":

> "The contract is equal between the parties; they have each of them equal knowledge or equal ignorance; and it is concerning an event which, reasoning by the rules of predestination, is to be sure so far certain, that it must be as it should afterwards happen to be. But it is a future event equally uncertain to the parties (*Jones v Randall* (1774) 98 ER (KB 1774))."

Whether or not privileged but undisclosed knowledge on its own violates this requirement is perhaps an open question. At all events, though, for one party secretly to manipulate the "uncertainty" at the root of any wager is clearly not acceptable. This must be the case when risks and chances of a financial derivative are shifted by one party without disclosing the fact to the other.

Equal chance

Related to the principle of uncertainty is that of equal chance, which requires that "the chances are equally favourable to all participants" (Gambling Act 2005, s 8).

Equal chance is expressed by the

Spotlight

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Victorian commentator Stutfield as follows (G Herbert Stutfield, *The law relating to betting time-bargains and gaming*, 3rd ed. (London, 1892)):

> "Each event or contingency must, of course, be uncertain, or, at all events, unknown to the parties, that is, it represents a chance, and where the chances are agreed to be uneven the inequality is represented by odds." (p 34)

To a degree, this represents a position now superseded by modern gambling legislation, which does permit wagers in which the inequality of chance is *not* compensated by adjustment of the odds. Indeed, departure from equal chance – ie shifting the chances in one's own favour – is one of the distinguishing characteristics of modern commercial gambling (*ibid*, pp 7, 8).

Nonetheless, improving one's own chances in a wager has only come to be permitted recently and under narrowly restricted circumstances. In the initial liberalisation of gambling in the 1960s, shifting chances in the context of gaming was entirely disallowed, as was any other attempt by casinos to extract money from the gambling process itself (see s 32 (1) of the Betting, Gaming and Lotteries Act 1963).

These requirements have subsequently been relaxed for specified games and for betting (to which (b) didn't apply anyway), but only in the context of a regulatory framework which exhaustively enumerates the games, activities and instruments permitted.

Two points must be made about this. First, departure from equal chance is a specific concession in the context of regulated commercial gambling. It remains a requirement for all other wagers.

Secondly, departure from equal chance, even when permitted, does not violate the "equal ignorance" principle. The casino's advantage in roulette, for example, represents a departure from equal chance, but it does not depart from equal ignorance because both sides know all there is to know about the probable outcome (the green zero-pocket on the wheel – which gives the house its advantage – is visible to all). Commercial gambling enterprises are permitted to shift the risks and chances to benefit themselves, but that does not mean that they are allowed to do so secretly. Lord Mansfield's "Equal ignorance or equal knowledge" remains paramount.

COMMON LAW ALTERED BY STATUTE?

The common law has a mature scheme of analysis for wagering contracts. It is not apparent that modern statutes have done any more than build on it.

Section 10 of the Gambling Act 2005, to which HHJ Behrens and Vos LJ both refer, provides that bets regulated by the FSMA are not "bets" for the purposes of the Gambling Act. This allows them to remain under the supervision of the Financial Services regulator (as had been recommended by the 2001 Budd report, CM 5206). It does not, however, mean that financial bets are "not betting", and has no bearing on the law otherwise applicable to such bets.

It is true that an important element of the Victorian law of wagering was altered by the FSA 1986 – namely, that financial wagers were henceforth to be *enforceable* (see Financial Services Act (FSA) 1986, s 63). However, the sanction of unenforceability was always a creature of statute, not of the common law (which regarded wagers as enforceable contracts). In that respect, s 335 of the Gambling Act 2005, which made *all* wagers enforceable, also has no bearing on the common law. Beyond this, the statutes contain *no* statement that the common law of wagering in general, or specific elements of it, is altered, replaced or superseded.

In any case, the chronology of the supposed "alteration" is entirely obscure. Is the common law supposed to have been replaced in 1986 (by the FSA), in 2000 (by the FMSA), or in 2005 (by the Gambling Act)? As far as the 1986 Act is concerned, the Court of Appeal in *City Index*, which was decided in 1991, and Lord Goff in *Westdeutsche Landesbank v Islington*, which was decided in 1996, both proceeded on the assumption that the common law applied.

In *City Index*, Leggatt LJ based his decision that the contract for differences at issue was a wager not on statute, but on common law authority, namely the *Carlill* case (which, as the current edition of *Chitty on Contracts* rightly says, contains the common law definition of a wagering contract – see Chitty 40-005, footnote 31).

It is not apparent that FSMA 2000 encroached any further on the common law in this respect, and as far as the Gambling Act 2005 is concerned, this statute explicitly does *not* concern activities regulated by the Financial Services legislation (GA 2005 s 10).

It is therefore unclear at what point, and in consequence of what provisions, the "replacement" of common law is supposed to have taken place. The only change statute has, perhaps, made to the common law is that departure from equal chance is now permitted in commercial gambling. That, however, does not mean it is permitted elsewhere, and, in any event, the cardinal principle of uncertainty ("equal ignorance") remains untouched in all contexts.

CONCLUSION

Advances in statistics have made it possible to value financial risks on the basis of empirical data, and this has opened up a huge market for those with access to the technology. It is, however, complex and expensive, and well beyond the reach of any lay customer.

Allowing customers to assume risks of which they are ignorant, and profiting from that very fact, seems intuitively unacceptable. The courts have hitherto found it hard to see why it should also be legally unacceptable. There is, however, a clear answer in the common law. Swaps are wagers, and wagers that are not transparent to both parties are void. Enforcing this well-established principle would benefit not only a few aggrieved SMEs, but the financial markets in general. ■

Further reading

- Should losses on payer swaps be recoverable? [2012] 11 JIBFL 680
- Financial Derivatives: Investments or bets? [2011] 6 JIBFL 315
- Lexis PSL Corporate Crime: Spread betting and contracts for difference

KEY POINTS

- A company may delay disclosure of inside information under DTR 2.5.1 until the information available to it is complete, where disclosure of incomplete information would lead to market disruption.
- The Tribunal's approach will permit pragmatic management of disclosure of sensitive information, but gives rise to scope for considerable uncertainty and appears to be at odds with the more stringent approach arguably provided for by the express provisions of DTR 2.

Feature

Author Michael Green QC

Acceptable delay in disclosure of inside information

This article considers the decision of the Upper Tribunal Tax and Chancery Chamber in *Hannam v The Financial Conduct Authority* in respect of a listed company's entitlement to delay disclosure of inside information under DTR 2.5.1.

BACKGROUND

In *Hannam v The Financial Conduct Authority* [2014] UKUT 0233 (TCC) the Upper Tribunal Tax and Chancery Chamber ("the Tribunal") found that Mr Ian Hannam, one of the City's best known investment bankers and dubbed "the king of mining", had engaged in market abuse contrary to s 118(3) of the Financial Services and Markets Act 2000 (FSMA 2000). Section 118(3) provides that disclosure of inside information by an insider to another person otherwise than in the proper course of the exercise of his employment, profession or duties will constitute market abuse.

The allegation made against Mr Hannam was that he improperly disclosed inside information in respect of Heritage Oil plc ("Heritage"). At the time of the disclosure, Mr Hannam was the Chairman of Capital Markets at JP Morgan, and Global Co-Head of UK Capital Markets at JP Morgan Cazenove. Heritage, which is an oil and gas exploration and production company listed on the London Stock Exchange, was a client of JP Morgan Cazenove.

The allegations against Mr Hannam concerned two emails that were sent by Mr Hannam to Dr Ashti Hawrami, the Minister for Oil in the Kurdish Regional Government in 2008. At the time of the emails, Heritage was engaged in exploratory drilling in Uganda. In the first email, sent on 9 September 2008 ("the September email"), Mr Hannam referred to a possible bid for Heritage by a third party acquirer. The second email, sent by Mr Hannam on 8 October 2008 ("the October email") contained a postscript that was found by the Tribunal to disclose that Heritage had discovered strong indicators of black oil, and that this was a positive development. The Tribunal found that both the September email and the October email disclosed inside information.

The emails and surrounding circumstances were investigated by the Financial Services Authority (FSA), predecessor to the Financial Conduct Authority (FCA). The FSA found that Mr Hannam was engaged in market abuse as a result of disclosure of inside information, and imposed a penalty of £450,000. This decision was challenged by Mr Hannam before the Tribunal.

The decision of the Tribunal is a lengthy and carefully reasoned judgment, which provides a detailed consideration of the constituent elements of market abuse under s 118(3) and the concept of "inside information" as defined by s 118C. However, the Tribunal had also to consider the circumstances in which a publicly listed company can properly delay the disclosure of inside information under s 2 of the Disclosure and Transparency Rules section of the FSA handbook ("DTR 2"). This was because it was relevant to one of the defences that Mr Hannam was running. This article concerns the Tribunal's conclusions in respect of the latter issue.

OBLIGATIONS UNDER DTR 2

Under DTR 2.2.1R, a publicly traded company must disclose inside information that directly concerns the company as soon as possible. DTR 2.5.1R provides a limited exception to the disclosure obligation set out in DTR 2.2.1R. It provides that a company may delay the public disclosure of inside information, such as not to prejudice its legitimate interests, provided that: (i) the omission would not be likely to mislead the public; (ii) any person receiving the information owes the company a duty of confidentiality; and (iii) the company is able to ensure the confidentiality of that information.

DTR 2.5.3 sets out circumstances in which it is legitimate to delay disclosure:

- It is legitimate to delay disclosure of negotiations where the outcome or normal pattern of those negotiations would be affected by public disclosure, such as where the financial viability of the company is in grave and imminent danger and disclosure would undermine specific negotiations designed to ensure the company's long-term financial recovery; or
- Where a company is required to have separation between two bodies, and a decision of one management body requires approval of the other, it is legitimate to delay disclosure where dual approval is pending, and disclosure of the initial decision in advance of that approval would jeopardise the correct assessment of the information by the public.

Although the circumstances set out in DTR 2.5.3R are expressed to be non-exhaustive, DTR 2.5.5G provides that, other than in relation to the matters described in DTR 2.5.3R or in DTR 2.5.5AR (which provides that an issuer may have a legitimate interest to delay disclosing inside information concerning the provision of liquidity support by the Bank of England or by another central bank to it or to a member of the same group), there are unlikely to be other circumstances in which delay would be justified.

Feature

Biog box

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DISCUSSION OF DTR 2 IN *HANNAM*

This issue was dealt with in paras 464 to 478 of the Tribunal's decision. Counsel for Mr Hannam argued that the FCA's position that the information disclosed in the October email constituted inside information was inconsistent with the FCA's position in respect of Heritage itself. Mr Hannam's disclosure in the October email related to information in respect of drilling carried out by Heritage on 6 and 7 October 2008. Heritage was aware of the drilling results as at 7 October, yet did not publicly disclose that information until 21 October 2008. However, the FCA did not suggest that Heritage was acting improperly by delaying disclosure of the information until that date. It was argued that it was only possible to reconcile this position with the contention that Mr Hannam was in possession of inside information that he disclosed to Dr Hawrami if Heritage was able to delay an announcement "such as not to prejudice its legitimate interests" under DTR 2.5.1. Counsel for Mr Hannam contended that Heritage had no such legitimate interest. Therefore, the only way in which the FCA's position regarding the propriety of Heritage's conduct was tenable was if the drilling results did not constitute inside information.

The FCA submitted that Heritage was entitled to delay announcing the discovery of oil until it had completed drilling to the target depth, and that such a delay was standard practice in the oil industry. The Tribunal rejected that a company might be entitled to delay disclosure of inside information on the basis that it was standard practice to do so in that industry. Companies must disclose inside information as soon as possible unless there was a legitimate interest in delaying disclosure under DTR 2.5.1R; there was no room for a third possibility that delay could be justified on the basis of standard industry practice.

However, the Tribunal considered that Heritage *could* be said to have had a legitimate interest in delaying the disclosure of information until the information available to it was complete. If potentially incomplete information had been announced, there would have been a significant risk of volatility in Heritage's share price because the market could be misled. To require Heritage to disclose the information as soon as possible would have placed a burden on Heritage to monitor on a daily basis whether the information would, if disclosed, be likely to have a significant effect on Heritage's share price. The Tribunal also considered that disclosure of incomplete information on a day to day basis could produce real volatility if the results came in indicating swings in the prospects of finding oil which would, in turn, create uncertainty in the market about Heritage's share price and disrupt the market. In those circumstances, the Tribunal concluded that it would be reasonable for Heritage to take the view that an announcement should wait until completion of the drilling programme *"unless, perhaps, some really significant results were obtained"*. As such, the Tribunal found that there was no inconsistency between the FCA's position that the information disclosed in the October email constituted inside information and its view that Heritage was entitled to delay disclosure of that information.

CONCLUSIONS

The Tribunal's approach is to be welcomed insofar as it will permit companies to manage disclosure of sensitive and uncertain information in a commercially sensible way. DTR 2 arguably provided for such an eventuality, in that DTR 2.2.9G provided that a short delay in disclosure would be permissible where a company was faced with an unexpected and significant event. In such cases, DTR 2.2.9G recommended that a holding announcement be made by the company where it was believed that there was a danger of inside information leaking before the facts and their impact could be confirmed. However, the mere fact that a company has made a holding announcement could itself give rise to uncertainty and market volatility, even if it did not in fact mislead the market.

However, the approach adopted by the Tribunal appears to be at odds with the provisions of DTR 2, which, it is suggested, provided for a considerably more stringent approach to delaying disclosure. The ability of a company to delay disclosure under DTR 2.5.1R is described as "limited" by DTR 2.2.9G. Further, as noted above, DTR 2.5.5G expressly provides that there are unlikely to be circumstances where delay would be justified, other than the circumstances set out in DTR 2.5.3R or DTR 2.5.5AR, (notwithstanding that the examples given in DTR 2.5.3R are expressed to be "non-exhaustive").

The approach of the Tribunal also gives rise to scope for considerable uncertainty. No guidance was given as to the level of market volatility necessary to give rise to a legitimate interest in delaying disclosure. For example, there may be circumstances in which a company has inside information that could cause minor fluctuations in its share price, but the information was not considered to be of a nature, or of a significance, that would cause serious share-price volatility or market disruption. It is not clear whether a company in this position would be entitled to rely on the exception to DTR 2.2.1R provided for in *Hannam*. In the circumstances, if the Tribunal wished to carve out a further exception to the general rule in DTR 2.2.1R, it would have been preferable if it had done so in a more tightly circumscribed manner.

LESSONS

The decision in *Hannam* gives greater flexibility to companies wishing to delay disclosing inside information where that information is as yet uncertain. However, the uncertainty surrounding the scope of the exception provided for in *Hannam* means that companies should be cautious in relying on this new exception to their disclosure obligations under DTR 2.2.1R. ■

Further reading

- Disclosure of emergency fundraising and the FCA's investigation into Barclays Bank [2014] 4 JIBFL 225
- European insider trading: European Court rejects probability magnitude test [2012] 8 JIBFL 484
- LEXIS PSL: Financial Services: Market Conduct and Corporate Crime: Financial Services Offences

KEY POINTS

- Anglo-Australasian law has failed to deal adequately with the competing priorities between secured creditors and preferred creditors on insolvency.
- Priorities determined by control or by asset class generate complex legal problems of compliance and application.
- The public policy drivers justifying the priority of preferred creditors should be reviewed with the aim of producing a more coherent way of addressing this issue without necessarily prejudicing secured creditors.

Author Professor John Stumbles

The competing priorities of secured creditors and preferred creditors on insolvency: an Australasian perspective

On a security provider's insolvency, Anglo-Australasian law has traditionally accorded priority to preferred creditors for unpaid employee entitlements and certain tax and other liabilities ahead of the rights of a secured creditor holding a fixed as distinct from a floating charge. Australia and New Zealand have had to consider how to maintain this priority, now that the distinction between the fixed and floating charge is largely irrelevant in each of those countries following their passing of personal property securities legislation. This article analyses how each country has addressed this issue and concludes that each of their differing approaches to this challenging problem has its deficiencies. The article also considers in passing how this issue is addressed under English law, in light of the recent critique of this aspect of the current English regime by the City of London Law Society's February 2014 Discussion Paper.

Liquidation does not prevent a secured creditor of an insolvent grantor from enforcing its security interest and satisfying the grantor's indebtedness to the creditor in priority to the claims of the grantor's unsecured creditors. Unless it surrenders its security, a secured creditor generally stands outside the liquidation process. Claims of unsecured creditors are only able to be satisfied out of the grantor's available unencumbered assets. If those assets are insufficient for these purposes, the unsecured creditors suffer a shortfall. Employees, suppliers and taxation authorities are the main stakeholders who are disadvantaged by this process. To remedy this mischief, English law has provided since the late 19th century that in these circumstances the claims of preferred creditors rank ahead of a security interest where that security interest is a floating as distinct from a fixed charge. Australian and New Zealand insolvency law adopted a similar approach, even though the list of preferred creditors, and the nature and extent of their respective priority entitlements, differed in each country.

In a recent Discussion Paper, the City of London Law Society has pointed out that the distinction between the fixed and floating charge as the criterion for conferring this priority on preferred creditors has given rise to some significant practical problems (see Discussion Paper 2, *Fixed and Floating Charges on Insolvency*, February 2014 ("the Discussion Paper")). Traditionally, the difference between each type of charge rested on the degree of control exerted by the secured creditor over dealings with the charged assets. If the grantor was given the authority to deal with the assets without reference to the secured creditor then the charge was generally regarded as floating. In contrast, if the secured creditor controlled dealings with the charged assets, the charge was generally regarded as fixed. At the same time, there was much uncertainty as to the degree of control which was required to ensure that a charge was fixed. The characterisation of the security interest was a question of law, determined by construing the actual language of the security agreement rather than the parties' intentions; it also depended on whether the requisite control mechanisms set out in the security agreement were adhered to in practice.

These problems have prompted questions as to whether the distinction between the fixed and floating charge is a useful tool for protecting the claims of unsecured preferred creditors over secured creditors. In 2004, the English Law Commission recommended the abolition of the floating charge as a distinct form of security from the fixed charge. The Discussion Paper once again reviewed the matter and identified the following three options for going forward:

(i) Clarifying the distinction between the fixed and floating charge.
(ii) Identifying particular assets out of which the claims of preferred creditors should be paid.
(iii) Stipulating that the claims of preferred creditors should be paid out of all charged assets but subject to a cap.

The first option involved retaining the distinction between the fixed and floating charge. The second and third options assumed the abolition of the distinction.

In Australia and New Zealand, the distinction between the fixed and floating charge was rendered irrelevant in any event following the commencement of the Personal Property Securities Act 2009 (Cth) ("Aus PPSA") in Australia in 2012 and the commencement of the Personal Property Securities Act 1999 (NZ) ("NZ PPSA") in New Zealand in 2002. Amongst other matters, the legislation in each country purports to regulate any arrangement which in substance functions as a security interest, irrespective of its form and irrespective of whether at general law the interest of the secured party is legal or equitable. Such a security interest (a "PPSA security interest") is regarded as a form of fixed security interest.

The reforms were not intended to affect preferred creditors' rights. As a consequence, legislators then had to determine an alternative mechanism for preserving the existing priority claims of preferred creditors on insolvency. In so doing, Australia continued with an approach based upon control which is closest to option (i), whilst New Zealand adopted an approach which is closest to option (ii). The purpose of this article is to assess each country's approach to this issue commencing with New Zealand. As the list of preferred creditors depends very much on a country's particular social policies, it is not proposed to review the appropriateness of the categories of preferred creditors in each country.

NEW ZEALAND

Priority over security interest in accounts receivable and inventory

In New Zealand, preferred creditors have priority over an existing PPSA security interest in "accounts receivable" and "inventory". These terms are defined in the NZ PPSA and incorporated by reference into the Companies Act 1993 (NZ). The source of this priority is found in cl 2(1)(b)(i)(A) of Sch 7 of the Companies Act 1993 (NZ) ("NZ CA") which provides that in so far as a company's available assets are insufficient to satisfy the claims of preferred creditors, those claims "have priority over the claims of any person under a security interest to the extent that the security interest… is over the company's *accounts receivable* and *inventory* or all or any part of either of them" (emphasis added). Subject to certain exceptions, accounts receivable means a "monetary obligation… whether or not that obligation has been earned by performance" (NZ PPSA s16). In reviewing this definition, the New Zealand Court of Appeal has recently held that for these purposes, a monetary obligation "means an existing [legally enforceable] obligation imposed on, or assumed by, one party to pay a certain sum of money to the other party on a specific or ascertainable future date" (*Strategic Finance Ltd (in receivership and in liquidation) v Bridgman* [2013] NZCA 357 at [54]). Given the breadth of the definition of accounts receivable, the priority is not just confined to "particular assets" such as book debts (*Strategic Finance* at [51]).

The Court of Appeal also noted that the wording of the definition was "enacted to ensure that the availability of 'accounts receivable' for preferential creditors would not be dependent on the wording of the particular instrument which creates the security interest" (*Strategic Finance* at [73]). Moreover, because the monetary obligation "need not have been earned by performance under a contract", the definition also captures "those [obligations] that exist under deed, statute or by virtue of a court order, independently of any need for performance" (*Strategic Finance* at [58]). Because of the width of this definition, few payment obligations fall outside its ambit. Furthermore, and by virtue of the NZ PPSA, the definition of accounts receivable also extends to account proceeds thereby further extending the reach of the defined term.

The term "inventory" is also given a wide meaning. Under s 17 of the NZ PPSA, the definition of security interest extends to personal property in the possession of the insolvent party but which is owned by another party (eg goods supplied subject to a retention of title). To avoid a loss of priority in these circumstances, the third party must perfect its security interest by the appropriate filing on the Personal Property Securities Register.

Application of preferred creditor regime in bankruptcy, liquidation, administration and receivership

The above priority rules apply not only in a corporate insolvency but also in an individual bankruptcy (Insolvency Act 2006 (NZ) ss 274 and 275)), receivership (Receiverships Act 1993 (NZ) s 30) and to mortgagees in possession (Property Law Act 2007 (NZ) s 153). Furthermore, an administrator has a prior claim to accounts receivable and inventory to secure personal liabilities and remuneration incurred during the course of the administration (NZ CA 1993 ss 239ADL-239ADN). In contrast to England and Australia, all charges created within six months of the commencement of liquidation are potentially subject to claw-back by a liquidator and no distinction is made between what were formerly known as fixed and floating charges (NZ CA ss 292-293).

Assessment

Despite the apparent simplicity of linking the rights of preferred creditors to designated assets, problems still arise under the New Zealand approach. First, the special priority rules accorded to preferred creditors upsets the priority rules contained in the NZ PPSA and results in circular priorities under which no clear winner emerges. Secondly, as the priority not only extends to accounts receivable but to the proceeds of accounts receivable, it is not completely clear how far the priority extends to existing proceeds of past accounts receivable. The better view is that the priority only extends to proceeds of accounts receivable and inventory which arise after a bankruptcy, liquidation or receivership. Thirdly, the NZ PPSA distinguishes between accounts receivable and chattel paper when in practice it is difficult to apply that distinction. Finally, the very broad definitions of accounts receivable and inventory mean that incoming financiers need to assess carefully the identity of preferred creditors and the impact of their prior claim, not just on the quality of their security but generally if they are unsecured. Such an assessment is even more important in the context of structured secured financing arrangements where an uninterrupted and prior access to cash flow is a key requirement of the security. While introducing some measure of clarity in this area, the current system is inflexible and may impact adversely on the availability of certain forms of financing.

AUSTRALIA

Priority over circulating security interests

As was the case with New Zealand, the introduction of the Aus PPSA was not intended to alter Australian insolvency law, including the law conferring priority on preferred creditors over assets subject to a floating charge. The aim was very much to maintain the status quo. In lieu of determining priority by reference to floating charge assets, Australia opted for an approach under which the preferred creditors would have prior access to assets subject to a PPSA security interest where that security interest is a "circulating security interest"; that is, a security interest over assets which are "circulating assets". For these purposes, assets are regarded as circulating if the secured party lacks the requisite degree of control over those assets.

In adopting control as its reference point, the drafters of the Aus PPSA appear to have drawn upon the considerations used in general case law for determining whether a charge over a book debt is fixed or floating, notably *Re Brumark Investments Ltd* [2001] 2 AC 710 and *Re Spectrum Plus* [2005] 2 AC 680. However, in some instances, the legislation also provides some more specific control tests. See Aus PPSA ss 340-341A respectively. This approach is summarised diagrammatically in Figure 1.

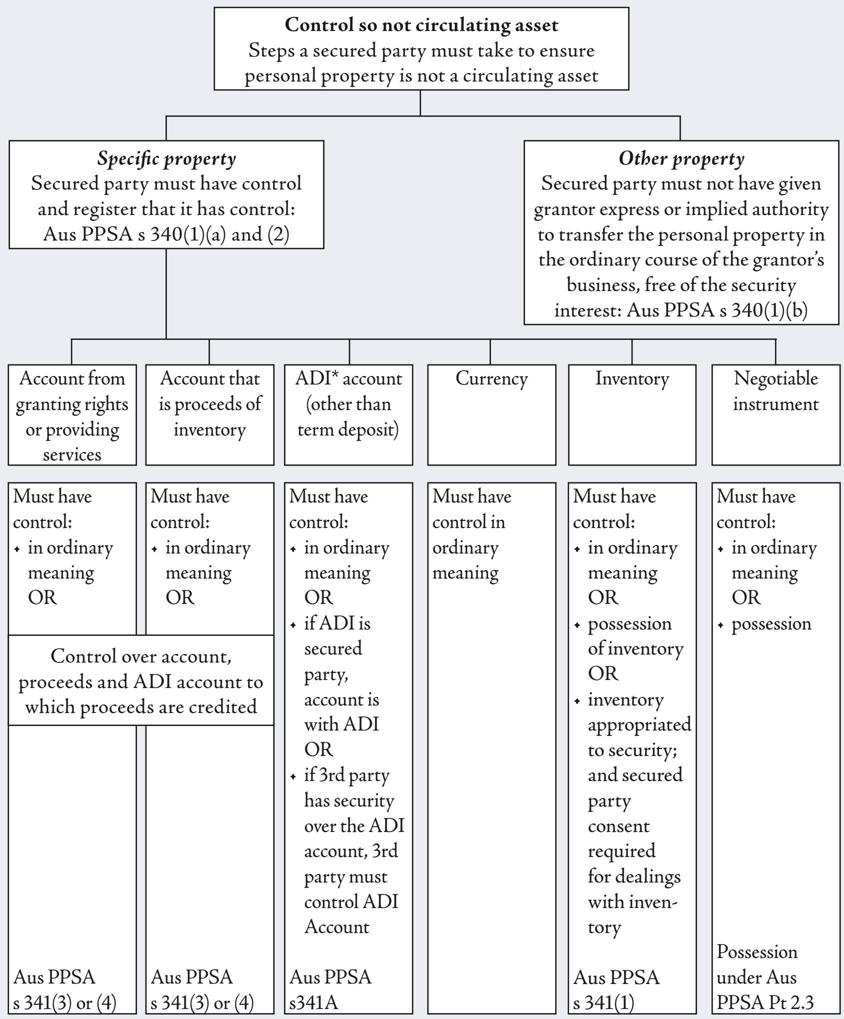
It will be observed that the Aus PPSA distinguishes between six categories of specific property and "other property". The category of other property would encompass those typical pre-PPSA floating charge assets in respect of which the security provider was authorised to deal in the ordinary course of its business. Likewise, a pre-PPSA fixed and floating charge was not usually fixed over the last three categories of specific assets namely, currency, inventory and negotiable instruments, not least because to do so would intrude excessively on the day to day business activities of the grantor. What then does "control in the ordinary meaning" denote in this context? The Aus PPSA gives no guidance, with the result that the issue falls to be determined by reference to general principles, including case law which has addressed this issue for the purposes of determining if a charge is fixed or floating.

However, the statute does provide some specific control tests for inventory and negotiable instruments. Relevantly, a secured party is regarded as having control over inventory and negotiable instruments if it possesses the same and in addition, in the case of inventory, if the inventory is appropriated to the security and if the secured party actually controls dealings with the inventory.

A similar approach is taken in relation to accounts and the proceeds of accounts or what in a pre-PPSA world would have been regarded as book debts and debt proceeds. Under the pre-PPSA law, the "account" in its manifestation as a book debt was often the property over which secured creditors aimed to fix their charges, even though they had limited success in doing so at least prior to crystallisation of the charge. For the purposes of the Aus PPSA preferred creditor regime, and in lieu of a reference to book debts, each type of account (including the ADI account) referred to in Figure 1 may be controlled so as to defeat preferred creditors (Aus PPSA s 340(5)). The definition of account is thus wider than just book debts. When it comes to these specific assets, however, the statute also provides some additional control tests, provided the control mechanisms are agreed to in writing by the parties. For the first two categories of account, control exists if the account resulting from the granting of rights or provision of services or the account which constitutes proceeds of inventory is controlled and if the account proceeds are usually paid into an "ADI account" (an account with a body corporate authorised to carry on a banking business) also controlled by the secured party.

ADI accounts themselves have their own particular control rules. If the ADI is the secured party, the ADI account is regarded as controlled simply by virtue of the ADI opening and holding the account for its customer. In this respect, ADIs are in an especially privileged position. In contrast, non-ADIs can only control an ADI account if they can direct dispositions from the account or if they become customers of the ADI. It appears that an account will not be regarded as controlled for these purposes if the deposit into the ADI account results in other moneys becoming

FIGURE 1: SPECIFIC CONTROL TESTS



*Authorised Deposit-Taking Institution: a body corporate authorised to carry on a banking business in Australia.

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payable to the account holder or related body corporate of the account holder, thereby drawing on a factor identified in *Re Brumark* (supra) which resulted in the charge in that case being characterised as a floating charge.

In summary, a security interest over an account will only be regarded as non-circulating under these specific rules if the secured party controls not only the actual account itself but also the account proceeds and the ADI account into which the account proceeds are paid. The test is thus very similar to that applying at general law in determining if a charge is fixed.

Application of preferred creditor regime in bankruptcy, liquidation, administration and receivership

The above priority rules apply in a corporate insolvency (Corporations Act 2001 (CA 2001) (Cth) s 561), and for corporate grantors, in a receivership or where a third party assumes possession of secured property on behalf of a secured party (CA 2001 (Cth) s 433). Unlike the position in New Zealand, the preferred creditor regime does not apply in a bankruptcy as distinct from a corporate insolvency.

A circulating security interest created within six months prior to the commencement of a company's winding up is also susceptible to being set aside in a similar way to which pre-PPSA floating charges created within six months of a winding up were also susceptible to being set aside by a liquidator (Corporations Act 2001 (Cth) s588FJ). The Discussion Paper is critical of the equivalent provision under English law (Insolvency Act 1986 (UK) s 245). The characterisation of a security interest as circulating or non-circulating is also relevant in voluntary administration. A voluntary administrator who personally incurs debts and other liabilities during a voluntary administration of a company has a right to seek indemnification for those debts and liabilities out of the company's assets. The indemnification right has priority over any debts of the company secured by a circulating security interest (CA 2001 (Cth) s 443E).

Assessment

Although the Aus PPSA has only been in operation for less than three years, it is still possible to make some preliminary observations on the current preferred creditor regime. First, the pre-PPSA preferred creditor regime has been largely maintained by the use of control tests which in many respects are in substance no different from those used to distinguish a fixed from a floating charge at general law. To some extent, the new "specific" control tests have introduced a greater degree of certainty in determining whether or not a security interest is circulating. In a jurisdiction which has not adopted personal property securities legislation, those specific tests may assist in clarifying the distinction between fixed and floating charges, as contemplated by the Discussion Paper. The retention of an alternative general control test (control in its ordinary meaning) also means that the new regime is flexible enough to permit alternative control mechanisms to be selected if circumstances require. At the same time, the new specific tests are very intrusive and there must be real doubts whether in practice grantors of PPSA security interests would be prepared to accept or comply with such a degree of control over their businesses and whether secured parties have the necessary resources to administer such a regime. All this raises the question whether the new regime constitutes a real improvement. In a non-PPSA regime, these objections apply equally to secured parties desiring fixed charges over a borrower's assets at general law.

Many practitioners find the new regime confusing and difficult to understand and to apply, a task which is not aided by the complex drafting of the relevant provisions. Unsurprisingly, many also think, incorrectly, that Australia's new personal property securities regime perpetuates the distinction between fixed and floating charges when, as previously indicated, the general priority rules in this new legislation render that distinction irrelevant. It has been said that the new regime excessively favours ADIs such as banks, over other financial institutions since the former institutions are treated as controlling an ADI account merely by moneys being deposited in an account with them. There is also no good reason for the preferred creditor regime not applying to personal bankruptcies as distinct from corporate insolvencies. More fundamentally, in its creation of a special priority regime for preferred creditors, the new preferred creditor regime is inconsistent with the priority rules in the Aus PPSA which were intended to be of general application. At a more technical level, the selection of control as the touchstone for identifying circulating or non-circulating assets is confusing, as the Aus PPSA also uses a separate control for another purpose, namely, for determining whether certain categories of collateral are perfected, as distinct from determining whether the security is circulating or non-circulating.

CONCLUSION

The deficiencies with the current regimes in both Australia and New Zealand raise the question of whether another method should be selected for protecting preferred creditors. As a starting point, good policy reasons are required to justify who should be a preferred creditor and why they should rank above secured creditors. For example, is it better to protect employee entitlements by a government sponsored scheme? Furthermore, why should secured creditors have to bear the burden of loss of priority to preferred creditors? Until these policy issues are properly considered, it is likely that debates concerning as to who should have priority over significant assets (such as accounts) and drafting strategies to avoid loss of priority by a secured creditor will continue unabated in jurisdictions which retain the distinction between the fixed and floating charge, as well as in those jurisdictions which have adopted personal property securities legislation. ■

Further reading

- Secured Transaction Reform [2013] 1 JIBFL 6
- Personal Property Security Law, where next? Parts 1 and 2 [2012] 8 JIBFL 465; [2012] 9 JIBFL 541
- Flawed assets and the Australian Personal Property Securities Act 2009 [2011] 9 JIBFL 539
- Lexisnexis Loan Ranger Webcast: Secured Transactions Law Reform Project July 2014

KEY POINTS

- Neither the English nor the DIFC courts can *directly* apply Sharia principles, because the proper law of a contract is required to be the law of a country.
- An *arbitral* tribunal in England or the DIFC *can* directly apply Sharia principles, even as a non-national system of law, under the relevant UK and DIFC statutes.
- The English courts can *indirectly* apply religious law, for example: where specific provisions are incorporated into an agreement; where the parties choose a national law based on religious law; where it is used as an aid to construction; or where a justiciable issue of fact arises as a condition of the existence of a right.
- In practice, Sharia principles are indirectly applied in deciding whether an agreement was *ultra vires* a party under the law of its seat.

Author Rupert Reed QC

The application of Islamic finance principles under English and DIFC law

Neither the English nor the DIFC courts can directly apply Sharia principles. In this article, Rupert Reed QC considers the ways in which the English and the DIFC courts can apply Islamic law indirectly.

INTRODUCTION

The total amounts of Islamic financial assets have grown exponentially in spite of the global financial crisis. An increasing number of Islamic finance (IF) instruments are being negotiated and written in the "new" IF centres of London and Dubai, including its financial "free zone", the Dubai International Finance Centre (DIFC), which has codified commercial and financial law based on English and other common law principles. Many of those instruments contain English and DIFC jurisdiction and choice of law provisions.

Neither the English nor the DIFC courts can apply Islamic law *directly*, but both can apply it *indirectly* in circumstances where they recognise it as being *"relevant"*. The English courts have shown themselves willing to apply Sharia principles, for example in assessing whether an instrument is void as having been beyond the constitutional powers of, or *ultra vires*, one of its parties insofar as it is *ribawi* or Sharia non-compliant (SNC).

NO DIRECT APPLICATION OF SHARIA PRINCIPLES BY THE COURTS

The position under English conflicts of laws principles, both at common law and under the Contracts (Applicable Law) Act 1990, which implements the Rome Convention on the Law Applicable to Contractual Obligations (RC), is that, subject to limited exceptions, parties can only provide for the application of the law of a *country* or *jurisdiction* as the applicable or "proper" law of their agreement: Art 1 RC. The applicable law, under Art 10 RC, is that which will govern interpretation, performance, the consequences of breach, and various ways of extinguishing obligations and prescribing and limiting actions. Issues such as the validity of the contract will therefore be ascertained by reference to the substantive law of the relevant *country*.

The parties therefore cannot provide for the application of a "non-national" system of law, such as Islamic or any other religious law: *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd* [2003] EWHC 2128 (Comm) [27], [35]; [2004] 1 WLR 1784 [48]; [62]-[63]; *Halpern v Halpern* [2007] EWCA Civ 291; [2008] QB 195 [20]-[29]; *Musawi v RE International (UK) Ltd* [2007] EWHC 2981 (Ch) [17]-[23]. The conventional explanation for this principle is that laws cannot exist "in a vacuum", in other words without being enforceable in the courts of any jurisdiction.

DIFC law similarly requires the DIFC courts to determine civil matters in accordance with the laws of a *jurisdiction* chosen from a "cascade" of connected jurisdictions: DIFC Law No 3 of 2004 (the Law on the Application of Civil and Commercial Laws (LACCL)), Art 8.

CONSEQUENCES OF DIRECT APPLICATION OF SHARIA PRINCIPLES

The judgment at first instance in *Halpern* suggests that an express agreement of Sharia as the applicable law may have the effect of making the contract unenforceable: [2006] EWHC 1728 (Comm) [50]. However, the Court of Appeal (CA) disagreed, taking the view that it would then be for the applicable law to decide the extent to which the agreement impliedly incorporated the relevant religious law as part of the contract: *Halpern* [36].

DIRECT APPLICATION OF SHARIA PRINCIPLES IN *ARBITRATION*

The direct application of Sharia principles was similarly excluded in arbitration, until a tribunal was permitted, under s 46(1)(b) of the Arbitration Act 1996, to decide a dispute "in accordance with such other considerations as are agreed by them or determined by the tribunal". Arbitral disputes are of course outside the RC: Art 1(2)(d). A tribunal can now apply Sharia principles and other non-national rules, where they are designated by the above choice of law rule. The CA recognised in *Halpern* that, if parties wish *non-national* systems of law to apply to their agreement, then they can do so by the inclusion of a provision for the *arbitration* of any dispute: *Halpern* [37]-[38].

The equivalent DIFC statute, Law No 1 of 2008 ("the Arbitration Law") is equally clear in providing, in Art 35(1), that the tribunal shall decide the dispute "*in accordance with such rules of law as are chosen by the parties as applicable to the substance of the dispute*".

Both the English and DIFC courts will therefore *recognise* agreements to arbitrate governed by Sharia law, both in staying actions brought in breach of those agreements and in enforcing awards made in applying the agreed Sharia "considerations": *Halpern* [37].

INDIRECT APPLICATION OF SHARIA PRINCIPLES

While the English and DIFC courts will not directly apply Sharia principles, there are ways in which they can *indirectly* apply them. In particular: they can apply Sharia principles that are incorporated in an agreement; they can apply a national law that itself applies Sharia principles; they can use Islamic law as an aid to construction; and/or they can decide a justiciable issue of IF principle on which the rights of a party are conditional.

In practice, the most common indirect application of Sharia principles occurs where a party seeks to avoid its obligations under an IF instrument on the basis of an *ultra vires* defence. By this, it contends that the instrument is SNC, therefore beyond the capacity of, or *ultra vires*, either party under the law of its place of incorporation, and therefore void and unenforceable as a matter of English law. However, the English courts, and in particular the English Commercial Court, have historically seemed uninterested in IF and Sharia compliance issues, and more concerned with enforcing IF instruments as if they were conventional finance.

In *Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems NV & Ors*, Unreported, 13 February 2002, Tomlinson J summarily rejected all of the various IF defences put up by the defendant, namely an *ultra vires* defence, an illegality defence and a defence based on misrepresentation. He did so even though the *murabaha* finance contract in that case presented obvious symptoms of artificiality, with the bank failing to acquire the goods and assuming no business risk, and with the purchaser assuming the entire risk, being liable to pay even if the goods were never shipped.

The Commercial Court and CA took a similarly diffident approach to issues of Sharia compliance in *Shamil Bank* [2003] EWHC 2118 (Comm); [2004] EWCA Civ 19; [2004] 1 WLR 1784. Although the issue in that case was whether the enforceability of a contract governed by English law, subject to Sharia law, was conditional upon its Sharia compliance, both the judge and the Court of Appeal approached that issue from the perspective that Sharia law raised complex philosophical issues from another period on which there was little or no firm authority.

However, in the later case of *The Investment Dar Company KSCC v Blom Development Bank SAL* [2009] EWHC 3545 (Ch), a judge of the Chancery Division took a very different approach. The defendant sought to resist summary judgment by reliance on an *ultra vires* defence in arguing that the wikala contract was SNC and therefore *ultra vires* the claimant as a matter of Kuwaiti law, and so invalid as a matter of English law. The judge found that the *ultra vires* defence had been "dredged up" late by the defendant's lawyers, and thus gave the claimant both permission to amend to plead a *restitutionary* claim and summary judgment on that claim. However, he also found that there *was* an arguable defence to the existing *contractual* claim to repayment of the USD 10.7m of principal, so that he would not have given summary judgment on that claim.

The judge in *Blom* did *not* dismiss Sharia law as medieval religious philosophy. Instead, he considered carefully the evidence of the parties' experts and their exhibited texts. He started with a standard inquiry as to whether the "profit" payable to the principal could be characterised as interest paid "indirectly". However, in doing so, he identified the key ingredient that was missing from the *wikala* contract in that case. There was no *risk* to the principal, who received payments of "profit" in pre-determined amounts even if the value of the investments made by the agent had in fact dropped. The judge was willing to consider the Sharia compliance of the contract even in circumstances where the defendant's own Sharia committee of Islamic scholars had approved the contract.

Certain IF instruments, notably *mudaraba* and *wikala* agreements, are often compared with appointments under English law of trustees and agents. It should therefore come as little surprise that it was a judge of the *Chancery* Division of the English High Court, with its *equitable* specialism, who first engaged with Sharia principles in finding it to be arguable that the relevant agreement was not SNC under those principles.

INCORPORATION OF SHARIA PRINCIPLES

The English CA has further reminded us that provisions of foreign law can not only be "applied to" the contract, but can also be "incorporated into" the contract, which exists as a form of private legislation: *Shamil* [49]-[51]; *Halpern* [30]-[33]. The foreign law becomes a *source* of rules and principles to be applied by the governing law.

An example given in *Shamil* is the incorporation of particular provisions from the French Civil Code, so that the relevant articles are incorporated as if terms of an English contract. The parties may accordingly choose one law to apply rules of another law incorporated in their agreement. The limits of such incorporation arise from a requirement of *certainty*, so that it will operate where the court can sufficiently identify the relevant rules to be incorporated. Where doubt remains, expert evidence can be used as an aid to the interpretation by the English court of the rules and principles incorporated.

In *Shamil*, this led to the suggestion that the relevant "provisions of foreign law or an international code or set of rules" should be specific "black letter" provisions, impliedly rules rather than principles, that may not give sufficient certainty [51]. The CA found that no terms had been identified as a "corpus" of terms apt to be implied as terms of the finance contract in that case [74]. In this regard, an English or DIFC court may be more willing to apply as incorporated terms provisions from such codifications of Islamic law as exist, most notably the *Sharia Standards* published by the Accounting and

Auditing Organisation for Islamic Financial Institutions (AAOIFI), or the *Majala*, the Ottoman civil code based on Sharia law of the Hanafi school of *fiqh*.

Clearly, the more specific the reference to rules to be incorporated, for example to a particular school of jurisprudence, the more likely it is that the court will apply them. However, the court in *Halpern* appeared to accept that "Jewish law" would be sufficiently certain to be relied on as part of the contractual framework [33]. The implication in that analysis, and in the proposed distinction with *Shamil*, is that Sharia law would similarly be sufficiently certain, as long as the relevant school of *fiqh* were identified.

Moreover, if the proposed incorporation was of Sharia *in general*, the court may well take the view that this was an improper attempt to make Sharia the applicable law of the contract, with the proper law being no more than a "shell" for the incorporation of Sharia: *Halpern* [32].

APPLICATION OF *FOREIGN LAW* INCORPORATING SHARIA PRINCIPLES

In *Al Midani v Al Midani* [1999] 1 Lloyd's Rep 923, Rix J found it likely that the applicable law in that case was *"either Sharia law or such law as modified by Saudi law"*, noting that he regarded Sharia law to be *"a branch of foreign law"*. In *Halpern* at [24], the CA found this to be consistent with conventional conflict of laws principles on the basis that the agreement being construed in that case was an agreement to arbitrate. However, Rix J's words remind us that Sharia law is a significant source of law in a number of jurisdictions in which it is directly enforced by civil courts, so that no "vacuum" exists.

It follows that if clients are keen for Sharia principles to be applied to their agreement, one option is to apply the law of a country whose laws are or incorporate the desired Sharia principles. The Kingdom of Saudi Arabia (KSA) would be an obvious example, with its Basic Rule of Governance (A/90) providing that the KSA's constitution is the Qur'an and Sunna (Art 1), which are the ultimate sources of law (Art 7), and that the courts shall apply the rules of Sharia according to the Qur'an and Sunna (Art 48) as the source of judicial decisions (Art 45), which are not subject to any other authority (Art 46). Sharia tends in practice to prevail even over the modern statutes of the KSA said to "supplement" Sharia where necessary. In general, the KSA courts will apply the Hanbali school of *fiqh*, and so that gives some basis for legal certainty.

> "Clearly, the more specific the reference to rules to be incorporated, for example to a particular school of jurisprudence, the more likely it is that the court will apply them"

Similarly, the constitutions of the UAE and Oman make Sharia the main source and the source of legislation, while those of the remaining GCC countries (Kuwait, Bahrain and Qatar) describe it *"a main source"* of legislation. Many of these countries now have significant numbers of resident commercial lawyers from common law jurisdictions and of dual-qualified local lawyers so that experts in the laws of the KSA and other GCC countries can readily be found to give evidence and otherwise assist in English or DIFC proceedings in relation to agreements that are expressly or impliedly subject to the law of those countries, and thereby Sharia.

The risk inherent in entering a contract under Saudi law is of course that issues as to its validity and enforceability will fall to be determined in accordance with that law, even if by an English or DIFC court. Under Saudi law, a contract that is SNC will be void and unenforceable without more. This invalidity will result without any intervening reference to issues of the capacity of the company or the authority of its purported agents.

AID TO CONSTRUCTION

It is clear that the English and DIFC courts may have regard to Sharia principles as an aid to the construction of an IF instrument, and that the English courts do not see such use as being contrary to the RC. In *Halpern*, the CA recognised that, although Jewish law, as a non-national system of law, could not be the proper law of a compromise agreement, it could still be relied upon as part of the contractual context as an aid to interpretation [34]-[35]. To that extent, the court recognised the *relevance* of religious law in that case.

In English law, the process of interpreting the parties' words is one of assessing *"the meaning which the document would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract"*: *Investors Compensation Scheme v West Bromwich Building Society* [1998] 1 WLR 896, 912. In *Halpern*, the agreement in issue purported to be the compromise of an arbitration before religious judges to which Jewish law had applied, and so it could reasonably be assumed that the parties would not have intended to depart from Jewish law in compromising that arbitral dispute. Similarly, in the case of a financial instrument said to be Sharia compliant, the context would include the core principles of IF.

Further, where there are two possible constructions of a relevant document, the court may prefer that which is more consistent with business common sense: *Rainy Sky SA v Kookmin Bank* [2011] UKSC 50; [2011] 1 WLR 2900 [15]-[21]. In the subsequent case of *LB Re Financing No 3 Ltd v Excalibur Funding No 2 plc* [2011] EWHC 2111 (Ch), Briggs J made clear that the greater the ambiguity, the more persuasive may be any argument as to the business common sense of a particular construction. Business common sense can itself be understood in the context of Islamic finance to include compliance with Sharia principles, not least given the further canon of construction that the court should prefer a meaning which validates an instrument rather than one which renders it void.

Similarly, the courts will depart from the ordinary meaning of the words used where it is clear, again in the relevant factual context, that there has been some linguistic mistake: *Chartbook Ltd v Persimmon Homes* [2009] UKHL 38; [2009] 1 AC 1101. This is sometimes referred to as "corrective construction". There may be circumstances where particular wording as drafted makes an IF instrument potentially SNC, but where the court could in effect correct the drafting to ensure the Sharia compliance the parties plainly intended. Applying the logic of *Excalibur*, the more obvious the drafting error, the more persuasive an argument that it should be corrected and the less ambiguity that will be required.

Evidence of Sharia may therefore serve all of the purposes for which arguments of construction are advanced before the English courts, not least to support the validity of the instrument, to ensure its compliance with the presumed intentions and reasonable understanding of the parties, and to correct errors that may result in its being SNC.

RIGHTS OF PARTY CONDITIONAL UPON IF ISSUE

There are other cases where the relief sought is not a determination of an issue of IF principle, but the rights of a party are conditional upon a prior determination of such an issue. In English and Scots law, the necessity has arisen principally in cases of religious schism where there have been issues as to who is entitled to trust property that have required the courts to ascertain the conformity of a purported trustee to religious tenets. The rule that, on a division in a religious body, the property held on trust for its purposes will go to the party that adheres to its fundamental religious principles is sometimes called the rule in *Craigdallie v Aikman* (1813) 1 Dow 1.

The issue of conformity with Sharia principles as a necessary prior issue in determining a matter of civil right arises most commonly where the ultimate purchaser or agent under an IF instrument declines to pay the bank or principal on grounds that the instrument is SNC and therefore void as being *ultra vires* one or both of the relevant parties or beyond the authority of the directors or other agents of those parties.

JUSTICIABILITY

There was until recently real concern as to whether issues of Sharia law were *justiciable* by the English and DIFC courts. In *Shergill v Khaira* [2012] EWCA Civ 983; [2012] PTSR 1697, the Court of Appeal, in a dispute as to the trusteeship of certain Sikh temples, found that an issue as to whether a claimant was the true spiritual successor to a saint venerated within a particular Sikh sect, was *not* justiciable. That issue was neither appropriate for, not capable of, decision by judicial method, and the court should abstain from adjudicating on the truth or merits of differences in religious belief or doctrine.

Fortunately, the Supreme Court took a different view, finding that the primary issues in the case were of the English law of trusts and of the construction of the relevant deed. The court explained that it *would* address questions of religious belief where necessary to enforce private rights and obligations.

The court considered the issues arising on claims that the governing bodies of unincorporated religious communities had acted *ultra vires*, for example in seeking a union with another religious community or in their dealing with members or employees. Where the *vires* in question arise from the civil contract in the constitution of the community or by statute, the courts may need to decide issues of religious belief and practice, insofar as capable of objective ascertainment, on the basis of expert evidence.

Although the court did not refer to cases in which it was alleged that a *corporation* had acted *ultra vires* by transacting in a way that is inconsistent with the tenets of a particular religion and therefore in breach of the contract between members and the company existing in its Articles, there are no obvious grounds for distinction. In both cases, the validity of the act taken on behalf of the association or company is dependent upon its consistency with the tenets and practices of the relevant religion. There was no suggestion in that case that the tenets of Nirmal Kutia Sikhism were particularly susceptible to objective ascertainment, or indeed more so than those of any school of Islamic jurisprudence.

As yet, there is no DIFC authority on the issue of the justiciability of points of Islamic law. It can, however, be assumed that justiciability would be decided on principles of English law as found in *Shergill*, on the basis of the final default application of English law under the "cascade" of jurisdictions found in Art 8 LACCL. That application of English law was described by Justice Sir Anthony Colman in CFI 8/2007 *Ithmar Capital v 8 Investments Inc* (24.11.08) in terms of the use of English and other Common law authorities "*to add flesh to the concise bones of [the codified] provisions*" of DIFC law [112].

There are, however, a number of indicators that the DIFC courts would be *un*likely to find issues of Islamic law and Sharia compliance to be non-justiciable.

First, the DIFC courts have a number of UAE-qualified judges, willing to apply directly their own knowledge of UAE law: CFI 012/2012 *Allianz Risk Transfer v Al Ain Ahlia Ince* (24.4.13).

Secondly, issues of UAE law, and the Civil Code in particular, arise commonly in DIFC cases, and the DIFC courts have expressed some comfort in dealing with those issues, in the first procedural instance on paper and without expert evidence: CFI 014/2010 *Taaleem PJSC v National Bonds Corporation PJSC* (14.1.13).

Thirdly, the DIFC courts have recently shown greater respect for IF structures. For example, in the recent case of CFI 032/2012 *Beydoun v Daman* (10.7.14), the court found, after detailed consideration of an IF *ijara* facility that an assignment of the right to purchase an apartment would have been effective as such to deprive the assignor of its cause of action if executed *after* the relevant purchase. It was not merely the creation of a security interest.

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ISSUES AS TO CAPACITY AND AUTHORITY OF PARTIES

The court in *Blom* clearly accepted that an IF instrument could be void as being *ultra vires* one of the parties under the law of its place of incorporation. Sadly, the defendant obtained a stay under the Kuwaiti Financial Stability Law before the claimant's cross-appeal of the judge's decision on the contract claim could be heard. The case assumed particular interest because the defendant's *own* supervisory board publicly criticised the defendant's raising of IF arguments without consulting it. If the case had proceeded to trial in the Chancery Division, there would have been a very interesting debate, on the expert Sharia evidence, as to whether the hybrid elements of the contract in question, which, although a wikala, included a sale and re-purchase of goods as between the principal and agent, would have saved the contract from being SNC.

When the judgment in *Blom* was first delivered, there was controversy as to whether it had *damaged* IF by creating significant SNC risk which would be required to be priced into IF contracts. However, there is now some sense that the engagement of secular courts in issues of IF may in fact have *assisted* in deterring more extreme cases of artificiality and in ensuring that banks continue to write IF business that is properly within their powers. It is no longer unusual to see parties plead in their defence that an IF contract was void as having been *ultra vires* one or both of the relevant parties and/or outside the authority of the Board or officers who executed it.

STATUTORY INTERVENTION IN ENGLAND AND THE DIFC

Under English principles as to the conflict of laws, issues as to the capacity of a company are determined under the law of the country where the company is incorporated. If that is England, then s 39 of the Companies Act 2006 protects third parties, just as under s 40 the authority of the directors is deemed free of limitation in favour of a person dealing or presumed to be dealing with the company in good faith. The result is that the *ultra vires* doctrine has in effect been abolished for the purpose of invalidating an instrument, and an excess of authority will invalidate only where the third party has acted in bad faith.

The position under DIFC law is more complex. The *ultra vires* doctrine was excluded under Art 24(2) of DIFC Law No 2 of 2009 ("the Companies Law"). This exclusion eliminates the risk of an *ultra vires* defence where the relevant party is incorporated in the DIFC, and gives a powerful argument for dealing with and/or through such parties. However, there is no specific statutory protection for third parties where the directors were acting in excess of their authority, although that authority can be drawn widely by reference to their apparent or "incidental" authority under DIFC Law No 6 of 2004.

Insofar as English or DIFC law requires issues of capacity to be decided in accordance with the law of the place of incorporation of the relevant company, the company laws of most Arab countries have a clear requirement that a company's memorandum should specify, among other things, the objects or purposes of the company. Often these are required to be legitimate and to be in accordance with such licences as the company needs to hold under policies intended to maintain uniformity and specialisation, as under Art 13 of the UAE Companies Law. It is implicit that SNC business, likely to be outside those purposes, or illegitimate or outside the scope of relevant licences, will be void or unenforceable.

MITIGATORY STEPS

There are clearly a number of ways in which the risk of a contract being found *ultra vires* can be prospectively mitigated. The most common is the taking of warranties that the agreement is Sharia compliant and/or intra vires the relevant counterparty, and/or a requirement of express undertakings that it will not seek to argue that the agreement is SNC or *ultra vires* any party. While such warranties and undertakings are effective in English law, they face two difficulties. First, under English law, a party cannot estop itself from asserting the invalidity of a contract which is invalid, so that an issue of capacity arises regardless of whether the point is taken by any party: *Freeman & Lockyer v Buckhurst Park Properties* [1964] 2 QB 480. Secondly, it may be argued, under Sharia principles, to which recognition may be given under the law of a company's seat, that such a warranty or undertaking may itself be SNC and void or unenforceable on that ground.

Other methods to mitigate SNC risk may be to require the certification of the contract as being Sharia compliant by the Sharia supervisory board of each party, or the inclusion of an arbitration provision for the appointment of an arbitrator with Sharia expertise capable of giving a prompt interim award on any issue of Sharia compliance that may be raised against payment. To the extent that an arbitration clause is discriminatory in requiring the appointment of an arbitrator from a particular religious or racial group, such discrimination is not prohibited under the Employment Act 2010 as an arbitral appointment is not "employment", and such discrimination would satisfy a genuine occupational requirement under Sch 9 to that Act: *Hashwani v Jivraj* [2011] UKSC 40.

CONCLUSIONS

There are a number of ways in which Sharia principles can be applied indirectly by the English and DIFC courts. In many instances, the parties may wish to provide for such application. There is, however, risk that those courts will find IF transactions to be void by indirect application of Sharia principles by the laws of countries in which the parties are incorporated. There are limited ways in which that risk can be managed. ■

Further reading

- The challenge of Islamic banking disputes in the English courts: the applied law [2009] 6 JIBFL 350
- Lexis PSL: Dispute Resolution: Applicable Law
- Lexisnexis Loan Ranger: Sukuk reaches western markets

Feature

KEY POINTS
- Recent legislation in the Republic of Turkey has opened up the Turkish sukuk market to non-financial institutions, including corporate, for the first time.
- The recent legislation has also paved the way for new types of sukuk structures to be used, so as to attract new capital investment into the country.
- The Turkish government is keen for the Republic of Turkey to become a global hub of Islamic finance.

Author Müfit Arapoğlu

The emergence of the Turkish sukuk market

As one of the new MINT economies and the 17th biggest economy in the world, the Republic of Turkey has in recent years began utilising Sharia compliant sukuk issuances as a means of attracting some much sought after capital investment into the country, particularly from the Middle East where the demand for Sharia compliant securities is far outstripping supply. Recent legislation in the Republic of Turkey has broadened the number of sukuk structures that are permitted, to allow the Turkish sukuk market to expand. For the first time these new structures will permit corporates and other non-financial institutions to issue sukuk and may attract investment into areas such as infrastructure projects, which is becoming one of the key areas of focus for the Turkish government. This article considers the new structures and the legislative framework.

In 2011, the participation bank Kuveyt Türk (after issuing a pioneering first Turkish sukuk in 2010) issued the first sukuk pursuant to newly enacted legislation entitled the Principles on Lease Certificates and Asset Leasing Companies (the "First Legislation"). The Republic of Turkey then issued its first US$1.5bn sovereign sukuk in September 2012 which was followed by a US$1.25bn sovereign sukuk issuance in October 2013. The Republic of Turkey also tapped the local sukuk market by issuing Turkish Lira dominated sukuk in 2012 and 2013, which proved to be another very important milestone in the growth of the Turkish sukuk market. These issuances mostly followed a traditional sale and lease back model known as an *ijara* structure. This structure was considered in some detail in the article "Is there nothing new under the sun?" published in [2012] 11 JIBFL 689.

The First Legislation allowed the formation of asset leasing companies which are special purpose vehicles regulated by the Capital Markets Board of Turkey (the "CMB"). Under the First Legislation the asset leasing companies issuing certificates under an *ijara* structure are incorporated specifically to be able to issue certificates bought by investors (known as "certificate-holders") so as to purchase assets and lease them back to the originator. In essence, the asset leasing company finances the acquisition of such assets using funds raised by the issue of certificates, and the lease rental payments from the originator mirror the profit distributions due under the certificates. The cash flows from the lease rentals are therefore used to service such profit distributions to certificate-holders.

The framework in which Turkish sukuk are issued uses deliberately different terminology, such as "asset leasing companies", as opposed to "sukuk trustees" used in typical non-Turkish sukuk structures. The asset-based as opposed to asset-backed *ijara* structure was originally the only type of structure allowed under the First Legislation. This opened the way for sukuk issuance in Turkey, and whilst highly useful, the *ijara* structure is not suitable for certain types of financings, such as infrastructure projects, as an asset leasing company cannot purchase and create a lease over an asset before it is built. The sovereign sukuk issuances were sought as the benchmark by which to establish the Turkish sukuk market as a global hub for Islamic finance. In addition to Kuveyt Türk, the three other Turkish participation banks (AlBaraka Bank, Bank Asya and Türkiye Finans Bank) also issued sukuk both in the domestic and international markets. The global capital markets community has followed the first sovereign and participation bank sukuk issuances with great interest and the desire to allow non-financial institutions to issue their own sukuk was given legislative support, in the recent Communiqué on Lease Certificates (III-61) issued on 7 June 2013 (the "Second Legislation") partly thanks to the CMB's great effort and willingness to improve and develop the sukuk market in Turkey. The Turkish government has also announced that it hopes to grow the participation banks' market share and has announced its intention to grant a participating bank licence to at least one of the state owned banks, which demonstrates the growing importance of Islamic finance in the country's wider fiscal strategy and the Turkish government's desire in bringing new players into the market.

In addition to the by now established ownership or *ijara* structures allowed under the First Legislation, the Second Legislation also allowed asset leasing companies to issue lease certificates based on management (*mudaraba*), purchase and sale (*murabaha*), partnership (*musharaka*) and contractor agreement (*istisna*) structures. While it is expected that the initial sukuk issued following the Second Legislation will follow the *ijara* model, the Second Legislation allows the possibility to finance a much wider range of projects and businesses.

Under the management or *mudaraba* structure certificates are issued for the purpose of transferring the income generated from the management of the assets of an originator, including via a lease of assets owned by such originator, to certificate-holders during the term of the sukuk. In this structure an agreement will be executed between the originator and the asset leasing company to govern the management of the assets of the originator without transferring the ownership.

The *musharaka* model is in essence a joint venture structure between the originator and the asset leasing company whereby the originator retains a role as managing agent and shares in the loss and profits of the structure with the certificate-holders. The Second Legislation regulates the financing of the joint venture through the issuance of certificates whereby the asset leasing company exclusively contributes capital and other parties contribute other tangible capital.

The *murabaha* model can be used in situations where there is no tangible assets in the underlying structure and the proceeds of a certificate issuance can be used to fund the purchase of commodities and the asset leasing company can on-sell the commodities to the originator to generate revenue from the deferred purchase price which is then distributed periodically to the certificate-holders during the term of the sukuk.

Of particular interest is the *istisna* structure, which could be used to finance infrastructure projects such as airports or motorways. The *istisna* structure works by means of a forward lease agreement, whereby capital is provided to purchase the initial raw materials or land involved in a project and the forward lease agreement provides that the eventually complete asset is sold and leased back to the originator and such profit distributions from the asset are distributed to certificate-holders much like in an *ijara* structure. While there is some debate among Sharia scholars as to whether certificates can be used before the project is finalised, it is clear that this particular structure has great potential to be used to finance some of Turkey's future infrastructure projects.

The need for a valuation report under certain structures is one of the most important aspects that the Second Legislation has introduced, which is especially important for originators to consider, in that it regulates the value of the asset portfolio on which the issuance is based. The Second Legislation provides that the issuance amount of lease certificates based on ownership (*ijara*), partnership (*musharaka*) or contractor agreement (*istisna*) structures may not exceed 90% of the fair value of the underlying assets determined under a valuation report prepared by a valuation company. This ensures that such issuances are sufficiently covered by the assets upon which they are based, and affords some reassurance for certificate-holders should such a structure go into default. Originators considering entering the Turkish sukuk market will therefore need to ensure that they have sufficient assets on which to base their issuance. Not only will such originators need to satisfy the requirements of the valuation report, they will also need to ensure that the assets on which the issuance is based are Sharia compliant.

The asset leasing companies at the centre of the Turkish sukuk market are unlike special purpose vehicles found in traditional securitisations or in other sukuk markets, in that they can issue multiple sukuk and can issue certificates for companies other than the company which was incorporated to issue them. However, the Second Legislation makes it clear that the entities listed in (d) (e) (f) and (g) below can only establish asset leasing companies if they are actual fund users and cannot establish on behalf of third parties. The Second Legislation has listed the entities being allowed to establish an asset leasing company as:

(a) banks;
(b) intermediary institutions engaged in either one of the following: (i) portfolio intermediation; (ii) general custodian service; or (iii) underwriting;
(c) mortgage financing institutions;
(d) real estate investment trusts listed in the stock exchange;
(e) public companies in the first and second groups determined in accordance with corporate governance regulations of CMB;
(f) companies issued with a long term investment grade rating; and
(g) companies more of which 51% or more is owned by the Undersecretariat of the Treasury.

The Second Legislation does not clarify if the investment grade referred to in limb (f) needs to be obtained from an international rating agency, although the CMB has approved local Turkish rating agencies' ratings on recent sukuk issuances, in respect of this requirement. It is also assumed that the rating only applies at the moment of issuance, as the Second Legislation is silent as to whether such investment grade rating needs to be maintained by such asset leasing company.

The asset leasing companies are also unlike other special purpose vehicles in that they are heavily regulated by the CMB.

The Second Legislation principally requires the CMB to approve the articles of association of an asset leasing company before it can issue sukuk. In addition, the CMB's approval is required in the following circumstances:

- where the asset leasing company is party to a merger and de-merger transaction and amends its articles of association;
- where any acquisition of shares that results in the acquisition of shares, by one person directly or indirectly, representing 10% or more of the capital of an asset leasing company or whereby virtue of a share acquisition the shares held by one shareholder exceed or fall below certain percentages of the asset leasing company's capital; and
- where there is a transfer of shares granting management or voting privileges.

In addition, pursuant to the Second Legislation, an asset leasing company may not:

- engage in any activities other than those indicated under its articles of association as approved by the CMB;
- grant any property rights in favour of third parties over its assets and rights other than as permitted under its articles of association;
- dispose of such assets and rights in any way which prejudices the interests of the certificateholders; and
- use any loans, be indebted or use any assets except for such activities set out in its articles of association.

Feature

Biog box
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The CMB also provides that the asset leasing company is to have at least three board members, one of which must be an independent board member who satisfies the CMB's independency criteria and certain decisions are subject to the vote of such board member. The board of directors of the asset leasing company is required to prepare quarterly investor reports which shall include revenues and collections made from the relevant assets and payments made to the certificate-holders.

As asset leasing companies can issue multiple sukuk, the importance of segregating assets to minimise the insolvency risk and the risks of cross-default is paramount. The Second Legislation also sets out that separate records are to be kept in respect of the assets which are subject to each issuance including the revenues generated, the collections made and the expenses incurred with respect thereto. The assets, rights and liabilities of each issuance for each company are separately monitored in the records of the asset leasing company and until certificates are redeemed, assets in the portfolio of an asset leasing company may not be disposed, collateralised or seized. It is important to bear in mind however, that unlike special purpose vehicles used in non-Turkish sukuk, the asset leasing companies are not entirely insolvency remote by virtue of the fact that they hold assets on behalf of different companies. However, under the Second Legislation, until the redemption of the certificates occurs, the assets and rights included in the portfolio of the asset leasing company cannot be included in the insolvent company's estate nor can they be subject to an injunction order.

Along with the First Legislation, amendments in the tax legislation have also afforded certain tax advantages on sukuk that mean that corporates wishing to raise finance through the sukuk market will be able to raise finance in a way which is competitive with traditional finance raising and could open them up to a currently unavailable investor pool, such as certain investors from the Middle East who can only purchase Sharia compliant securities. Below are some of the key tax advantages of the sukuk that have been recently passed pursuant to Turkish tax legislation:

- Pursuant to the Corporate Tax Law (Law No 5520), any capital gains to be derived by an originator from the sale of asset portfolio to an asset leasing company and from an asset leasing company to an originator are exempt from corporate tax on the condition that such sales are only made for the issuance of the certificates by the asset leasing company. In order to benefit from such exemption, the capital gains derived from such sales must be reserved in equity as a fund which is not to be distributed for five years and the sale proceeds must be collected in cash within a two-year period.
- Under the VAT Law (Law No 3065), the delivery of certificates is exempt from VAT. In addition, the transfer of assets to an asset leasing company as well as the lease of assets by an asset leasing company and transfer to the originator are exempt from VAT.
- Pursuant to the Charges Law (Law No 492), the sale of the asset portfolio in a sukuk is exempt from the Title Deed Registry Fee and other fees.
- The Income Tax Law (Law No 193) requires withholding tax from the interest income received under the certificates issued abroad. However, the rate of such withholding tax is reduced to 0% for such certificates with a maturity of five years, as is typical for a sukuk.
- Pursuant to the Stamp Tax Law (Law No 488), the transfer of assets to an asset leasing company, the transfer of such assets by an asset leasing company to the originator, documents issued with respect to the lease and the certificates are all exempt from Turkish stamp tax. A non-resident holder will also not be liable for Turkish inheritance, registration or similar tax or duty with respect to its investment in lease certificates.

Currently the tax legislation has mainly been applied to the *ijara* structured sukuk and it may be that further tax legislation will need to be enacted to encourage the use of the other structures that have been introduced by the Second Legislation.

The Turkish government is very keen to use Islamic finance as a means of attracting investment into the country, particularly from the Middle East, and the initial sovereign issuances were many times oversubscribed. There are certain tax advantages by using sukuk to raise finance and both the First Legislation and the Second Legislation have been enacted to create a framework by which different Sharia compliant structures can be utilised and are specifically designed to allow new players to enter the market. While it is clear that there are excellent opportunities in the Turkish sukuk market, there are a few challenges that new entrants into the market may face including understanding the scope and limitations of Islamic finance and the difficulties in reconciling the new structures against existing Turkish capital markets and tax legislation. Once these obstacles are addressed and the new structures become tested and established, Turkey is perfectly placed to become a global hub of Islamic finance.[1] ■

1 Given the complexity of the topics covered herein, this article does not necessarily seek to cover every aspect of the Turkish sukuk market or the relevant legislation and is not designed to provide legal advice and the opinions expressed herein reflect only the author's own views. The author would like to thank his colleagues Claudio Medeossi and Stuart Mason for their assistance in compiling this article.

Further reading

- Is there nothing new under the sun? [2012] 11 JIBFL 689
- Striving for consistency: an analysis of the enforcement mechanisms of Islamic capital markets debt documentation [2013] 9 JIBFL 559
- LexisNexis Loan Ranger Blog: Sukuk reaches Western markets

KEY POINTS

- The assertion that rights *in rem* and rights *in personam* represent a distinction between property rights and non-property rights must be rejected.
- The distinction between rights *in rem* and rights *in personam* is a distinction between two different types of property rights.
- Only the benefit side of the obligation to pay falls within property.

Feature

Author Professor John Tarrant

The nature of a debt

A widely asserted proposition is that property rights are restricted only to those rights that are rights *in rem* and that rights *in personam*, such as debts and bank accounts, are not property rights. The author rejects this assertion and explains why debts in the form of money obligations owed by one person to another are indeed property rights. When valuable assets are held in the form of loans and bank deposits it is critically important that there be clarity as to whether or not such assets are property rights.

INTRODUCTION

The nature of a debt is fundamental to the banking industry. Often it can be critical to know whether or not a debt is a property right where, for example, security is taken over all the property owned by a borrower. An erroneous assumption is often made that only rights *in rem* are property rights and rights *in personam*, that correlate with obligations, are personal rights and not property rights. If accepted, such an assertion is likely to lead to uncertainty and confusion especially in circumstances where the assertion cannot be reconciled with the case law. A recent expression of this idea is reflected in Worthington's view that equity has effectively eliminated the divide between property and obligation.[1] Worthington proceeds on the basis that there is a "general assumption that there is a sharp doctrinal and functional divide between property and obligation".[2] A significant difficulty with this approach is that it is irreconcilable with the case law indicating that a debt, which is a common personal right or right *in personam*, is a property right.[3]

The place of property and obligation in private law can only be fully understood once the proposition that property rights are restricted to rights *in rem* is rejected. Far from property and obligations being mutually exclusive, it will be argued that obligations are simply one side of one type of property right and that a debt is both a property right and a personal right.

THE MYTH OF THE PROPERTY/ OBLIGATION DIVIDE

A critical issue in understanding property is how and why rights such as debts are property rights. A debt clearly differs from items of tangible property such as land or motor vehicles. A debt also differs from other types of property rights such as copyright, patents and goodwill.

The starting point for understanding why a debt is a property right is that in the context of a debt the right to be paid correlates with an obligation to pay. That is, there are two sides to a debt: one person has an asset and the other a liability. The right to be paid is a property right, and thus legitimately falls within the law of property, and the obligation to pay forms part of the law of obligations. Including the benefit of obligations within the definition of property does not merge both sides of obligations with property; only the benefit side of obligations falls within property. The liability side of obligations remains distinct from property and thus the property and obligation distinction is not dissolved.

> "...it will be argued that obligations are simply one side of one type of property right and that a debt is both a property right and a personal right"

It is helpful to use four descriptive terms to explain the different aspects of the law of property and how property, duties and obligations fit together within private law. When these terms are fully understood it is possible to understand why a debt is in fact a property right. Two of the four terms represent property rights while the other two represent duties and obligations. The first two of the four terms, "rights *in rem*" and "rights *in personam*" are the well-established descriptive labels for the respective rights. A right *in rem* is a right that is enforceable against all the world while a right *in personam* is only enforceable against a specific person. They are simply two different types of rights based on the different characteristics of the subject matter of the right. However, the distinction between the correlative duties and obligations to these rights are not always clearly and adequately described. Penner has helpfully suggested that the duty that correlates with a right *in rem* should be described as a "duty *in rem*"[4] and that is very appropriate as a description of the third of the four terms. But what is missing is a descriptive label for the liability side of a right *in personam* that distinguishes the liability from the benefit side of an obligation and also distinguishes an obligation owed from a duty of non-interference.

To date such an obligation or liability is referred to as an obligation but this immediately creates ambiguity because there are two sides to an obligation: in the context of a debt there is both a right to be paid and an obligation to pay. The term obligation is of limited use where precision of language is essential. Using the one term to describe a relationship that has both an asset side and a liability side is unhelpful. It is therefore proposed that when referring to the liability side of an obligation it would assist to describe such an obligation as an "obligation *in personam*", which is adopted here as the description of the fourth term needed to adequately describe the different aspects of property.

TABLE 1

Type of right	Correlative duty or obligation
Right *in rem*	Duty *in rem*
Right *in personam*	Obligation *in personam*

With these four descriptions it becomes much clearer that a property right *in rem* has a correlative duty *in rem*, a duty of non-interference, and a right *in personam* has a correlative obligation *in personam*. The law of property consists of both rights *in rem* and rights *in personam*. The law of obligations (when viewed from the perspective of liabilities) consists of the law of *obligations in personam*. Obligations *in personam* always refer to obligations owed to identifiable individuals. The distinction between these obligations and property is not lost by including the benefit of an obligation within the law of property. In the context of a debt, the right to be paid by the person who has the obligation to pay is a property right. That is, the benefit side of an obligation is a property right.

> "In the context of a debt, the right to be paid by the person who has the obligation to pay is a property right. That is, the benefit side of an obligation is a property right"

Chambers is of the view that property rights are generally restricted to rights *in rem*[5] and refers to the so-called distinction between property and obligations as "the great property/obligations divide".[6] Accordingly Chambers concludes that "by definition, the law of obligations excludes the law of property".[7] But Chambers realises, correctly, that having property law and the law of obligations examined separately effectively divides private law down the middle with the possibility that like cases might not be treated alike.[8]

To address this issue Chambers suggests that property and obligations should be integrated within an expanded framework of obligations.[9] But that would only be necessary if the distinction between property and obligations based on rights *in rem* and rights *in personam* was valid. But the distinction between rights *in rem* and rights *in personam* as a distinction between property rights and non-property rights is nothing more than an assertion. The problem that Chambers attempts to solve is not a real problem at all. If the assertion is rejected as unsound there is in fact no problem in need of a solution. The case law that confirms that debts are property rights only reinforces the need to reject the assertion that rights *in personam*, including debts, are not property rights.

To understand the possible divisions of private law Table 1 (above) depicts some of the main building blocks of private law. The table includes property rights *in rem* and their correlative duties *in rem*, or duties of non-interference. The table also includes rights *in personam* that correlate with obligations *in personam*, as distinct from duties *in rem*. It is not suggested that this table includes all of private law. There are complexities in relation to trusts and some property rights such as intellectual property and goodwill which are not necessary to explore here. Accordingly the table is designed to depict only the major components of private law that are sufficient for current purposes. The important components of private law that relate to property rights *in rem* and property rights *in personam* can be depicted as shown in the table.

Chambers sees property and obligations as two mutually exclusive parts of private law because he divides the above table horizontally. That is, for Chambers the top half of the table (rights *in rem* and duties *in rem*) is the law of property and the bottom half of the table (rights *in personam* and obligations *in personam*) is the law of obligations. Adopting a rights *in rem* definition of property leads to this inevitable division. But if the rights *in rem* definition of property is rejected, as it should be, then the appropriate division of private law in the above table is a vertical division. That is, the law of property is reflected in the left half of the table and the law of obligations owed and duties owed is the right half of the table. The law of obligations does not need to be integrated into property law because the law of obligations is directly connected to the law of property by virtue of being the correlative of *some property rights*, those property rights that correlate with obligations. The content of a right *in rem* correlates directly with the duty *in rem* recognised by Penner.[10]

Using an example of personal property, the right to enjoy the use of a bicycle correlates directly with the duty of others in society not to interfere with that bicycle. That is, the recognition of a duty of non-interference by the law gives content to the correlating right *in rem*. In the same way an obligation gives content to a property right *in personam*. For example, an obligation to pay £5,000 gives content to the correlative right which is the right to be paid £5,000.

Whereas Chambers is of the view that there is work to do to integrate property and obligations Worthington is of the view that equity has effectively eliminated the divide between property and obligation.[11] Like Chambers, and as said above, Worthington proceeds on the basis that there is a "general assumption that there is a sharp doctrinal and functional divide between property and obligation".[12] This represents the express adoption by Worthington of the view that rights *in rem* are property rights and rights *in personam* are obligations.[13]

Another useful way of considering the issue is to look at the rights in the context of assets and liabilities. Some

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property rights can exist without any correlating liability, such as a property right to land which is unencumbered. The owner of the land has an asset and there is no corresponding liability owed by any person. The owner's rights are protected by a correlative duty of non-interference but there is no liability as such involved in the recognition of that duty. By contrast a debt can only exist if there is a correlative liability. A debt requires the existence of an obligation to pay and thus when a debt exists there is both an asset and a liability. This simply demonstrates that not all property rights are the same. Property rights can have different characteristics.[14]

It is also worth examining the insolvency context to highlight how one side of an obligation forms part of the law of property. This is particularly relevant in the banking context. In the insolvency context it is important to understand why a person who has the benefit of an obligation might obtain some priority in an insolvency. It is *never* solely on the basis that they have the benefit of an obligation, for example because they are owed a debt. There must be something more, some right in addition to having the benefit of an obligation owed by the insolvent debtor. That additional right might be a property right in the form of equitable ownership or it might be a form of security.

What is important here is that the divide between property and obligation does not collapse. Rather, in addition to having the benefit of an obligation, that is the benefit of a debt owed to the creditor by the debtor, the creditor has an *additional right* in the form of some security interest created by consent between the borrower and the lender.

In relation to security interests a creditor does not receive any form of priority based solely on having the benefit of an obligation owed by an insolvent debtor. Rather, a creditor receives priority by virtue of having negotiated for a security interest, for example when loaning money to the debtor that gave rise to the relevant obligation. Obligations in these circumstances can arise in two different contexts. First, the property provided as security may itself be the benefit side of an obligation, for example, an accounts receivable. The second context where an obligation arises is where a debtor obtains a loan and enters into an obligation to repay that loan. They might, as part of the transaction, provide security for that loan. They are providing security to secure their obligation to pay the lender and they may provide that security in any number of ways. If they choose to provide debts owed to them (the benefit side of obligations) as the relevant security then security is taken by their lender over those assets. These discrete parts of a secured loan transaction need to be clearly stated so that it is clear what side of an obligation is being referred to.

CONCLUSION

The assertion that rights *in rem* and rights *in personam* represent a distinction between property rights and non-property rights, together with the related "assumption that there is a sharp doctrinal and functional divide between property and obligation",[15] must be rejected. These two types of rights do not represent a distinction between property rights and non-property rights. The distinction between rights *in rem* and rights *in personam* is a distinction between two different types of property rights: those that correlate with a duty of non-interference and those that correlate with an obligation *in personam*.

The common law courts have adopted a wide definition of property rights which comprise both rights that correlate with a duty of non-interference and rights that correlate with obligations. That definition of property in the case law includes a debt being a property right. Any assertion that property rights only include rights *in rem* is simply contrary to the case law and an assertion made without any foundation.

The so-called problem, that obligations and property need to be integrated, is not an issue at all. Obligations already form an important part of the law of property. The benefit side of an obligation represents a property right that correlates with the liability side of an obligation. That is, the benefit side of an obligation is already an important part of private law and a debt is a property right. ■

1 Sarah Worthington, "The Disappearing Divide Between Property and Obligation: The Impact of Aligning Legal Analysis and Commercial Expectation", in Simone Degeling and James Edelman (eds), *Equity in Commercial Law* (2005) 93.
2 *Ibid*.
3 See eg *Loxton v Moir* (1914) 18 CLR 360, 379 (where Rich J said that a "right to sue for a sum of money is a chose in action, and it is a proprietary right"); *Yanner v Eaton* (1999) 201 CLR 351, 388 (where Gummow J observed that a "common law debt, albeit not assignable, was nevertheless property"); *Lipkin Gorman v Karpnale Ltd* [1991] 2 AC 548, 574 (where Lord Goff observed that a debt owed by a bank "constitutes a chose in action, which is a species of property").
4 J Penner, *The Idea of Property in Law*, Oxford University Press, Oxford, 2000, p 84.
5 R Chambers, *An Introduction to Property Law in Australia*, 2nd ed, Lawbook Co, Pyrmont, 2008, p 6.
6 R Chambers, "Integrating Property and Obligations" in Andrew Robertson (ed), *The Law of Obligations: Connections and Boundaries* (UCL Press, 2004) 127, 128.
7 *Ibid* 127.
8 *Ibid* 128.
9 *Ibid* 143.
10 Penner, above n 4, p 84.
11 Worthington, above n 1.
12 *Ibid* 93.
13 *Ibid* 103.
14 See J Tarrant, "Characteristics of Property Rights" (2008) 16 APLJ 51 and J Tarrant, "Obligations as Property" (2011) 34 UNSWLJ 677.
15 Worthington, above n 1, 93.

Further reading

- The assignment of debts: Which law applies to the question who has the better proprietary right to an assigned debt? [2011] 9 JIBFL 544
- Lexis PSL: Banking & Finance Glossary
- Lexis PSL: Proof of Debt

KEY POINTS

- A lasting consequence of the 2008 financial crisis has been a sharp decline in bank lending across Europe.
- As the European economy improves, demand for credit across all business sizes and asset classes continues to increase.
- Alternative credit providers have emerged in a number of different forms to fill the funding gap as banks retrench, bringing about a fundamental structural change in the operation of Europe's debt markets.

Author Alistair Hill

Alternative credit providers in Europe

This article considers the reasons for structural change in Europe's debt markets and illustrates new ways for banks and alternative credit providers to work together.

One of the most enduring consequences of the financial crisis is that Europe's debt markets have moved, particularly for the funding of mid-market transactions (classified as those in the range of £20m-£120m), to a model more akin to that which prevails in the US, where bank loans only account for approx. 25% of corporate debt.

This shift away from banks (traditionally accounting for between 80-90% of financing for European companies) to new debt providers such as private equity, institutional investors, insurance companies, pension funds and a variety of alternative credit providers (collectively, "ACPs") is now a permanent, structural feature across a number of different asset classes. For example, Fitch Ratings research shows that between 2011 and 2012 Europe's largest banks reduced corporate lending by 9% (accounting for approximately a EUR 440bn funding "gap"). Likewise, according to the Bank of England, net lending to UK businesses by banks has fallen every year for the last six years. By contrast, Deloitte's most recent alternative lender "deal tracker" reported that in the UK there has been a 50% year-on-year increase in transactions involving ACPs in the first quarter of 2014 (as compared to the first quarter of 2013). In mainland Europe the increase has been 120% over the same period.

REASONS FOR STRUCTURAL CHANGE

The pace and pervasiveness of this structural change has been precipitated by, and will continue as a result of, the following factors.

Regulatory change

The panoply of national and international regulatory frameworks introduced since the financial crisis have forced banks to strengthen their balance sheets. In particular, Basel III imposes more onerous capital requirements on banks and increased risk weighting across certain asset classes thereby forcing banks to hold a greater share of their assets rather than advancing them for a return (broadly speaking Basel III requires commercial banks to more than triple their holdings of tier one capital to at least 7% of risk-weighted assets). The overall impact of the new liquidity standards and capital ratios included within Basel III, as well as the "ring fences" suggested by the Vickers and Liikanen reports, has been a significant and continued retrenchment of banks from their pre-crisis lending activities and this, first and foremost, has created an environment in which ACPs (unconstrained by such regulatory fetters) can flourish.

Government intervention

Many European states have traditionally given banks a preferred status in lending transactions, for example the requirement for bank licences in France and Italy in order to lend directly to corporates in those jurisdictions. In addition, in some countries only banks have been able to take certain types of security or benefit from certain withholding and other tax advantages. Whilst the credit crisis has led to the harmonisation of a number of financial regulations, there remain a large number of national regulations, particularly in relation to bank licensing requirements. Therefore, whilst the UK, Ireland and Spain do not require a licence to lend, any entity that originates loans to corporates in France or Germany is required to have a licence.

European governments have recognised, however, that in order for there to be a sustained economic recovery it is necessary to improve the mixture and overall resilience of funding sources to corporates and have therefore taken action to encourage this diversification. For example in Italy, where direct lending has traditionally been reserved to banks and certain financial entities registered with the Bank of Italy which are subject to regulatory and prudential provisions similar to those applicable to banks, legislation has recently been introduced with the specific aim of "liberalising" the lending market so that securitisation vehicles as well as Italian insurance companies are now allowed to lend directly to Italian companies provided they retain a "significant interest" for the life of the transaction. The changes will also enable collective investment schemes to invest in loan receivables effectively enabling them to also lend directly. Allied to this, the tax rules in Italy have been changed so that a withholding tax exemption (the current withholding rate being 26%) will apply to payments of interest to certain non-resident lenders, including financial institutions established in an EU member state and insurance companies established and authorised under the law of an EU member state.

Low interest rates and the search for yield

The unprecedented low interest rates which have prevailed in most major economies over the last five years has meant that pension funds and other institutional investors have had to diversify their range of investments in the search for yield to match their expected liabilities. Into this category falls floating rate senior secured corporate loans which are generally regarded as "safe" for the returns on offer, with default rates remaining low and, even where there are defaults, recoveries being 60% or more. ACPs and private placements have therefore acted as a conduit for institutional investment into the relatively new asset class of illiquid mid-market corporate credit as a halfway house between the mid-teens return on illiquid private equity investments and the lower returns (circa 5%) on more liquid credit investments.

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Greater flexibility

As the European economy continues to improve and corporates become less dependent on relationship banks and increasingly aware of the funding available from ACPs, the anecdotal evidence is that they are warming to the terms and process flexibility which ACPs can generally offer. Whilst the margins offered by ACPs (typically 6.5%-10%) tend to be higher than those offered by banks (albeit the price differential has reduced in a more competitive market), the greater covenant flexibility, increased leverage (often through a unitranche structure) and absence of an amortisation requirement which ACPs can generally offer is finding increasing favour with European corporates and sponsors. Some ACPs are often also able to write much bigger tickets for mid-market event driven lending than the typical bank hold of £25m. This terms flexibility is matched by a process flexibility as commercial banks typically struggle to match the response times of ACPs and borrower clients can often find themselves frustrated by what they sometimes perceive as "big bank bureaucracy".

Whilst banks will obviously remain of fundamental importance to the healthy operation of Europe's capital markets and the continent's economic recovery, the trend for banks to be much more selective about their borrowers, preferring to lend to larger companies in their domestic markets and for shorter durations is unlikely to disappear in the foreseeable future. This will continue to create opportunities for ACPs particularly in the SME and mid-market where companies are not able to access the bond markets and have therefore traditionally relied on Europe's commercial banks for their funding needs. For example, it has been estimated that in 2012 SMEs in France sourced approximately 90% of their capital through banks, and only got 2% from the capital markets.

COMPETITORS OR BEDFELLOWS?

It is important to recognise, however, that whilst there is clearly a competitive threat posed to commercial banks from ACPs and the deployment of institutional capital more generally in banks' traditional lending markets, in many instances commercial banks and ACPs are working together to structure transactions for the mutual benefit of clients. This structuring takes account of the fact that banks and ACPs may have different risk appetites and can therefore structure (through a unitranche arrangement) a "one loan" solution for borrowers whilst at the same time apportioning the risk on that loan between themselves by virtue of an intercreditor agreement between lenders.

In the infrastructure market, a group of European banks has developed the PEBBLE (Pan European Bank to Bond Loan Equisitation) initiative to fund greenfield projects in combination with institutional capital. Under this structure institutional investors are expected to provide 85% of the core debt for each project, and banks the remaining 15% on a subordinated, first loss basis thereby credit enhancing the institutional strip of funding. Whilst subordinated, the bank debt is the controlling creditor class for all but the most important decisions and pays down in advance of the institutional investor core funding during the riskiest phase of funding. The structure has been designed to address two issues which have historically prevented institutional investment in project finance, namely the administrative inconvenience associated with cash management and waiver requests, which are often most acute during the construction phase of a project and the fact that the credit rating of most projects (typically low investment grade) has prevented significant institutional investor investment.

In all asset classes commercial banks will continue to be a key provider of hedging, working capital and other ancillary banking arrangements (often necessitating the use of bespoke super senior priority intercreditor arrangements). The co-operation between banks and ACPs has in some instances been formalised into non-exclusive relationships or joint ventures such as BlueBay's and Barclays' joint venture for mid-market corporate and sponsor-backed lending.

The rationale behind these arrangements is to ensure that clients can take advantage of a "one-stop shop" whereby the whole range of lending products (including acquisition and capex debt provided by the ACP combined with the day-to-day banking services of a clearing bank) are available on terms and subject to documentation which has already been agreed by the commercial bank and ACP, thereby shortening deal execution time and minimising legal cost.

CONCLUSION

It is perhaps easy to overstate the shift in bank lending to ACPs in Europe; comparisons to the US market only go so far as Europe remains from the perspective of mid-market and SME borrowers, fundamentally, a bank's market with approximately £100bn of SME financing continuing to be made available by banks. Commercial banks will remain, for some time, the first port of call for many corporate treasurers. That said, the past 18 months represent a definite structural tipping point, where Europe's reliance on bank intermediation to fund long-term investments in a variety of corporate, real estate and infrastructure assets has given way to a more diversified model with much greater involvement of institutional investors and alternative credit funds and significantly higher shares of direct capital market financing.

This structural shift should not, however, be regarded as a zero-sum competition between banks' market share and the market share of ACPs as banks and ACPs find new ways to work together to navigate the challenges of meeting corporates' funding needs as the continent as a whole emerges from recession. Whilst too early to call, there are signs that the desire of regulators and governments to encourage, in the words of the Financial Stability Board, a more balanced and diversified "funding ecosystem" better placed to withstand economic downturns and leading to more efficient credit allocation and innovation may be coming to fruition. ■

Further reading

- Borrowing from a fund: 10 points to watch out for in LMA documentation [2013] 8 JIBFL 516
- The rise of unitranche financing in Europe [2013] 10 JIBFL 659
- Lexis PSL Banking & Finance: Intercreditor issues on European unitranche deals

Feature

KEY POINTS

- The US permits an extremely broad scope for discovery for litigation, and also permits pre-trial discovery.
- The EU Directive restricts the transfer of personal data outside of the EEA, particularly to countries which have less stringent protections for personal data, although there are limited exceptions.
- A litigator dealing with this clash of laws should recommend that their client implements certain best practices to mitigate future harm.

Author Chris Ninan

The clash of cultures: discovery and data privacy

This article discusses the data privacy regime in place in the European Union, the US litigation discovery process (and obligations to transfer data for discovery purposes from the EU) and concludes with ways to mitigate the difficulties which arise when these two systems clash.

INTRODUCTION

EU persons subject to US litigation come up against the worst of all worlds: data protection laws in their home countries which recognise an individual's fundamental right to privacy and US laws which impose wide-ranging discovery obligations on the EU entity, while being loath to recognise the foreign privacy laws. The European is in an invidious position – does it breach its local law (which can lead to criminal penalties) or does it substantially weaken its position in the US litigation?

While this article focuses on the US litigation discovery process, many of the same principles apply to foreign entities facing requests to transfer data to the US from the EU in relation to internal investigations or in response to requests from US regulatory authorities.

UNITED STATES DISCOVERY

The US permits an extremely broad scope of discovery for litigation, and also permits pre-trial discovery. This, while familiar to English common lawyers, stands in stark contrast to the restrictive disclosure approach taken in civilian countries, which often requires the party to the litigation to offer evidence in support of their case, and nothing more.

The primary means by which parties to US litigation can seek discovery are: (i) the Federal Rules of Civil Procedure ("FRCP"); and (ii) the Hague Convention on Taking Evidence Abroad in Civil or Commercial Cases (the "Hague Convention"). The FRCP permits a broader form of discovery, including pre-trial discovery, while the Hague Convention requires more complex procedures, is only available in countries which have signed the Convention, and generally does not apply to pre-trial disclosure.

In deciding which discovery approach to take, US courts have favoured the use of the FRCP considering it a "permissive supplement, not a pre-emptive replacement [to the Hague Convention]". This stems from the fear that requiring mandatory application of the Hague Convention would mean that foreign parties would be subject to more lenient discovery procedures than their domestic counterparts (the latter would be subject to the FRCP). The courts seem to have reached a conclusion that use of the Hague Convention is only required when it is the only way to get the evidence from a foreign party – for example, if complying with the FRCP would lead to criminal sanctions being imposed on the foreign litigant because the foreign state considered that disclosure under the Hague Convention was the only acceptable exception to data privacy rules.

When a party to US litigation is required to provide EU-based data as part of the US discovery process, the party subject to discovery must look for a path through the strict and complex EU data privacy rules.

DATA PRIVACY IN THE EU

Data privacy law in the EU is primarily governed by the EU Data Protection Directive 95/46/EC (the "EU Directive") which requires member states to "protect the fundamental rights and freedoms of natural persons, and in particular their right to privacy with respect to the processing of personal data". Further Regulations and Directives have added to the EU Directive, and the "Article 29 Data Protection Working Party" publishes opinions providing guidance on EU data privacy laws. Each member state has enacted domestic laws which reflect the EU Directive, though there are significant differences between these.

Before considering the detail of the EU privacy rules and their relationship with US discovery requests, it is important to define a few key phrases:

- "Personal data" means data about a living person who can be identified from that data or from that data in conjunction with other information in the possession of (or likely to come into the possession of) a data controller. Personal data includes expressions of opinion about the person.
- "Data subject" means the individual who is the subject of the personal data.
- "Data controller" means a person who determines the purposes for which, and the manner in which any personal data is, or is to be, processed.
- "Processing" means obtaining, recording or holding the information or data or carrying out any operation or set of operations on the information or data. In short – it means doing most things to data.

While this is beyond the scope of this

article, the EU data protection regime is likely to considerably change in the coming years, with a General Data Protection Regulation replacing the EU Directive and creating a single unified law across member states.

PROCESSING PERSONAL DATA

The EU rules require that personal data is processed fairly and lawfully and only for specified purposes. The detailed meaning of these requirements are beyond the scope of this article, but require a data processor to meet one or more of the "conditions for processing" before being able to process personal data. Note, as will be discussed below, that processing is not the same as transferring data outside of the EU. Some conditions are obvious – where the data subject has consented to the processing, or where such processing is necessary because of a contractual or other obligation.

However, none of the conditions specifically allow for the processing of personal data in response to a US discovery request or subpoena. One condition allows processing "to meet the controller's legal obligations". Unfortunately, this has been held not to encompass such extraterritorial legal requirements, though it may include foreign legal obligations which arise domestically in the member state, for example, as a result of the Hague Convention.

Another, which permits processing "deemed necessary for the purposes of legitimate interests pursued by the controller" may be more helpful and the Data Protection Working Party has suggested that litigation discovery requirements may be considered a legitimate interest pursued by a data controller. However, these interests must still be balanced against the rights of the data subject to the privacy of his information.

The EU data privacy regime frequently involves such balancing exercises, requiring the data controller to consider issues such as proportionality, security, and notice. In practice, this requires a data controller to seek to limit the discovery of personal data to the narrow issues being tried in the case and to anonymise and redact data where possible (to meet proportionality), to take precautions to preserve the security of the data to protect it from destruction, loss and unauthorised disclosure or access (to meet data security) and to provide notice that the personal data will be processed for discovery purposes (including details of the recipient of the data, the purpose of the processing and the data subjects' rights in respect of that data (to meet notice).

All of this refers to the processing of data within the European Economic Area (EEA) in relation to US discovery requests. As described above, processing includes each stage of discovery, from retention, to disclosure and onwards. And while onward transfer is considered "processing" as well, the processing exceptions above do not fully answer the question as to whether such data can be transferred outside of the EEA in response to US discovery requests.

TRANSFERRING PERSONAL DATA OUTSIDE THE EEA

Unsurprisingly, the EU Directive restricts the transfer of personal data outside of the EEA, particularly to countries which have less stringent protections for personal data. One such country, with a less strict view of individual privacy, is the United States. In order to transfer personal data to a non-EEA state, Art 26 of the EU Directive provides various exceptions to the general prohibition against such transfer.

Several Data Protection Working Parties have weighed in on the issue of US discovery and EU data protection. For example, the Working Document 1/2009 on pre-trial discovery for cross-border civil litigation ("Opinion 158") offered various suggestions on how EU data protection laws should interact with US discovery requests. It found that the most pertinent exception for US discovery purposes is Art 26(1)(d) which permits transfer "necessary or legally required… for the establishment, exercise or defence of legal claims".

This exception is, unsurprisingly, not the end of the matter as it is interpreted narrowly and has to be considered in the context of the data subject's rights of privacy more generally. In particular, commentary on this exception suggests that it is only available:

(i) in the context of litigation;
(ii) which is already in existence (not where it is a mere possibility); and
(iii) where the court has used the provisions of the Hague Convention to seek the evidence.

In addition, it appears only to be permitted if the relevant information is transferred in a single delivery. This means that, amongst other things, discovery in aid of internal investigations or regulatory proceedings, or supplemental discovery, may not be permitted.

Given the limited efficacy of this exception (and the even more limited value of other exceptions which are not discussed in this article), a corporation may need to consider other ways to transfer personal data outside of the EEA:

- First, transfer is permitted to a third country which ensures an "adequate level of protection" with the European Commission making a determination of adequacy. Several countries, such as Canada, Israel and New Zealand are deemed to have adequate protections in their legal systems. The US is not so deemed to have adequate protection.
- Secondly, the personal data can be transferred to the US under the Safe Harbor (sic) Program, developed after discussions between the US Commerce Department and the European Commission. This permits onward transfer of personal data to US entities governed by the US Department of Commerce (which excludes financial institutions) which state that they have put in place structures that satisfy the US-EU Safe Harbor framework. These structures are similar to those found in the EU Directive – for example, notice must be given to data subjects about the transfer, onward transfer can only be made to entities which are similarly certified or which promise to hold the information to the same degree of protection, and the

Biog box

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data must be protected from loss, misuses or unauthorised disclosure.

- Thirdly, personal data can be transferred to companies outside the EEA which adopt "binding corporate rules". This allows one company to transfer personal data to another company (or to a different company within the same group) which has signed contractual terms which broadly reflect the Safe Harbor Rules. The EU Directive contains model terms which can be used in such contracts.

APPROACH OF US COURTS TO EU DATA PRIVACY CONCERNS

Based on the above, it seems as if parties subject to US discovery requests for EU-based data may have a good basis upon which to resist those requests to avoid a breach of data privacy laws.

However, the US takes a mixed approach to claims of foreign parties that they cannot disclose information for fear of breaching foreign laws. The approach of the US courts seems to depend on the proof that a foreign law will be breached (and there is a high bar to pass in order to successfully make this proof) and proof that the foreign law supports a legitimate interest of the foreign country, and is no mere "blocking statute" (ie the law was not enacted to frustrate foreign discovery requests). For example, a French blocking statute (Law No 80-538) which was enacted in response to US enforcement of its anti-trust laws has generally been ignored by US courts which have found that the statute was merely intended to provide French subjects with "tactical weapons and bargaining chips in foreign courts" (*Compagnie Française d'Assurance Pour le Commerce Extérieur v Phillips Petroleum Co*). Even after a French lawyer was convicted under the blocking statute in 2007 US courts refused to defer to it when determining discovery decisions holding that "the chance of prosecution under the French Blocking Statute is minimal…" (*In re Global Power Equipment Group, Inc*).

However, US courts sometimes accept that foreign privacy rights trump US discovery requests. For example, in *Salerno v Lecia, Inc*, the court accepted that the EU Directive and German privacy laws would lead to liability for the foreign party if discovery was compelled, and refused to do so.

SUGGESTED STEPS

Given the limited ways in which EU-based data can be successfully processed and transferred to the US, and given the US courts' reluctance to award full comity to EU data privacy rules, a litigator dealing with this clash of laws should recommend that their client implements certain best practices to mitigate future harm, before it arises and during the litigation process. This could include:

- telling data subjects in advance how their data may be processed and transferred in a comprehensive data usage/retention policy so as to manage employees' data privacy expectations;
- putting in place specific plans in the event of US litigation – including "Safe Harbor" arrangements, mechanisms to identify and anonymise/redact personal data and checks to ensure that personal data does not leave the EEA outside of a formalised process;
- engaging with the litigation opponent or government authority at an early stage to mitigate any data privacy issues, for example by reducing the scope of requests and ensuring that data transfer takes place in a single transfer, where possible;
- discussing data privacy concerns with the court (if relevant) at an early stage (this has the added benefit of complying with the FRCP).

Every party to litigation, or subject of an authority's document request will have a different set of circumstances and different obligations to their data subjects (if any), so the early involvement of counsel experienced in discovery and data privacy issues is extremely important. ■

Further reading

- The rise and rise of information governance [2012] 2 JIBFL 117
- Between a rock and a hard place: international institutions providing information to domestic regulators [2010] 10 JIBFL 622
- Lexis PSL: Corporate Crime: data protection offences

KEY POINTS

- Alternative Investment Funds managed by AIFMD authorised or registered Alternative Investment Fund Managers will have to comply with the most stringent requirements under EMIR.
- Certain AIFs are likely to belong to the category of counterparties that will need to comply with the clearing obligations 18 months from the date of entry into force of the regulatory technical standards on the clearing obligation.
- The margin requirements will be particularly onerous for entities such as real estate funds which will no longer be able to secure the derivatives they enter into against their property portfolio.

Feature

Authors Isobel Wright and Nora Bullock

Key interactions between EMIR and AIFMD

Following the G20 commitment to implement measures to increase transparency and reduce counterparty credit risk and operational risk in the derivatives market, the European Commission introduced Regulation (EU) No 648/2012 on over-the-counter (OTC) derivatives, central counterparties and trade repositories (more commonly known as the European Market Infrastructure Regulation or EMIR), which came into force on 16 August 2012. EMIR sets out new requirements, including clearing obligations, risk mitigation techniques for uncleared trades and trade reporting for all OTC derivatives. The extent to which the new requirements will apply will depend on how parties are classified under EMIR. This article looks at how these requirements may affect alternative investment funds (AIFs or funds) (ie non-UCITS funds) that enter into derivative transactions and the interaction between EMIR and the Alternative Investment Fund Managers Directive (Directive 2011/61/EU (AIFMD)).

Under the AIFMD, an internal or external alternative investment fund manager (AIFM) must be appointed for each fund. AIFMs established in the EU must be authorised under the AIFMD (or subject to a lighter registration regime if they fall below the de minimis thresholds). In the UK, existing AIFMs have been able to rely on a one-year transitional period to 22 July 2014. The AIFM is the entity responsible for compliance with the AIFMD and the entity that should be authorised or registered under the AIFMD, if required, and must have appropriate substance (and retain sufficient portfolio management or risk management functions) so it is not considered a "letter box entity".

EMIR will have an impact on funds structuring and in particular on the choice of AIFM. This is because AIFs managed by AIFMD authorised or registered AIFMs will have to comply with the most stringent requirements under EMIR. These AIFs (regardless of domicile) will be classified as Financial Counterparties (FCs) under EMIR, along with banks, insurers, investment firms established in the EU and UCITS funds.

Any entity established in the EU which is not an FC will be a Non-Financial Counterparty (NFC) and is subject to less stringent EMIR requirements. EU AIFs will be treated as NFCs until their AIFM becomes authorised or registered under the AIFMD, at which point they will be treated as FCs. EU AIFs that are marketed in the EU without a passport by non-EU AIFMs will be considered NFCs as they are not managed by authorised or registered AIFMs.

The European Securities and Markets Association (ESMA) has also clarified that special purpose vehicles (SPVs) created by real estate and private equity AIFs will be classified as NFCs.

Entities whose aggregate positions in OTC derivative trades on a worldwide basis exceed certain clearing thresholds (see below) are known NFC+s and are subject to similar requirements as FCs.

As AIFs are treated differently under EMIR from other fund related entities, such as acquisition vehicles, it is necessary to identify the AIFs within fund structures (which are often complex and multi-tiered). The determination of whether an entity will be deemed to be an AIF is ultimately a matter of how the AIFMD has been implemented in the jurisdiction where the AIFM is established, so it is necessary to seek local legal advice. For example in the UK, the FCA Handbook, Perimeter Guidance (PERG), clarifies when an entity is deemed to be an AIF and contains guidance on how to distinguish AIFs from other fund related entities (which are either specifically exempted, or do not fall within the AIF definition in the AIFMD), such as joint ventures and holding companies.

EMIR OBLIGATIONS

Funds (whether FCs, NFC+s or NFCs) are subject to the requirements to report derivative trades to a trade repository and put in place risk mitigation techniques for uncleared OTC derivatives trades. Funds that are FCs or NFC+s (as explained below) will be subject to requirements to clear new (but not existing) trades with a central clearing counterparty (CCP) when the clearing obligation becomes effective for a class of OTC derivatives traded by an entity.

For the purposes of EMIR, ESMA has clarified that funds will generally be considered the counterparty to a derivative contract rather than the AIFM or delegated manager (unless it executes trades on its own account). If the derivative contract is concluded at the sub-fund level, the counterparty should be the sub-fund and not the umbrella fund.

AN NFC- OR NFC+?

In order to establish whether an EU fund that is not an FC (and therefore an NFC) could in fact be an NFC+ and thereby be subject to more stringent requirements, it is necessary to calculate the nominal value of all outstanding OTC derivative contracts of the NFC and the other NFCs within the group (excluding those contracts which are entered into for specified hedging purposes). The clearing threshold values in respect of each asset class, which, if exceeded, would subject NFCs to the clearing obligation are:

- Interest rate derivatives – EUR 3bn in gross notional value;
- FX derivatives – EUR 3bn in gross notional value;
- Credit derivatives – EUR 1bn in gross

notional value;

- Equity derivatives – EUR 1bn in gross notional value; and
- Commodity and any other OTC derivatives – EUR 3bn in gross notional value.

In determining the amount of derivatives measured against the clearing thresholds, OTC derivative transactions which are entered into for hedging purposes and meet specified requirements as being "objectively measureable as reducing risks directly in relation to the commercial activity or treasury financing of the NFC or that group" will not count towards the clearing threshold.

THE CLEARING OBLIGATION

EMIR contemplates that clearing will apply to contracts that are standardised and suitable for clearing. Before the clearing obligation applies with respect to any individual OTC derivative contract, CCPs must be authorised to clear that particular class of OTC derivative and that class must also then be declared by ESMA to be subject to the clearing obligation. To date 12 CCPs have been authorised to clear certain classes of equity, interest rate, credit and commodity derivatives.

On 11 July 2014 ESMA launched the first round of consultations and draft regulatory technical standards (RTS) in relation to the central clearing of interest rate swaps and credit default swaps. The consultation papers propose that the clearing obligations will take effect following a phased implementation, with clearing members having to comply from six months after the entry into force of the RTS on the clearing obligation. Many AIFs, whether they are NFC+s or FCs, (provided that they are not clearing members) are likely to belong to the next category of counterparties that would need to comply with the clearing obligations 18 months from the date of entry into force of the RTS on the clearing obligation. All NFCs would then need to comply three years after the entry into force of the RTS on the clearing obligation.

Any entities incorporated outside the EU will need to apply the same criteria as their EU counterparties to determine the category to which they would belong if they were established in the EU.

Where a contract is concluded between two counterparties in different categories, the date from which the clearing obligation takes effect will be the latest date.

In its consultation paper, ESMA proposed that the following classes of interest rate swaps (with no optionality and with a single settlement currency) should be subject to the clearing obligation:

- Float-to-float "basis" swaps and Fixed-to-float interest rate swaps, referencing either EURIBOR or LIBOR, with a maturity of 28 days to 50 years (this includes instruments which settle in Euros, US dollars, GBP or Japanese Yen);
- Forward Rate Agreements, referencing either EURIBOR or LIBOR, with a maturity of three days to three years (this includes instruments which settle in Euros, US dollars or GBP); and
- Overnight Index Swaps referencing EONIA, FedFunds or SONIA, with a maturity of seven days to three years (this includes instruments which settle in Euros, US dollars or GBP).

ESMA has also proposed that the following credit OTC derivative classes (traded in Europe and settled in EUR only) should be subject to the clearing obligation:

- Index CDS (untranched index), referencing iTraxx Europe Main; or
- iTraxx Europe Crossover indices, in each case with a series of 11 onwards and a maturity period of five years.

At this stage, ESMA is not proposing to submit any OTC equity derivatives classes or OTC interest rate future or option classes to the clearing obligation.

TRADE REPORTING

Funds also need to comply with the trade reporting obligation which came into force on 12 February 2014. Counterparties and CCPs now need to ensure that each derivative contract they have entered into (and any modifications or early terminations) is reported to a trade repository that is recognised or registered in accordance with EMIR no later than the next working day. This includes derivatives whether traded on or off exchange as well as intragroup transactions. Certain derivative contracts entered into prior to this date also need to be reported. In many instances, trade reporting for investment funds will be performed by the investment manager or other service provider, although the fund will still be legally responsible for reporting the trade under EMIR. As of 12 August 2014, FCs and NFC+s need to report data on posted collateral and valuations to trade repositories.

RISK MITIGATION

All uncleared OTC derivative trades are subject to the risk mitigation techniques (timely confirmation, portfolio reconciliation and compression, dispute resolution, daily mark-to-market and margin requirements) that came into effect on 15 September 2013 (other than the timely confirmation requirements which came into effect on 15 March 2013 and the margin requirements, which are explained further below).

All uncleared trades must be confirmed, where available, by electronic means as soon as possible and, at the latest, by specific deadlines determined by the status of the counterparties entering into the trades. FCs should also have procedures in place to report on a monthly basis to their competent authority the number of unconfirmed OTC derivative transactions that have been outstanding for more than five business days.

MARGIN REQUIREMENTS

Funds may need to comply with requirements to post highly liquid assets or cash margin against uncleared trades. The rules for these provisions are not yet established, although on 14 April 2014 the joint committee of the European Supervisory Authorities published draft RTS which follow the recommendations of the joint BCBS-IOSCO working group's final report dated 2 September 2013. Proposals include that the initial margin requirements should be phased in over a four-year period from 2015 (starting with the largest derivative market participants). At the end of the phase-in period in 2019, the initial margin requirements would apply to uncleared derivative transactions where at least one counterparty belongs to a group

Biog box
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whose aggregate month-end notional amount of uncleared derivatives is more than EUR 8bn. The RTS also indicates that EU entities would have to collect margin from all third country entities, unless they were explicitly exempt from EMIR or under the EUR 8bn threshold, even if they would be NFC-s if they were established in the EU. There will be a threshold of EUR 50m which, in respect of investment funds, should generally be counted per single fund. Counterparties will also need to exchange variation margin on a daily basis. Eligible collateral broadly includes cash, allocated gold, debt securities issued by government entities, multilateral development banks, credit institutions or investment firms, corporate bonds, the most senior tranche of a securitisation provided it is not a re-securitisation, convertible bonds and equities.

The margin requirements will be particularly onerous for entities such as real estate funds which have traditionally secured the derivatives they enter into (eg interest rate swaps) against their property portfolio. This would no longer be eligible as collateral.

THIRD COUNTRY ENTITIES

There are certain circumstances where other entities that are incorporated outside the EU (third country entities or TCEs) might also need to consider EMIR. At present, AIFMs established outside the EU cannot be AIFMD authorised or registered, but they can still market funds in the EU under national private placement regimes (and, if so, be subject to certain AIFMD obligations relating to transparency, reporting and, if applicable, the rules preventing asset stripping and any additional requirements of the member state where the investor is based). ESMA has initiated a consultation on the possibility for third country AIFMs to become authorised under the AIFMD and use the associated AIFMD marketing passport (non EU passport). However, this is not expected to be available until 2015 at the earliest.

In its Q&As on EMIR, ESMA has clarified that all of the following are FCs:

- EU AIFs managed by authorised or registered EU AIFMs;
- Non-EU AIFs managed by authorised or registered EU AIFMs; and
- EU AIFs managed by authorised or registered non-EU AIFMs (subject to the introduction of the non EU passport).

ESMA has also indicated that Non-EU AIFs that are marketed in the EU by non-EU AFIMs will be considered TCEs. In terms of the obligations under EMIR that TCEs may be subject to, broadly, TCEs:

- may be subject to the clearing obligation where its EU counterparty is an FC or NFC+. However, this obligation would only apply to funds which would be classified as an FC or NFC+ if they were established in the EU (a hypothetical FC/NFC+) and not to funds which would be classified as NFC-;
- may be subject to the clearing obligation where it contracts with another TCE, where both entities would be hypothetical FCs/NFC+s and the contract has a direct, substantial and foreseeable effect within the EU or such obligation is necessary to prevent the evasion of any provision of EMIR; and
- may need to comply with the risk mitigation techniques for uncleared trades if it contracts with another TCE where both entities would be hypothetical FC/NFC+s and the contract has a direct, substantial and foreseeable effect within the EU or such obligation is necessary to prevent the evasion of an EMIR provision.

Even if a third country AIF is not subject to the EMIR requirements directly, it is likely to have to put in place procedures to facilitate their EU counterparties' EMIR compliance. For example, their EU counterparties may require a representation as to their FC/NFC+/NFC- or hypothetical FC/NFC status and they may need to identify such funds in their trade reports and may require the fund to provide certain information such as a Legal Entity Identifier.

WHAT SHOULD FUNDS BE DOING?

It is expected that in many cases the fund will delegate its EMIR obligations to its AIFM (which in turn may appoint other service providers for example to manage collateral). It is essential that the relevant EMIR obligations are set out in any agreement for the appointment of the AIFM, service provider agreement and/or delegation agreement, so it is clear which entity is in practice performing the required tasks under EMIR. It should, therefore, be examined whether the AIF has its own master agreements and clearing documentation. Also, in order to determine whether an NFC is above (NFC+) or below (NFC-) the clearing threshold, it will be necessary that the derivatives activity of the AIF's group is monitored and communicated to the relevant service providers.

If funds are entering into new trades with an existing counterparty, the parties can enter into a bilateral agreement which would amend the existing derivative documentation to ensure compliance with the relevant EMIR requirements. Counterparties that are currently negotiating derivative documents are likely to include the relevant provisions into the documentation directly. ISDA has introduced language to address many of the issues and, although some firms have taken different approaches, most documentation is based on the ISDA model language.

The implementing regulations under EMIR are not yet fully finalised and are constantly evolving. Investment funds and their advisers will need to ensure that all their derivatives activity complies with the derivative regimes as implemented over the next few years and related requirements as part of the directive and regulation amending the Market in Financial Instruments Directive (known as MiFID II) and the Dodd-Frank Wall Street Reform and Consumer Protection Act in the US. ■

Further reading

- The AIFMD created a harmonised regime for marketing funds in Europe. Discuss. [2014] 4 JIBFL 250
- LexisNexis Financial Services blog: EMIR + OTC derivatives + TCEs = some TLC required?
- LexisNexis Financial Services blog: ISDA protocol: EMIR compliance and swap market agreements

Feature

KEY POINTS

- Both *Schuldscheine* and N Bonds are becoming popular for non-German financial institutions entering the German market.
- Some features of a *Schuldschein* are similar to loans, others to bonds.
- Neither *Schuldscheine* nor N Bonds can be listed or traded on stock exchanges.

Authors Rüdiger Litten and Judith Morton

Schuldscheine and N Bonds in demand

Schuldschein and *Namensschuldverschreibung* are two traditional German debt instruments which are in some ways very similar but differ in some respects. Both instruments have gained popularity with non-German Issuers as a useful contribution to their funding diversification. This article provides an overview of their key features.

The *Schuldschein* is a long-established German floating or fixed debt instrument. Some features of a *Schuldschein* are similar to those of loans, others are more similar to bonds. *Schuldschein* is not a legally defined term. Technically, a *Schuldschein* is a separate note issued by the borrower under a loan agreement and generally serves as documentary evidence of a debt.

The *Namensschuldverschreibung* evidences an obligation of an issuer and is made out in the name of the creditor – hence the term "Name Bond" or "N Bond". Although not bearer bonds, they are not the same as English or New York law-governed registered bonds. Despite not being a legal requirement, market practice provides that N Bonds are registered in a register. As a result, the term 'Registered Bond' is also commonly used. N Bonds are treated like loans for a number of purposes. This includes accounting purposes in the first instance which means they have the same accounting treatment as *Schuldscheine*. *Namensschuldverschreibungen* can be described as being a hybrid between a bond and a loan.

A specific type of N Bond is the N-covered Bond, which is a match between the German *Pfandbrief* and Anglo Saxon financial legal structures. A *Pfandbrief* is a covered bond which is secured by an asset pool. It is regulated in strict compliance with German legislation to ensure that the value of the pool remains equal to or greater than the outstanding obligations under the bonds. Because the *Pfandbrief* is considered so solid and secure, it is popular with conservative investors. Many institutional investors such as pension funds and insurance companies use them frequently. Unfortunately, banks which do not have their corporate seat in Germany are unlikely to be allowed to issue *Pfandbriefe* (mainly for insolvency law reasons) and are therefore barred from entering an interesting refinancing market. The N-covered Bond is intended to bridge this gap.

MARKET

Schuldscheine are mainly issued by German public authorities, banks and medium-sized companies as a debt-financing instrument. However, the issuer base has expanded over the last few years and large German corporates such as Porsche and Deutsche Telekom as well as non-German companies (Swiss Lonza, Austrian Strabag and French Lafarge) and banks have issued substantial amounts of *Schuldscheine*. Whilst the *Schuldschein* still serves as a financing instrument in the first place, an investor-driven market for structured *Schuldscheine* has emerged and is developing. *Schuldscheine* in this market, such as index- or credit-linked *Schuldscheine*, serve to transfer certain economic benefits and risks of underlying assets to sophisticated investors.

N Bonds are mainly issued by credit institutions and are issued for example as index-linked, credit-linked, fixed or floating rate interest or zero coupon bonds. German and foreign issuers have sometimes included them in their debt issuance programmes. Investors in both *Schuldscheine* and N Bonds are typically banks, insurance companies, pension funds and to a lesser extent investment funds. Recently multicurrency *Schuldscheine* have been issued. The *Schuldschein* is becoming more and more international.

Whereas the typical maturity of a *Schuldschein* would be in the range of two to seven years and the typical volume would be EUR 50m to 250m, the maturity rate of N Bonds would normally go beyond ten years. The reason is that German law provides for a mandatory termination right for the borrower of loans (including *Schuldscheine*) whereas such mandatory termination right does not exist with respect to bonds.

Schuldscheine and N Bonds cannot be listed or traded on stock exchanges. N Bonds are not deposited in any clearing system and can usually only be transferred by way of assignment and registration in the register. There is a lively secondary market for *Schuldscheine* for which the arranger of the *Schuldschein* issue usually takes a market maker role. The secondary market for N Bonds is less developed.

QUALIFICATION AS DEBT SECURITY

A *Schuldschein* is a certificate of indebtedness evidencing a loan (or a cash deposit) and is not a debt security. A *Schuldschein* is constituted by the underlying loan agreement entered into between the issuer of the *Schuldschein* as the borrower and the initial holder of the *Schuldschein* as the lender.

A *Schuldschein* differs from a debt security in many material aspects. It can be enforced without presentation or surrender of the instrument and there is no legal requirement to prepare a sales prospectus in connection with the issue of a *Schuldschein*. Whereas the issuer of securities may only raise defences against the holder of the instrument, the *Schuldschein* issuer is, under certain circumstances, entitled to raise defences against the assignees based on the underlying loan agreement or any defences it may have against previous holders. Prior to a notification of the assignment to the *Schuldschein* issuer, the issuer will be discharged from its obligations evidenced by the *Schuldschein* by payment to the assignor. International and German accounting rules do not require marking to market of *Schuldschein* loans.

N Bonds are not transferable securities under the Prospectus Directive yet national German law provides for the publishing of a prospectus for public offers. Exemptions from this requirement apply when the N Bonds are offered to professional investors or are privately placed. They are securities in a

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broader sense, meaning that it is the certificate which is decisive for the enforcement of the bondholders' rights. There may not be an active secondary market for N Bonds, which is compensated for by them being treated as loans from an accounting perspective and also not being marked-to-market.

ISSUERS

In recent years, German public authorities represented the largest group of borrowers issuing *Schuldscheine*. They include the Federal Republic of Germany, the Federal States (*Bundesländer*) and the municipalities. Companies that require medium- to long-term financing have discovered *Schuldscheine* as an easy way to access capital markets. The trend has moved towards mid-sized companies issuing *Schuldscheine* after the bond market was more or less shut down after 2008 for a period of time. Financial institutions nevertheless remain the larger issuer group in comparison to corporate issuers.

N Bonds are recently becoming more popular for non-German financial institutions entering the German market. Due to the private placements of the N Bonds with institutional investors, the procedure might at first be perceived as unusual for the issuers in comparison with issuances through the clearing system and will therefore require good communication between the issuers, arrangers and the investors.

DOCUMENTATION

N Bonds may be described in the issuers' prospectus under their program or in standalone documentation. However, their inclusion in general debt programs may raise concerns with the German Federal Financial Supervisory Authority (*Bundesanstalt für die Finanzdienstleistungsaufsicht* (*BaFin*)). Additional documentation in the German language may be requested by the investors. Typically a form of assignment will be included. The transfer by assignment is normally subject to the registration of the new bondholder in the register to be kept by the issuer or a registrar. N Bonds can be assigned fully or partially, each assignment requiring a new certificate.

As for *Schuldscheine*, there are no legal requirements as to the form of *Schuldschein* loans. They are usually documented by using fairly standardised terms and conditions. Provisions that would be expected from an English law perspective, like business day convention, termination rights or extensive representations and warranties already appear in either statutory or case law and apply by operation of German law. However, as a contribution to market standards, documentation for *Schuldscheine* raised or granted by non-German institutions often contain more extensive provisions which market participants expect to see in international syndicated loan agreements (eg a list of specified events of default, negative pledge provisions and financial and information covenants). Slightly more complex documentation, even in the German market, is required for structured *Schuldscheine*.

TRANSFER

Unlike (bearer) securities, *Schuldscheine* cannot be transferred by way of delivery of the instrument but only by assignment of the underlying obligation. Once the loan has been transferred, the transferee is entitled to request the transfer of the instrument. The transfer of the loan may not only be effected by way of assignment but is also possible by an assumption of contract. The effect of the latter is comparable to a novation under English law. Even though an assignment has the disadvantage that the initial creditor remains a party to the loan agreement and hence carries residual liability to some extent, assignment is considerably simpler and has become the market standard.

N Bonds also require the assignment of the underlying claim against the issuer, and in addition the delivery of the instrument and/or registration of the new holder in the register.

SOME REGULATORY ASPECTS

BaFin has taken the view that the acceptance of monies under a loan agreement (which would include a *Schuldschein*) may, to some extent, require a banking licence. In addition, both the German Banking Act (*Kreditwesengesetz*) and the Securities Trading Act (*Wertpapierhandelsgesetz*) provide for *Schuldscheine* as money market instruments if the maturity is less than a year. Thus, dealing in *Schuldscheine* may be subject to the rules of conduct for marketing and trading.

Licensed German banking institutions are not subject to restrictions concerning the purchase or granting of *Schuldschein* loans. However, they must comply with the capital adequacy and solvency treatment of the *Schuldschein* loans, which is the same as for similar debt instruments such as bonds and loans. *Schuldschein* issuers like the German Federal Government, the Federal States, the *Kreditanstalt für Wiederaufbau* (*KfW*) and public and private insurance companies are generally exempted from German banking regulations and thus, are not subject to any capital adequacy treatment nor to any licence requirements. Foreign *Schuldschein* issuers and investors are not likely to be subject to German banking regulations if they are targeted by German counterparties instead of actively targeting them and/or if the counterparties are credit institutions. The same holds true, in principle, for foreign issuers of N Bonds which, as opposed to bearer bonds, are not generally exempted from the definition of deposit taking (raising of repayable moneys from the public).

A further regulatory aspect has recently emerged under the new German Capital Investment Code (*Kapitalanlagegesetzbuch*) which implements the Directive of the European Parliament and of the Council on Alternative Investment Fund Managers. *BaFin* has published a guidance note concerning the scope of application of the Capital Investment Code. In the Guidance Note *BaFin* explicitly points out that registered notes may under certain conditions qualify as units of an investment fund (*Anteile an Investmentvermögen*) under the Capital Investment Code. As a result, N Bonds may theoretically fall within the scope of the Capital Investment Code, and may therefore require licensing and product regulation. ■

Further reading

- Trustee instruments for bonds under German law [2013] 4 JIBFL 237
- The overdue reform of the German bond restructuring scheme [2009] 9 JIBFL 555

Feature

KEY POINTS

- All foreign tax crimes, with effect from 1 September 2014, became a predicate offence under Singapore's CDS Act, and financial institutions may need to re-consider their know-your-client (KYC) account opening and anti-money laundering (AML) surveillance parameters.
- Reporting regimes under FATCA and the OECD's proposed structure for the automatic Exchange of Information are becoming more prevalent.
- The parameters to establish tax crimes as predicate offences and to define reporting requirements can be made consistent.

Author Andrew Chow

Tax crime & reporting: a convergence?

This article suggests how the parameters to establish tax crimes as predicate offences and to define global tax reporting requirements can be made consistent.

This commentary follows on from "Traffickers, Terrorists and Tax Criminals", first published in [2013] 10 JIBFL 654. In the article, the author sought to explain the then novel aspects of tax criminality in Singapore, and how it added a new dimension to the anti-money laundering (AML) and countering the financing of terrorism (CFT) regime by including as criminals persons who may generate their income legitimately, but who fail to pay their taxes.

The scenario arose because of the amendments to the Corruption, Drug Trafficking & Other Serious Crimes (Confiscation of Benefits) Act (CDS Act), where the evasion of income tax, and the evasion of goods & services tax became predicate offences when they were listed in Part XII of the Second Schedule of the CDS Act. But as explained in that article, the concept of a serious offence under the Act was fairly narrow in respect of tax evasion as it was limited to four different offences under the Income Tax Act (IT Act) and the Goods & Services Tax Act (GST Act).

The corresponding foreign serious offence committed offshore would have to be "the equivalent act or omission… if it had occurred in Singapore, [and had] constituted a serious offence [in Singapore]" (ie the equivalent of the offences under the IT Act and GST Act). That gave rise to concerns that not all tax offences committed overseas would be caught as a predicate offence in Singapore due to this dual criminality requirement. For example, as estate duty no longer exists in Singapore, in a situation where a resident of the UK avoids paying estate duty there, and remits funds which would be considered criminal property under the UK Proceeds of Crime Act to his Singapore bank account, such funds would not be considered property possessed in Singapore as a result of criminal conduct under the previous regime.

EXPANSION OF THE DEFINITION OF FOREIGN SERIOUS CRIMES

In May 2014, a Bill was introduced to the Singapore Parliament to enlarge the scope of foreign serious offences in relation to tax. The following definition has been approved by Parliament, and this came into force on 1 September 2014 in accordance with the CDS (Amendment) Act that was published in the Singapore Government Gazette on 29 August 2014:

> "'Foreign serious tax offence' means an offence against the national law of a foreign country that consists of the doing of any of the following (howsoever described) wilfully with intent to evade any tax of that country:
>
> (a) omitting from, or understating or overstating in, a return made for the purposes of that tax any information which should be included in the return;
> (b) making any false statement or entry in any return, claim or application made, or any document or information required to be given, for the purposes of that tax;
> (c) giving any false answer, whether verbally or in writing, to any question or request for information asked or made for the purposes of that tax;
> (d) failing to inform the authority responsible for the collection of that tax, in the required manner, of any incorrect information appearing in any assessment made by the authority, when required to do so;
> (e) preparing or maintaining, or authorising the preparation or maintenance, of any false books of account or other records, or falsifying or authorising the falsification of any books of account or records;
> (f) making use of any fraud, art or contrivance, or authorising the use of such fraud, art or contrivance."

As stated by the Second Minister for Home Affairs during the Parliamentary debate:

> "the CDSA currently has the requirement of dual criminality, that is, it recognises a foreign offence only if the same act also constitutes an offence in Singapore. However, a strict application of dual criminality constrains our ability to prosecute money laundering cases involving the evasion of foreign taxes, where there is no local equivalent.
>
> To address this, the amended definition of a 'foreign serious offence' will include a foreign tax evasion offence, so long as the offence has been criminalised in the foreign jurisdiction and it is committed willfully with intent to evade tax. These amendments are consistent with Singapore's commitments under tax treaties, and will deter tax-illicit monies from flowing into Singapore."

Therefore, all foreign tax crimes committed with wilful intent, with effect from 1 September 2014, became a predicate offence, and financial institutions may have to re-consider their know-your-client (KYC) account opening and surveillance parameters.

CLARITY REQUIRED

With the removal of dual criminality (ie that the predicate offence must be an offence both in Singapore as well as in the foreign country), it becomes incumbent on a financial institution in Singapore to understand that laws of that foreign country in which their customer is tax resident. Wealthy French

Biog box

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residents may be subject to asset based taxes, for example, and this is an unfamiliar concept in Singapore. In essence, existing declarations by clients to their banks that they comply with income tax and goods and services tax requirements in their home countries would no longer be sufficient as the definition of foreign serious tax offence is extremely broad.

There is also no all-encompassing definition of "tax" in Singapore. In the IT Act, tax is narrowly defined as "the income tax imposed by this Act". Does the term in the CDS Act include the evasion of customs duties, pension fund contributions or other seemingly disparate obligations? Even more complicated are the issues arising out of corporate tax regimes, where legislators speak of "aggressive" tax avoidance, and tax "inversions". In an article in the *Financial Times* entitled "Tax Avoidance: The Irish Inversion" (29 April 2014), the author states:

> "Dozens of US multinationals have moved their tax base outside the country to escape the high tax rate, global reach and perverse incentives of a system that has encouraged companies to build up a $1tn cash pile trapped overseas. Yet inversions are increasingly contentious, focusing attention on corporate ploys when governments around the world are intent on cracking down on tax avoidance."

In order for financial institutions to provide cogent and meaningful suspicious transaction reports to the authorities, it would therefore be necessary to define or give dimension to the scope of the word "tax" in the CDS Act.

RISE OF FATCA AND OECD EXCHANGE OF INFORMATION (EOI) REGIMES

The Foreign Account Tax Compliance Act (FATCA) was enacted in the US Congress in 2010, and has been discussed ad infinitum in other articles and scholarly work, and will not be referred to in detail within this article. It establishes a process in which foreign financial institutions (FFI) are to report to the US Inland Revenue Service (IRS), via Singapore's Inland Revenue Authority of Singapore (based on the Model 1 Agreement) information about financial accounts held by US taxpayers, or by foreign entities in which US taxpayers hold a substantial ownership interest.

Following the implementation of FATCA in relation to Singapore based financial institutions, details relating to accounts held by US persons in Singapore will become transparent to the IRS for FFIs who have registered and obtained a Global Intermediary Identification Number (GIIN).

In similar fashion, the OECD has proposed a structure for the automatic EOI between nations, together with a Common Reporting Standard (CRS) for countries to adopt via bi-lateral agreements. In the context of individuals, the CRS proposes that reporting financial institutions provide, *inter alia*, the following information on reportable accounts relating to individuals:

- in the case of any individual that is an Account Holder and a Reportable Person: the name, address, jurisdictions(s) of residence, TIN(s) [tax identification numbers] and date and place of birth;
- the account number (or functional equivalent in the absence of an account number);
- the account balance or value (including, in the case of a Cash Value Insurance Contract or Annuity Contract, the cash value or surrender value) as of the end of the relevant calendar year or other appropriate reporting period or, if the account was closed during such year or period, the closure of the account.

A SUGGESTED CONVERGENCE

It is clear from the rise of the FATCA and OECD EOI regimes that tax transparency via reporting requirements will become more prevalent. While the discussion is still theoretical for Singapore in the context of the EOI as it is not an early adopter of the CRS, the rationale for such a process is made clear.

In an August 2014 Joint Statement by the Early Adopters Group, it was stated that:

> "Tax evasion is a global problem and requires a global solution. We therefore welcome the new standard in automatic exchange of information between tax authorities developed by the OECD (the Common Reporting Standard). This will provide a step change in our ability to clamp down on tax evasion..."

The establishment of tax crimes as predicate offences and the imposition and expansion of the tax reporting requirements may seem to be mutually exclusive processes. But on closer examination, the intention is the same, ie to clamp down on tax evasion. It is therefore suggested that the criminality and reporting processes be bridged, to:

- create and maintain consistency of application in relation to the scope of the relevant tax crimes and the means to identify, capture and prevent the illegal activities;
- to establish a standard for financial institutions which is neither impossible to apply due to the size or complexity of the scope of the crimes, or too simplistic to identify, capture and prevent the criminal activities concerned; and
- provide impetus and incentive for the tax account reporting activity.

The tools, therefore, to bridge the process are:

- establishing a consistent definition of the scope of tax crimes to be covered by suspicious transaction reporting (STR) and tax reporting/exchange of information; and
- creating a safe harbour provision in the CDS Act, whereby a failure to file an STR relating to a tax criminal is mitigated by the fact that the details of relevant customer and/or account has been previously filed with the appropriate tax authorities.

Under such circumstances a platform would be created for financial institutions and relevant tax authorities to co-operate in identification and prosecution of tax criminals. ■

Further reading

- Traffickers, Terrorists & Tax Crimes [2013] 10 JIBFL 654
- LexisNexis Loan Ranger Blog: Implementation of some of the FATCA rules
- LMA incorporates FATCA riders into its suite of documents

Feature

KEY POINTS

- A significant portion of the most senior ranking notes were issued as re-marketable securities, which meant it was possible to place the notes with investors on attractive financial terms.
- The transaction documentation contained representations and undertakings to confirm compliance with CRR "skin in the game" requirements and the requirements applicable to alternative investment managers.
- The transaction envisaged that loan level data will be made available on the website of the European DataWarehouse to meet Eurosystem Eligible Collateral requirements.

Author Jonathan L Lewis

Crédit Foncier re-launches the French RMBS market with CFHL-1 2014

In this article, Jonathan L Lewis explains the key features of CFHL-1 2014's French RMBS originated by Crédit Foncier.

The residential mortgage backed securities (RMBS) issuance by CFHL-1 2014 originated by Crédit Foncier in May 2014 heralds the re-opening of the market for French RMBS. The transaction was the first French RMBS to be wholly placed with investors since the financial crisis. It achieved de-consolidation both for accounting and regulatory purposes and included innovative features for the French securitisation market in that a significant portion of the most senior ranking of notes, the Class A2 notes, were issued as re-marketable securities.

The success of the issue means that financial institutions engaged in the French residential home loan market can look to securitisation as a credible funding alternative to the issue of covered bonds, using their deposit base or re-financing via the Eurosystem to finance the origination of new residential home loans. The fact that the issuance was significantly over-subscribed demonstrates that there is investor demand for well-structured, prime French RMBS.

The transaction included a number of features necessary to be compliant with the new post-crisis regulatory and financial environment including the retention of risk by the Crédit Foncier group and disclosure of loan level portfolio information on the European DataWarehouse in order to meet Eurosystem Eligible Collateral requirements.

TRANSACTION STRUCTURE

The portfolio of home loans were sold by Crédit Foncier and its subsidiary Compagnie de Financement to CFHL-1 2014, a *fonds commun de titrisation* (French securitisation fund (FCT)) constituted under the French Monetary and Financial Code by Eurotitrisation (as Management Company) and Crédit Foncier (as Custodian). The FCT is bankruptcy remote by law, does not have legal personality and its sole function is to acquire the portfolio of home loans and to issue notes and units backed by the portfolio of home loans. The portfolio is static – with no faculty to re-charge or substitute new home loans and comprises home loans made available to obligors located in France which are either secured by a first ranking mortgage or guaranteed by a caution issued by Crédit Logement.

The notes and units issued by the FCT comprised:

- EUR 428m Class A1 Notes due 28 April 2054;
- EUR 376m Class A2 Notes due 28 April 2054;
- EUR 33m Class B Notes due 28 April 2054;
- EUR 28m Class C Notes due 28 April 2054;
- EUR 19m Class D notes due 28 April 2054;
- EUR 23m Class E Notes due 28 April 2054;
- Two Subordinated Units, each of aggregate nominal amount EUR 100,000; and
- Two Residual Units, each of aggregate nominal amount EUR 150.

All the classes of Notes were admitted to listing issued on the official list of the Luxembourg Stock Exchange and to trading on its regulated market. All series of Units were privately placed. The notes are rated both by Moody's Investors Service and by Fitch Ratings.

Crédit Foncier was appointed as servicer of the home loan portfolio. It also acts as swap counterparty under the interest rate swap, data protection agent and account bank for the general account of the FCT, with Natixis being the account bank for the reserve account. The structure diagram of the transaction is set out in Figure 1 opposite.

CREDIT ENHANCEMENT AND LIQUIDITY

There are a number of mechanisms which create credit enhancement or liquidity:

- The senior notes benefit from the sub-ordination of the lower ranking series of notes and the units issued by the FCT.
- A non-amortising general reserve fund was constituted up-front which represents around 0.5% of the initial principal balance of the rated notes.
- The interest rate swap includes an excess spread mechanism which permits the FCT to retain 1.0% per annum and amounts equal to senior expenses of the FCT.

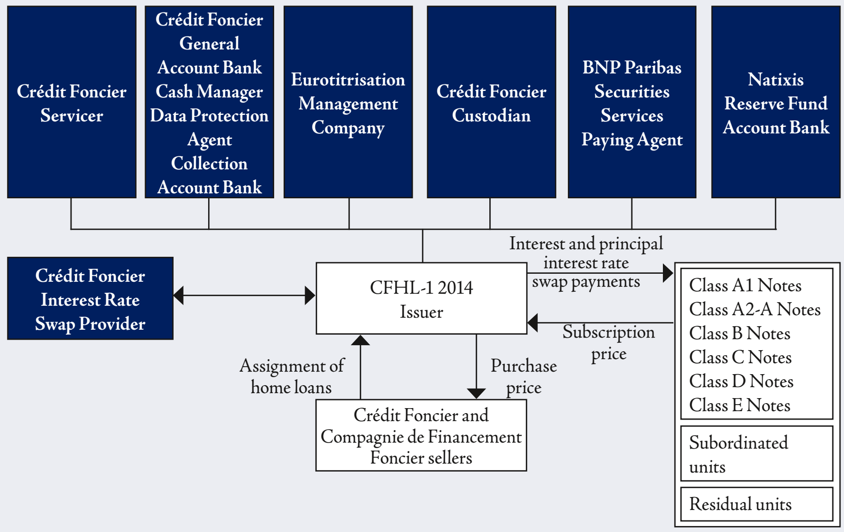
A liquidity reserve is also built-up out of principal collections and once fully constituted will represent 3% of the principal amount of the rated notes. If drawn, this reserve will be replenished under the principal payment waterfall.

SERVICING AND MITIGATION OF COMMINGLING RISK

Crédit Foncier is appointed as servicer of the portfolio and will receive collections into collection accounts in its own name. These collections will be transferred to the FCT on a monthly basis.

If the rating of the Servicer falls below the required rating it is required to constitute a commingling reserve equal to approximately 10 weeks of collections by way of a cash security deposit with the FCT (*remise de sommes d'argent en plein propriété à titre de garantie*). If in such circumstances the Servicer implements a daily sweep of collections to the FCT the required level of the commingling reserve is reduced to six weeks of collections. The required level of the commingling reserve may also be reduced if the Servicer establishes a specially dedicated account (*compte d'affectation speciale*) to receive such collections on behalf of the FCT. Such accounts are by law segregated from the general assets of the Servicer and such segregation on behalf of the FCT is preserved even in the case of insolvency proceedings being commenced in relation to the Servicer.

FIGURE 1: STRUCTURE DIAGRAM OF THE TRANSACTION



SPECIAL FEATURES OF THE CLASS A2 NOTES

Whilst the Class A2 Notes have a Legal Final Maturity Date of 28 April 2054, they include specific conditions which mean that they may be redeemed early by the FCT if it can successfully issue a new series of Class A2 Notes to re-finance the existing series of Class A2 Notes on or after the date on which there is a step-up in the margin of such series of Class A2 Notes and provided that all the conditions to issuance of a new series of Class A2 Notes are satisfied.

On 28 April 2019, the margin on the initial series of Class A2 Notes will be doubled and will step-up from 65 basis points to 130 basis points. Prior to the step-up date the FCT will ensure that the feasibility of an issuance of a new series of Class A2 Notes is assessed and, if market conditions permit such an issuance to be realised at an all-in-cost that would be lower than continuing with the current series of Class A2 Notes to maturity at the stepped-up margin, the FCT can trigger a mandatory redemption of the existing series of Class A2 Notes which will be redeemed out of the proceeds of issuance of the new series of Class A2 Notes. If, on or around the step-up date, market conditions do not permit a successful re-issuance of Class A2 Notes, the existing series of Class A2 Notes will remain outstanding and accrue interest at the stepped-up margin. However, the process of assessing market conditions as to the feasibility of a redemption of the current series of Class A2 notes and their re-financing by the issuance of a new series of Class A2 Notes on more advantageous terms will be repeated until a successful redemption and re-issuance has been realised.

It is envisaged that the initial series of Class A2 Notes will be subject to a re-marketing process in 2019 and that any new series of Class A2 Notes issued on or after the step-up date in 2019 will be subject to a similar re-marketing and redemption process five years after their issuance.

The inclusion of the step-up and re-marketing feature meant that it was possible to place the Class A2 Notes with investors on more attractive terms than if this series of Notes had been vanilla RMBS notes with long maturity.

RETENTION OF MATERIAL INTEREST

Following the financial crisis, one of the regulatory reforms was to require that originators of securitisation transactions retain "skin in the game" or a material on-going interest in the transaction throughout its duration. These requirements are currently set out in Art 405 *et seq* of the Capital Requirements Regulations. In order to comply with these obligations, the Sellers have undertaken to retain, on a consolidated basis, a material net economic interest which shall in any event not be less than 5%. In practice, this was implemented by the Sellers retaining randomly selected exposures equivalent to not less than 5% of the portfolio of exposures which would otherwise have been securitised under the transaction. They also undertook not to sell or to enter into any hedge or credit risk mitigation in relation to the retained exposures. The retained exposures were selected randomly by an independent auditing company.

Similar risk retention requirements apply to alternative investment managers which are required to be authorised under the AIFMD. The requirements applicable to AIFMs exposed to securitisation also impose obligations on such managers

Biog box

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to ensure that the originators comply with certain criteria as to the origination and any amendments to home loans, the on-going administration and monitoring of the portfolio of home loans, credit risk management and the provision of data. Crédit Foncier represented in the transaction documents that its policies and practices comply with these requirements.

LOAN LEVEL DATA

In December 2010 the Governing Council of the European Central Bank decided to introduce loan-level data reporting requirements for asset-backed securities to qualify as eligible collateral for Eurosystem monetary policy and intra-day credit operations. This became mandatory for RMBS securities with effect from 3 January 2013. Accordingly, the transaction envisages that the Servicer will use reasonable commercial endeavours to make such loan level data available on the website of the European DataWarehouse which receives and publishes such data for the purpose of compliance with these Eurosystem requirements.

PERSPECTIVES

The CFHL-1 2014 transaction demonstrates that it is possible to structure and execute French RMBS transactions in the post-crisis regulatory and financial environment and that international investors are interested in prime RMBS transactions with underlying French assets. The re-launch of the French RMBS market may not only offer an additional funding tool for financial institutions but also indicate the beginning of a return to normal health of the term asset backed security market in continental Europe. ■

Further reading

- Titan-ic struggles: servicer replacement disputes in CMBS transactions [2014] 7 JIBFL 444
- Risk retention under the CRR: portfolio acquisitions and business financings [2014] 6 JIBFL 401
- LexisNexis Loan Ranger Blog: How to revive the European securitisation market
- Lexis PSL: Restructuring & Insolvency: Key features of securitisation and asset based lending

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In Practice

Author Farmida Bi

The impact of the UK sovereign sukuk: only the beginning?

When David Cameron announced on Tuesday 29 October 2013 at the World Islamic Economic Forum in London that the UK would issue a sovereign sukuk in 2014, the hope was that this would stimulate investment into the UK from wealthy Muslim investors as well as providing a highly rated instrument for Islamic banks to invest in to meet their liquidity requirements under Basle III. The £200m UK sukuk was duly issued on 2 July 2014, and although it is still early days, an assessment of its initial impact may be useful.

THE STRUCTURE

The sukuk issuance was highly successful, attracting orders of more than £2bn and was priced in line with a UK Government conventional gilt issue which had a comparable maturity, thus overcoming concerns about a sukuk issue achieving "value for money" which had been frequently expressed by the UK Government, since its initial proposed issuance of a £2bn Treasury bill programme in 2008 had been put on hold. The enthusiasm of Islamic investors was also matched by the banks who sought to act as arrangers on the deal. In the end, HSBC as lead arranger was joined by Barwa Bank, CIMB, National Bank of Abu Dhabi and Standard Chartered, although the UK Islamic banks were disappointed not to be a part of the manager group.

The deal was structured as a £200m sukuk *al-ijara*, based on rental income generated from leases from government-owned properties and was listed on the London Stock Exchange. This straightforward instrument had a twofold advantage: as the first sovereign sukuk issued by the government of a non-Muslim country, the structure was easy for subsequent UK corporate issuers to understand and replicate, and it also ensured the UK Government used the most well established sukuk structure, thus ensuring that no unforeseen problems with Sharia compliance would arise. The sovereign sukuk issue complied with the "alternative finance investment bond" framework set out in the UK's 2007 Finance Act, which was specifically designed to facilitate sukuk issuance. This requires the sukuk to meet certain eligibility requirements such as listing on a recognised stock exchange and ensuring that payments to investors do not exceed more than a reasonable commercial return on the principal deployed. The issue shows that the UK tax and regulatory regime has provisions in place to accommodate a sukuk issuance that can be used by a corporate as well as the UK Government.

THE EFFECTS

Since its undeniably successful launch, what has been the UK sukuk's impact? The most immediate and striking consequence of the UK sukuk appeared before it was issued, when it initiated a race among non-Muslim countries to become the first to issue a sovereign sukuk.

After a summer lull, September has seen issuances coming to the market from Hong Kong, South Africa, Goldman Sachs and Luxembourg. It was well publicised that each of these issuers had been contemplating a sukuk issue for a number of years but they had been grappling with finding appropriate assets and, in the case of the sovereigns, with amending domestic tax and regulatory legislation in order to enable sukuk issuances to be made. The successful issuance of the UK sukuk provided the impetus needed for these deals to come to the market.

Hong Kong issued its US$1bn sukuk on 18 September 2014. It is a five-year *ijara* sukuk underpinned by commercial buildings in Hong Kong. South Africa also issued its sukuk in September, coming to the market with a US$500m sukuk *al ijara*, based on infrastructure assets. The Goldman Sachs sukuk, which closed on 23 September 2014, used a different sukuk structure, *a wakala*, where 51 per cent of the issue proceeds were invested in Sharia-compliant commodities and 49 per cent in a *murabaha* trade. The Luxembourg sukuk is expected to price at the end of September. All these deals have attracted strong investor demand and have priced competitively against their conventional bond issues, demonstrating that Islamic investors are open to issuances from non-Islamic issuers and that a significant faith premium is not required in order to tap this liquidity pool as had been feared by the UK Government.

Yet despite excitement at a number of non-Muslim sovereign sukuk by year's end, the most important benefit of the UK sukuk was meant to be the flood of inward investment by Muslim investors, as the UK signalled that it was open to Islamic finance. The UK, and London in particular, has long been a popular destination for Muslim investors who see it as a second home and a safe market in which to invest their wealth. The property market in particular has benefitted and the Islamic investment banks and Islamic windows at conventional banks exist primarily in order to service wealthy overseas Islamic investors looking to invest in the UK and to passport into the EU rather than the home-grown British Muslim population. That investment is likely to continue and the Islamic markets are pleased that the UK has fulfilled its stated intention to issue a sukuk, first mooted six years ago.

CONCLUSION

It is a paradox that the immediate effect of the UK sovereign sukuk was to stimulate enormous activity and interest not just in the UK itself, but in Luxembourg, South Africa and Hong Kong. The Goldman Sachs sukuk, issued pursuant to English legislation, shows that the tax and regulatory framework in the UK can be used by any corporate in the UK wishing to follow the benchmark created by the UK sovereign sukuk, and that the *ijara* structure is not the only possibility open to them. It will now be interesting to see whether the momentum which has built up following the UK deal can be maintained. ■

SLAUGHTER AND MAY

Slaughter and May is a leading international law firm with an extensive financing and banking litigation practice. It acts for both lenders and borrowers on a broad range of lending and capital markets deals, including acquisition, asset, project and structured financings and derivative, securitisation and corporate recovery transactions. Its banking litigation practice handles all types of dispute – domestic and international – from letter of credit and derivatives disputes to cases involving fraud, asset tracing, and issues of sovereign immunity as well as insolvency work. It also acts on the full range of investigations and inquiries.

In Practice

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Deferred prosecution agreements: a leap of faith?

This article considers the benefits of, and key concerns with, co-operating with the Serious Fraud Office (SFO) during the deferred prosecution agreement (DPA) process.

On 24 February this year, under the Crime and Courts Act 2013 (CCA 2013), DPAs became part of the SFO's toolkit to tackle fraud and economic crime. While the SFO currently reports 25 cases under investigation (up from eight last September), David Green, the SFO's Director, has been reluctant to predict when the SFO will enter into its first DPA. DPAs are discretionary tools that enable corporates, if invited to do so by the SFO or Crown Prosecution Service (CPS), to settle – without prosecution – allegations of, primarily economic, criminal conduct. In simple terms, a DPA allows the SFO and CPS, the current designated prosecutors, to agree to suspend a prosecution for bribery (and certain other offences) in return for the corporate accepting financial penalties and agreeing to implement remedial measures and/or to the appointment of monitors.

The DPA Code of Practice, issued jointly by the SFO and the CPS under the CCA 2013, sets out a two-stage test that must be satisfied:

- the **evidential stage**: essentially, is there sufficient evidence to provide a realistic prospect of conviction, or, if not, are there reasonable grounds for believing that continued investigation would provide such evidence within a reasonable time frame, ie evidence that would confirm the prosecutor's reasonable suspicion, based on existing admissible evidence, that an offence has been committed; and
- the **public interest stage**: ie would it be in the public interest to enter into a DPA rather than prosecuting.

When considering the appropriate financial penalty, the SFO and CPS will have reference to the Sentencing Council's Definitive Guideline for Fraud, Bribery and Money Laundering Offences (insofar as it relates to corporates). The Guideline applies to all corporates sentenced on or after 1 October 2014, but was published by the Sentencing Council earlier this year so that it could inform the negotiation of financial penalties in any DPAs. The important point to remember about DPAs is that they are exactly what their name suggests: an agreement to defer prosecution. Therefore, if the corporate breaches the terms of the DPA – or if new information comes to light – the prosecution may, if the court approves, resume. Further, the SFO has made it clear that "prosecution remains the preferred option for corporate criminality" and that the use of DPAs as an alternative will only be deemed appropriate in a minority of cases.

A COLLABORATIVE (NOT RISK-FREE) PROCESS

"Maximum co-operation on the part of the corporate and its lawyers is an intrinsic part of the DPA process," said Green in March this year. The principal advantage for the corporate of co-operating with the DPA process is that it provides the corporate with an opportunity to negotiate the outcome of the SFO investigation in terms of any statement of facts (which does not require an admission of guilt), the level of financial penalties and the nature of any other sanctions, and to do so in a shorter time than a full investigation and prosecution would take.

The necessarily collaborative nature of the DPA process also has other benefits. For example, it may enable the corporate to manage media coverage and limit reputational damage, especially where details of the DPA (including any statement of facts) are published on the prosecutor's website. This is particularly the case where the corporate self-reports. In addition, self-reporting may allow the corporate to influence the timing and direction of an investigation, thereby reducing costs and the burden on management time.

The DPA process presents very real challenges for corporates, especially pending any UK precedent. A couple of these include:

- **Disclosure**: under the DPA Code of Practice, provision by the corporate of inaccurate, misleading or incomplete information (where the corporate knew or ought to have known that the information was inaccurate, misleading or incomplete) may lead to prosecution; further, it is only a limited category of documents that cannot be used by the prosecutor against the corporate in subsequent proceedings if the DPA negotiations break down, eg documents (including drafts) created for the purpose of the DPA and the accompanying statement of facts. When engaging with the DPA process, the corporate will therefore need to weigh up carefully its disclosure obligations against the risk of material disclosed being used against it in subsequent proceedings.
- **Privilege**: the SFO is already expecting corporates to consider voluntary waiver of privilege and has made it clear that it considers a claim of privilege over witness accounts unhelpful and incompatible with a corporate's assertion that it is willing to co-operate. In addition, the SFO recently confirmed that it is "quite prepared to challenge any claim to privilege of any kind on such accounts, particularly if it seems [to the SFO] that a lazy, blanket approach is being taken". We can therefore expect careful scrutiny by the SFO of all claims of privilege.

CONCLUSION

Whether or not to enter into a DPA will be a difficult and sensitive judgment call for any corporate. However, the court's key role in the process – it scrutinises and has to approve the terms of a DPA – may provide some comfort. Given the publicity surrounding the introduction of DPAs and the likelihood that the SFO's caseload will only continue to increase, we expect the SFO to be keen to conclude one or more DPAs soon – despite its preferred option being prosecution. When that moment comes, it will be, as Green says, "a leap of faith, and… a question of maintaining public confidence". ■

For further detail, see [2014] 2 JIBFL 128 and [2014] 4 JIBFL 267.

ReedSmith

In Practice

Author Jacqui Hatfield

Changes to consumer credit in the UK

From 1 April the regulation and supervision of consumer credit moved from the Office of Fair Trading (OFT) to the Financial Conduct Authority (FCA). Those with OFT licences were required to apply for interim permission from the FCA prior to 1 April and should be in receipt of their interim permission, together with their time period allotted for applying for authorisation. This article tracks the next steps.

Any firm commencing consumer credit services after 1 April, including peer-to-peer lending platform operators which have been included within the scope of consumer credit regulation and any firm which did not apply for interim permission before the deadline, needs to be authorised by the FCA and permitted to provide consumer credit services before doing so. The FCA has published a list of OFT-licensed firms which did not apply for interim permission. As at August, the list totalled 16,142. The FCA has sent out a warning to firms on the "name and shame" list. It is conceivable that some firms on the list are not offering consumer credit in the UK any more, in which case they should notify the FCA that they have stopped providing consumer credit, so that the name of the firm can be deleted from the list. Others may be able to amend their terms so that they can fall within an exemption from the authorisation requirement and not need to be authorised or be able to arrange to be an appointed representative of an FCA authorised firm where this is permitted. If any firm on the "name and shame" list is carrying on consumer credit activities in the UK without an interim permission or authorisation, they are technically operating illegally, which is a criminal offence and contracts entered into are potentially unenforceable. Firms on the "name and shame" list, whether or not based in the UK, should not simply sit on the warning letter and do nothing. Legal advice should be sought.

Completing the application is time intensive and firms with their interim permission should commence the application process at the beginning of their allocated authorisation window rather than at the end. If the FCA application is not submitted within the allotted time, the interim permission will fall away and the firm will be operating illegally from that point.

CHALLENGES

One of the key challenges for those requiring FCA authorisation to carry out consumer credit activities is one of the threshold requirements for regulated firms which requires the firm to be capable of being effectively supervised by the FCA. In most cases this will require a UK establishment and the firm to show that it will be able to comply with all the requirements, which will include supervising and monitoring any activities carried out overseas. If it is a subsidiary it will need to show that the mind and management is in the UK. Helpfully, it appears that the FCA is prepared to consider a branch with a representative in the UK, which is less burdensome and expensive to operate than a subsidiary.

Any firm setting up a permanent establishment in the UK in order to meet the threshold requirement, which provides consumer credit services, for example debt collection services to a consumer credit lender, will need to check any non-compete or non-solicitation clauses in their services agreements to ensure that by doing so they are not breaching any covenants. Those firms wishing to become authorised or are currently subject to interim permission can find useful information from two sources on the FCA website, notably Policy Statement 14/3 and the FCA guide to being regulated for consumer credit firms. The FCA application forms and guidance notes for completion are also on the FCA website, including guidance on whether light or full authorisation is required. Providers of consumer hire contracts and credit broking intermediaries of them are a couple of the limited activities which fall within the light regime. A different application form and requirements apply to each.

Firms should be aware that information regarding controllers of the consumer credit firm, certain key staff, an organisation structure charge and a detailed business plan meeting the criteria set out by the FCA are all information required by the FCA as part of the full authorisation application and the FCA will need to approve the controllers and certain staff members to be registered as approved persons before they can act as controllers or carry out their functions. Failing to receive the required controller approval and approved persons approval is potentially a criminal offence.

LEGAL REQUIREMENTS

Most of the legal requirements relating to consumer credit are based on EU Directives which have been implemented through legislation in the UK and remain the same but there are differences for those firms which have interim permission or authorisation with the FCA. A notable difference is that the FCA supervises and monitors firms more intrusively than the OFT and will aggressively enforce its rules, most of which are now set out in the Consumer Credit Sourcebook ("CONC"). These rules will be enforceable from 1 October 2014. Until then, compliance with the OFT rules will be sufficient.

In addition, FCA-authorised firms are subject to the Principles; overarching requirements applicable to all regulated firms, including requirements to treat customers fairly and to have adequate systems and controls. The Principles are wide and vague and are subject to disciplinary action by the FCA. Treating customers fairly has been a continuing focus of the FCA and there

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In Practice

are six detailed treating-customer-fairly outcomes which need to be complied with. Detailed compliance procedures and compliance monitoring plans will be required to comply with the Principles in addition to the rules in CONC.

The individuals required to be approved person, will be subject to their own Principles and can be individually disciplined. This individual should ensure that they are aware of their responsibilities and liabilities and check their D&O insurance to ensure they are covered. In addition changes of control will be subject to prior approval by the FCA and will affect the timetable for acquisitions and sales.

Pay day lenders are a key focus of the FCA and have been challenged from day one. They are currently experiencing the more intrusive and aggressive stance of the FCA. The promotion rules have been strengthened, which will affect pay day lenders in particular. In addition pay day lenders can no longer roll over more than twice. They are also currently subject to a thematic review on debt collecting for pay day lenders and other short-term high cost lenders.

Thematic reviews are just one of the many supervisory tools available to the FCA and they can lead to attestations being required and potentially disciplinary action being taken in the future. ■

Author Louise Gullifer

Book Review

Louise Gullifer, **Professor of Commercial Law, University of Oxford**; **Fellow and Tutor in Law, Harris Manchester College, Oxford**; and **Executive Director, Secured Transactions Law Reform Project** reviews a recent financial title

Title: ***Australian Personal Property Securities Law***
Authors: Antony Duggan and David Brown
ISBN: 9780409330328 (book); 9780409330335 (eBook)
Price: $80.00 (book); $80.00 (eBook)
Publisher: Lexis Nexis (2012)

INTRODUCTION

A number of the major common law jurisdictions have followed the lead of the United States and have introduced a comprehensive code governing secured transactions, that is, the law relating to security over personal property.[1] The US scheme was introduced as Art 9 of the Uniform Commercial Code in 1952, and the conceptual framework, though not the drafting, has been followed in the Personal Property Securities Acts (PPSAs) of Canada, New Zealand and, in 2012, Australia.[2] The framework also forms the basis of the UNCITRAL Legislative Guide on Secured Transactions, adopted in 2008, which has already been used as the basis of reform of the law of several African jurisdictions,[3] as well as the UNIDROIT Cape Town Convention on International Interests in Mobile Equipment, which was adopted in 2011 and now has 60 contracting states.[4] A version of the framework, modified for use in civil law jurisdictions, was used as the basis of the European Bank for Reconstruction and Development's Model Law, which itself has been used to inform reform of secured transactions in many jurisdictions. A similar approach has been followed in Book XI of the Draft Common Frame of Reference. The reform of English law along PPSA lines has been considered and recommended by a number of bodies,[5] and currently has been taken as a starting point by the Secured Transaction Law Reform Project, a project involving practitioners, bankers and academics, looking at the need for, and shape of, future reform.[6]

Against this background, a book on the recent Australian reforms is valuable not only to English lawyers advising on transactions with an Australian dimension, but also to those interested in comparing the English law system to the PPSA system, and assessing whether the latter would increase the efficiency and efficacy of secured transaction law in this country. *Australian Personal Property Securities Law*, by two leading experts on both the Australian reforms and the PPSA legislation in Canada and New Zealand, is particularly useful in this regard. Before it was reformed, the Australian law of personal property security was very similar to English law, having developed from the same common law roots. The book therefore focuses on explaining PPSA concepts to common lawyers. For example, it describes how the PPSA "single security interest" includes interests which were previously classified as legal and equitable, created by grant or reservation and were fixed or floating, and explains with admirable precision how each former kind of interest is treated under the new legislation. The new priority rules are compared with the previous rules, which depended on both registration and notice, and the statutory means of enforcement are explained against the background of the pre-PPSA enforcement rights of secured creditors.

CONCEPTUAL CLARITY FOR ENGLISH LAWYERS

One benefit of this book for English lawyers is its clarity of exposition. Although the Australian legislation is discussed in detail, the book is not set out as commentary.[7] Rather, its structure reflects the conceptual architecture of the system. It moves from a discussion of the scope of the statute (both in terms of the types of property covered and the types of interests in such property) to an analysis of the building blocks of the law: attachment, perfection, registration, priority and enforcement. While some of the terminology may be unfamiliar to common lawyers, when explained properly the concepts are perfectly comprehensible, and are in many cases very similar. Duggan and Brown describe attachment and perfection as "old wine in new bottles".

The concept of "attachment", for example, refers to the criteria[8] which must be fulfilled before a security interest in collateral is valid against the grantor. For a security interest to be valid against a third party it must be perfected, that is, it must have attached and one of the perfection steps must have been carried out: these are registration, the taking of possession or the assumption of control. As Duggan and Brown explain, perfection is not a guarantee of priority (there may be another secured party who has also perfected, in which case the priority rules govern), but it is "the best protection a secured party can aspire to within the statutory framework".

Although the Act (in common with all PPSA schemes) is a complete code governing all aspects of the law of personal property, a very fundamental philosophy of freedom of contract underlies the scheme, and very many of the statutory provisions are default rules, so that either the parties can opt out altogether or can modify the default position by agreement. This means that a mere description of the legislation does not suffice as a practical guide to the new system: it is necessary to consider the effect of parties' agreements. This nettle is grasped by the authors, who discuss some common agreements in the book, informed by case law from Canada and New Zealand

Book Review

in which particular wording is judicially considered. The text of the Australian legislation was, like that of the New Zealand statute, based on the Saskatchewan PPSA, and although there are some considerable differences on particular points, the use of Canadian case law to suggest both potential areas of difficulty and possible solutions is very helpful.

The priority rules under a PPSA scheme are, on the whole, straightforward: the statutory rules apply irrespective of notice, and depend on easily identifiable points in time, such as the time of registration, the time possession is taken or when control is assumed. Often, their practical application often gives results similar to a common law regime, even if the conceptual route to reach that result is different. This is illustrated in the book by frequent discussion of hypothetical examples, where both the result and the application of the internal logic of the legislation are explained, and the position compared to the pre-PPSA common law.

As well as analysis of the statutory provisions, the book explains the policy reasons underlying them. Not only does this aid understanding, for common lawyers, of the PPSA scheme itself, it also facilitates reflection on the reasons for our own rules, and whether their scope is optimal. There is, for example, a discussion of the publicity function of perfection, and the policy reasons for the super-priority of a purchase money security interest, achieved in English law by retention of title devices.

FIXED AND FLOATING CHARGES

The discussion of the floating charge, and how it has translated into the PPSA regime, is of particular interest for English lawyers. The function of the floating charge, as a security interest which can be taken over assets which a borrower needs to dispose of in the ordinary course of business, has been replicated easily in the Australian PPSA by a fixed security interest which attaches to circulating assets when they are acquired, together with rules allowing buyers and lessors to whom collateral is transferred in the ordinary course of business to take free of a security interest unless they have actual knowledge that the transfer is in breach of the terms of the security agreement. The book discusses how this conceptual structure compares to the common law one, as well as the detailed mechanics of the "taking free" provisions.

Perhaps even more fascinating for those of us who have grappled with the problematic distinction between fixed and floating charges in the insolvency context is the discussion of how Australian insolvency legislation has been amended to deal with the abolition of the concept of the floating charge. The amendments are complex: the term itself is replaced with "circulating security interest", that is, a security interest over circulating assets. "Circulating assets" are defined as certain types of assets, such as inventory, currency, bank accounts and receivables, but an asset will not be a circulating asset if the secured party has either possession or control of it. "Control" in this context is specifically defined in relation to specific types of assets and, in relation to bank accounts, is, rather confusingly, wider than the concept of control used as a method of perfection.[9]

It should be noted, however, that fewer insolvency consequences hang on the distinction than under English law; for example, there is no prescribed part deducted from "floating charge" assets, and liquidation expenses do not appear to be paid out of such assets, although the expenses of a voluntary administration are. No attempt seems to have been made in Australia to rethink the question of who should pay for insolvency proceedings; rather, an attempt has been made to replicate the existing statutory boundary.[10] It is not clear whether *ex ante* certainty is thereby improved,[11] or whether a wider reform of insolvency funding would have been preferable: consideration of both these points in the book would have been helpful, at least from an English viewpoint.

A COMPREHENSIVE POINT OF REFERENCE

This book is a clear and thoughtful exposition of the Australian PPSA scheme. While there is a very considerable amount of detail, the broad outline of the scheme is described at the beginning of each chapter, so that an English lawyer wishing to obtain an overview and a comparison with a common law system could do so by reading the first few pages of each chapter. However, the book is comprehensive in its coverage and would also serve as an excellent point of reference for any detailed point of Australian personal property security law an English lawyer might wish to investigate. ■

1 Security over real property is dealt with in separate legislation, which covers both the sale of land and the grant of security over land.

2 The Australian PPSA was passed in 2009 but came into effect on 30 January 2012.

3 Malawi, Ghana and Liberia.

4 The Aircraft Protocol to the Convention has 54 contracting states. The UK Government is working on ratification of the Convention and the Aircraft Protocol at the moment.

5 The Crowther Report of 1971, the Diamond Report of 1989 and the Law Commission's Consultative Report 176 (2004) and Report 296 (2005).

6 Reform of the law of security is also being considered by the Financial Law Committee of the City of London Law Society, although it is not taking a PPSA model as its starting point.

7 This is in contrast with a seminal work on the New Zealand Personal Property Securities Act, by M Gedye, R Cuming and R Wood, which used this format very successfully.

8 These are that there is a valid security agreement, that value is given and that the grantor has rights in the collateral.

9 See below. A similar disparity arises under English law between the concept of control as a defining feature of the floating charge and the concept used as a criterion for when a security interest is a security financial collateral arrangement under the Financial Collateral Arrangements (No 2) Regulations 2003, SI 2003/3226 (FCARs).

10 This is clear from the Explanatory Memorandum to the PPSA para 9.55.

11 For a trenchant opinion that it has not, see "Fixed Charges over Receivables and the Personal Property Securities Act" D Turner (2011) 19 Insolv LJ 71.

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23 Essex Street is a set of barristers' chambers specialising in criminal litigation and noted in the financial field for its work in white-collar crime cases, including money laundering, confiscation and asset recovery, revenue and customs, business and market-related and intellectual property crime. In addition, it is noted for its expertise in the associated fields of professional regulatory and disciplinary proceedings.

Author Cameron Scott

Financial Crime Update

Cameron Scott of **23 Essex Street** reviews the latest financial crime developments

TCHENGUIZ V THE SFO

The recent settlement of the civil claim brought by Vincent and Robert Tchenguiz against the Serious Fraud Office, for a figure reported to be approximately £4.5m, avoided what could have been an embarrassing and extremely expensive trial for the SFO in October (although it would no doubt argue that settling the claim for less than 2% of the reported damages claimed represents something of a victory). It also provides an opportunity to review some of the legal issues arising from that dispute which remain relevant for those prosecuting and defending complex financial crime in dealing with search warrants and disclosure issues.

Background

The Tchenguiz brothers' dispute with the SFO had its origins in the collapse of Iceland's Kaupthing Bank in October 2008. The collapse led to a number of investigations by various authorities including the SFO. At the heart of the SFO's investigations were various loans made by the bank to entities ultimately controlled or owned by the brothers.

Grant Thornton had been appointed as joint UK liquidators of the bank and, amongst other things, had investigated various loans to the Tchenguiz entities. The SFO was given access to a number of these investigation reports and was provided with information by Grant Thornton including allegations of criminal conduct on the part of the brothers. In March 2011, using its powers under s 2 of the Criminal Justice Act 1987, the SFO obtained and executed search warrants against the brothers and arrested Robert Tchenguiz.

Almost immediately, lawyers instructed by the brothers issued proceedings against the SFO and sought judicial review of the search warrants and the arrests. The SFO was forced to admit that certain of the warrants had been obtained on the basis of inaccurate information. It subsequently dropped its investigations into the brothers who sued the SFO for a reported £300m.

The legality of the search warrants

The brothers sought judicial review of the search warrants and the arrest. The Administrative Court declared that the warrants had been improperly obtained.[1] In his judgment, Sir John Thomas summarised the basic principles for the granting of a search warrant to the SFO:

- The judiciary exercises a duty to protect the citizen from arbitrary invasion of privacy by the authorities.
- All the material necessary for the granting of a warrant must be placed before the court.
- The SFO has a duty of full and complete disclosure to the court including disclosure of anything which might undermine the grant of a search warrant. The prosecutor must "put on his defence hat and ask himself what... he would be saying to the judge".[2]
- The SFO has a duty to ensure that the information put before the judge is clear and comprehensive.
- Cases involving the financial markets should set out in writing the commercial and market background and the relevant transactions.
- The allegations should be verified by independent market or accounting experts.
- The judge has to be satisfied that there are grounds for reasonable suspicion.
- The judge should give reasons for granting the warrant.

One of the main concerns of the Administrative Court was that much of the information supplied to the judge who granted the search warrants was based on information supplied by Grant Thornton. However, the judge was not made aware of the full extent of Grant Thornton's role as liquidators in pursuing litigation against the brothers. The judge should have been made aware of the possibility that SFO was being used to promote those interests and GT's conclusions should have been independently verified. They were not. In a criminal case, the effect of a failure to comply with the duty of disclosure will depend on whether the non-disclosure would in fact have made a difference to the decision of the judge to grant the warrants. This is to be contrasted with the position in civil proceedings where any material non-disclosure will normally result in the civil search order being set aside.

The SFO was also criticised for failing to return documents seized using the search warrants which the SFO conceded was not justified. The SFO sought to retain some of them in purported exercise of its powers under s 2. This was unlawful. All of the documents should have been returned. If the SFO had wished to retain any of the wrongly seized documents, it should have applied to the court under s 59 of the Criminal Justice and Police Act 2001 which gives the court power to authorise the retention of property wrongfully seized if it would be appropriate to issue a search warrant at the time the application for authorisation was made (in other words, even if the original seizure was unlawful, a fresh and lawful, warrant would nevertheless be issued).

The legality of the arrest

The SFO and police contended that Robert Tchenguiz' arrest was

Financial Crime Update

necessary to prevent collusion with other witnesses. This, they argued, was a rational conclusion at the time albeit that it was based on information supplied by the SFO which was subsequently accepted to be inaccurate. Mr Tchenguiz argued that the investigation into the collapse of Kaupthing and his potential involvement had been known about for months and therefore there had already been ample opportunity to collude or to destroy evidence had he wished to do so. Further, had he been asked, he would have attended for interview voluntarily.

However, the court decided that the arrest was justified at the time. The fact that there had already been an opportunity to collude did not preclude further potential collusion. Further, while the fact that Mr Tchenguiz could have been given an opportunity to attend voluntarily was a factor, it was not determinative. Voluntary attendance did not preclude the possibility that he may have walked out of an interview. There was also a risk of destruction of documents which the police were entitled to take into account.

LPP and further disclosure issues

Another issue considered by the court was the correct procedure to be adopted to deal with privileged material. The SFO had used its own officers and lawyers to decide upon what was and was not privileged. The proper procedure is for independent lawyers to be present when the search is conducted to assess any claims for privilege. For these purposes, the independent lawyers should not be SFO lawyers, or lawyers from the same firm as the firm conducting the search. However, barristers from the same set of chambers are independent of each other. In the civil litigation which followed, a number of further issues arose relating to documents obtained by the SFO in the course of their investigation. In *Tchenguiz v Director of the SFO*,[3] the issue was whether the SFO was prevented from disclosing, in the civil proceedings, documents which the SFO had obtained from third parties using its powers under s 2. It was decided that the SFO had an obligation to disclose such documentation although it was not at liberty to give such disclosure voluntarily.

The Tchenguiz brothers themselves sought disclosure of the Grant Thornton reports. These had never actually been provided to the SFO and so a third party disclosure order was sought. Despite strong objections from Grant Thornton, Eder J granted the disclosure order on the basis that the reports were relevant to the issues in the civil case against the SFO and that they were not protected by litigation privilege.[4]

This latter point was appealed by Grant Thornton but upheld by the Court of Appeal.[5] The Court reiterated the law that, for litigation privilege to apply, a document must have been made:

> "with the dominant purpose of being used in aid of or obtaining legal advice from a lawyer about actual or intended litigation ... Where litigation has not been commenced at the time of the communication, it has to be reasonably in prospect; this does not require the prospect of litigation to be greater that 50% but it must be more than a mere possibility."

Tomlinson LJ added that the litigation must be adversarial, not investigative or inquisitorial.[6]

Having obtained, amongst other things, the Grant Thornton reports, the brothers then sought, and were granted, permission to obtain legal advice as to whether Grant Thornton had committed a criminal offence by providing false and misleading information to the SFO.[7] Although Grant Thornton did not object to this, permission was required as CPR 31.22 restricts the use to which documents disclosed in civil proceedings may be used (use is restricted to the purpose of the proceedings only unless the court gives permission).

Finally, in *Tchenguiz v Director of the SFO*,[8] the brothers sought, and were again granted permission, to allow independent counsel to review documents disclosed by the SFO in the civil action to consider whether any were relevant to related proceedings in Guernsey. These documents had been obtained under a request for mutual legal assistance from the Guernsey authorities. However, they were denied permission to use the documents in the Guernsey proceedings.[9] It was accepted that the documents did not contain "evidence" as that term is used in s 9 of the Crime (International Co-operation) Act 2003 and were thus not subject to the prohibition on using them for any other purpose without the consent of the Guernsey authorities. However, although the documents were potentially relevant to the issues in the Guernsey case, they contained information relating to the SFO's investigation and the co-operation between the SFO and the Guernsey authorities. There was therefore a strong public interest in preventing use of the documents for a collateral purpose since it could jeopardise future co-operation by foreign states.

Conclusion

This does appear to be the conclusion of the Tchenguiz' brothers battle against the SFO (there remains the possibility of further litigation against Grant Thornton). What the case has shown is the ability of well-funded and determined individuals seriously to challenge the SFO and it has exposed a number of weaknesses in the SFO's approach to investigations. The courts have now given quite clear guidance as to how the SFO must exercise its powers. It is unlikely that the SFO will repeat past mistakes but defence lawyers will be quick to act if they do. ■

1 [2013] 1 WLR 1634.
2 Hughes LJ in *Stanford International Bank* [2011] Ch 33.
3 [2014] 1 WLR 1476.
4 [2013] EWHC 2297(QB).
5 [2014] BCLC 1.
6 *Three Rivers District Council v Bank of England* [2005] 1 AC 610.
7 [2014] EWHC 1315 (Comm).
8 [2014] EWHC 2379 (Comm).
9 [2014] EWHC 2597 (Comm).

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Cases Analysis

Hugh Lyons, **Ricci Potts**, **Andrea Monks** and **Catherine Robert** of **Hogan Lovells** report on the latest banking law cases

COURT OF APPEAL CONSIDERS THE EXTRA-TERRITORIAL EFFECT OF POCA

R v Bradley David Rogers and others

[2014] EWCA Crim 1860

Court of Appeal (Treacy LJ, Lang J, Bevan QC)

SUMMARY

The Court of Appeal upheld a money laundering conviction, deciding that the English courts had jurisdiction over the defendant even though the acts which he was alleged to have committed all took place outside the UK. The case considers whether money laundering offences under the Proceeds of Crime Act 2002 (POCA) have extra-territorial effect.

FACTS

The appellant, Rogers, had been convicted of converting criminal property, contrary to s 327(1)(c) of POCA, and appealed against his conviction. He had been acquitted on two counts of conspiracy to defraud. The case arose from two advance fee frauds carried out by Rogers' co-defendants. Both frauds were carried out from call centres in Spain and Turkey. One fraud involved debt elimination services: consumers in the UK were cold-called and were promised that their debts would be written off in return for a fee. The second fraud involved escort services: consumers were promised that if they paid a registration fee, they could earn money by going on dates and that there was a date available for them. Once the fee had been paid, the date was cancelled.

In both cases, the calls appeared to be made to and from a UK call centre, and the fees were paid to UK bank accounts held by a network of UK companies. The accounts were controlled from Spain. In total, the two frauds made £5.7m.

Rogers was not the principal behind the fraud, but £715,000 was paid into an account which he controlled in Spain. The funds were paid in small amounts so as to avoid any anti-money laundering controls. Once the funds had been received, Rogers allowed the principal behind the fraud to withdraw some of the funds. Rogers was based in Spain and all of his alleged criminal conduct took place there.

DECISION

Rogers appealed against his conviction on three grounds. The first two grounds related to whether the judge should have permitted an amendment to the indictment and the second related to whether the count under s 327(1)(c) of POCA was subsumed by the two counts of conspiracy to defraud. This article only considers the ground relating to the scope of POCA, namely that the Crown Court did not have jurisdiction to convict because all the alleged activities were carried out in Spain by a non-resident of the UK in relation to a Spanish bank account.

Section 327(1)(c) of POCA provides that: "A person commits an offence if he… (c) converts criminal property." It was not disputed that, if Rogers had permitted the proceeds of the fraud to be paid into and transferred from an account which he held in the UK, he would have committed an offence under s 327(1)(c).

Rogers argued that because the fraud led to consumers paying money into UK bank accounts, the consumers suffered loss at that point, in the UK. Although he had been convicted of converting criminal property by permitting the funds in the UK bank accounts to be paid into and then withdrawn from his Spanish bank account, this did not involve any additional loss to any UK consumer or any activity within the UK. As a result, the UK criminal courts did not have jurisdiction over Rogers' actions. His primary argument was that the jurisdiction of the English criminal courts is territorial and they do not have jurisdiction over conduct which takes place abroad unless the statute creating the offence clearly states that this is the case.

The Crown accepted this general principle, but argued that the criminal courts had the necessary jurisdiction under POCA. In addition, the appropriate test was not whether the conduct had been committed within the jurisdiction, but whether the essence of the offence took place within the jurisdiction. The rules of comity (which would generally require a sovereign state to refrain from taking action in relation to conduct which occurred within another sovereign state) do not prevent a sovereign state from taking action in relation to conduct which occurred within another sovereign state if the conduct had no harmful consequences within the second state.

The Court of Appeal held that s 327(1)(c) of POCA was intended to have extra-territorial effect, relying on the following provisions of POCA:

- The definitions of criminal conduct and criminal property in ss 340(2) and (9) respectively. The definition of criminal conduct includes conduct which would constitute an offence in any part of the UK if it occurred there; and the definition of criminal property includes all property wherever situated.

- There was no geographical limitation on s 327(1)(c), unlike s 327(1)(e) (which makes it an offence to remove criminal property from any part of the UK), which again pointed to s 327(1)(c) having extra-territorial effect.
- Section 340(11) provides that money laundering is an act which constitutes an offence under ss 327, 328 or 329 (or a conspiracy, attempt, etc) or would constitute an offence if done in the UK, which also supported the argument that s 327(1)(c) had extra-territorial effect.

The Court of Appeal noted that the money obtained from the fraud constituted criminal property in the UK, and remained criminal property when it was transferred to Rogers' account in Spain. The argument that the transfer of the funds to Spain did not harm consumers was rejected, on the ground that the transfer made it more difficult for the consumers to recover their funds.

The Court of Appeal also accepted the Crown's alternative argument on jurisdiction, noting that the offence of money laundering was often international in nature. The victims of the fraud were British, and so the Spanish authorities would not have an interest in prosecution and the principle of comity was therefore not a bar to jurisdiction.

COMMENT

This case clarifies the extra-territorial effect of POCA and establishes that the UK authorities can take action in relation to conduct which takes place outside the UK, which will be helpful in the fight against fraud and money laundering.

WHETHER AN "ALL MONEYS" LEGAL CHARGE COULD BE CONSTRUED MORE NARROWLY

Ashwood Enterprises Ltd and Others v The Governor and The Company of The Bank of Ireland and Others

[2014] EWHC 2624

Mrs Justice Asplin

FACTS

This was a trial of preliminary issue as to liability on a claim brought by Thomas and Derek McFeely (the "McFeelys"), and Ashwood Enterprises Ltd ("Ashwood") against the Bank of Ireland (the "Bank") in respect of the financial arrangements for the development of a property situated in Stratford, east London (the "Property").

The Property was held in the joint names of the McFeelys on a bare trust for Ashwood. In January 2007 Ashwood executed a debenture in favour of the Bank to pay all of its obligations to the Bank. It was decided that for tax reasons the Property would not be developed by Ashwood but instead by a company called Inis Developments Ltd ("Inis"). In June 2007 the Bank extended a £27m facility to Inis (the "£27m Facility").

Inis' liabilities were secured by an all moneys third party legal charge over the property given by the McFeelys with Ashwood's consent (the "TPLC"), Ashwood also gave a guarantee in respect of Inis' liabilities to the Bank (the "Original Guarantee"). In May 2008 and December 2008 two further facilities of £10m and £6m were extended to Inis (the "£10m Facility" and "£6m Facility" respectively). The £10m Facility was used to fund the development of a different property, also in London.

In May 2010 the Bank served notice on Inis that it had failed to repay the £10m Facility as required on 30 April 2010 and accordingly an event of default had occurred under the Facility Agreements. On 21 October 2010 the Bank notified solicitors acting for Inis that the loans had been transferred to Irish National Asset Management Agency (NAMA).

On 4 November 2011 the Bank made formal demand of the sum of £39,349,640.58 under TPLC in respect of the £27m Facility, the £6m Facility and an overdraft facility. On the same day the Bank appointed Receivers under the TPLC and the Law of Property Act 1925.

THE CLAIM

The claimants' case consisted of seven separate issues. However, these can be divided into two main strands:

- The claimants alleged that (either on a proper interpretation of the written contracts, by collateral warranty, estoppel or by a comfort letter sent by the Bank in 2008) the £10m Facility was excluded from the TPLC; and
- The claimants alleged that the Receivers were not properly appointed either because the amount set out in the demand was incorrect or because the Bank had appointed the Receivers not on its own behalf but as an agent acting on behalf of NAMA.

DECISION

The arguments made by the claimants were fairly fact specific and it is not necessary to deal with all of them in detail here, however there are a number of points which are worth noting. The court rejected all of the claimants' arguments that the TPLC did not secure Inis' obligations in respect of the £10m Facility.

CONTACTUAL INTERPRETATION

The TPLC was an all moneys clause expressed to secure the Debtors' Obligations which were defined as:

> "All of the Debtor's liabilities to the Bank of any kind and in any currency (whether present or future actual or contingent and whether incurred alone or jointly with another) together with the Bank's charges and commission Interest and Expenses."

Although this wording appears to be clear and unambiguous the claimants sought to argue that the "all moneys" wording had only been included because the TPLC was a standard Bank document and that it was not the parites' intention for it actually to be an all moneys charge. The judge said that, following the decision in *Investors Compensation Scheme Ltd v West Bomwich Building Society* [1998] 1 WLR 896, the question was what the reasonable person with the background knowledge which would be reasonably available to the parties at the time of the contract would have understood it to mean. In particular, the judge noted that where a document was to be publicly registered, as the TPLC was, the admissible factual background is more limited than would otherwise be the case (*Cherry Tree Investments Ltd v Landmain Ltd* [2013] CH 305).

The claimants said that as the TPLC was to be given in consideration of the Bank entering into the £27m Facility this showed that it was the parties' intention for the TPLC to cover the £27m Facility only. The court disagreed noting that the TPLC actually provided:

> **"In consideration of the Bank entering into a facility agreement (the "Facility Agreement") dated on or around the date hereof with the Debtor, pursuant to which the bank agreed to advance up to £27,000,000 to the Debtor,** *and for the purpose of securing the discharge on demand of the Debtor's Obligations***." (emphasis added)**

Accordingly the consideration for the provision of the TPLC was much wider than the claimants' counsel had suggested.

The claimants argued that as the £27m Facility contained details about the development of the Property, while the £10m Facility was used to develop another property, the TPLC should not be interpreted to include the £10m Facility. The claimants also pointed to evidence that it was unusual for moneys secured on one property to be used to develop another. However, the judge felt that in circumstances where there was no apparent ambiguity in the words of the TPLC the mere fact that something was "unusual" would not cause a reasonable reader to interpret the TPLC differently.

The judge ultimately found that using the test described above "a reasonable person… would have understood the parties to have intended the TPLC to extend to further advances made by the Bank to Inis and to all its liabilities to the Bank and not to confine them to the £27m Facility."

2 DECEMBER 2008 EMAIL

On 2 December 2008 (ie after the £10m Facility had been entered into but before the £6m Facility) a solicitor acting for the Bank sent an email setting out the current status of the security containing the following "health warning":

> **"I am not anticipating many (if any) amendments to the content of this email, but please be aware that it may be necessary to make further changes and I must reserve the right to do so."**

The email was written in black with the points italicised below in red:

> **"1.1 Third Party Legal Charge**
>
> **We will need to retake this as it is, in effect, a guarantee from Ashwood Enterprises Limited and secures only the original £27m loan.** *I will deal with this in the side letter. This Charge can, therefore, remain as drafted***."**

The claimants argued that this email could be taken as either a collateral warranty amending the terms of the TPLC so that it did not cover the £10m Facility or alternatively a representation by the Bank giving rise to an estoppel by convention which prevented it from recovering the £10m Facility under the TPLC.

The judge rejected both arguments noting that the email formed part of correspondence between the parties in relation to the £6m Facility which needed to be read as a whole. In particular the judge noted that this email was, in fact, the opening shot in the negotiations leading to the £6m Facility, it was not sent at the end of the process. A number of exchanges of correspondence and discussions followed and these did not result in any of the executed documents providing that the TPLC was limited to the £27m Facility.

Elsewhere in the email exchanges it was made clear that the current security would remain in place and cover the £6m Facility, this would contradict any implication that the TPLC covered the £27m Facility only. The judge also noted that the red text said that this matter would be dealt with in a side letter and that the TPLC could remain as drafted. This contradicted any suggestion that the intention of this email was to amend the terms of the TPLC. On the basis of these matters the judge decided that this email could not be viewed as a collateral warranty as there was not a clear statement that the TPLC would only cover the £27m Facility that the parties intended to have contractual effect.

For similar reasons the judge concluded that the content of the email could not be the basis for "a clear and unequivocal assumption" that the TPLC did not cover the £10m Facility.

APPOINTMENT OF RECEIVERS

Under the Irish NAMA Act 2009 (the "Act") NAMA may inter alia acquire from certain Irish lenders their significant property related loans. In the case of Irish law assets they will be legally transferred to NAMA, however in the case of "foreign bank assets", defined under s 91(1) of the Act as assets where the governing law of its transfer or assignment is not Irish law, this may not be possible. Instead, NAMA will simply take on the economic benefit and risk of the asset and the asset will be replaced on the bank's balance sheet with NAMA securities. Thereafter the bank in question, while continuing to legally own the asset, will under s 91(4) of the Act hold the asset for the benefit and at the direction of NAMA.

The claimants therefore argued that in appointing the Receivers in respect of the Property the Bank was not acting for itself but as an agent for NAMA and, accordingly, the appointment was invalid as NAMA was not a party to the TPLC. The Bank on the other hand argued that there had been no legal transfer or assignment of the asset to NAMA as this was not possible, NAMA had simply taken on the financial benefit and risk of the asset. The Bank in fact continued to manage the loans on a day-to-day basis but NAMA would give the Bank direction as to what to do in key situations.

The judge held that the legal interest remained with the Bank and there was no agency between NAMA and the Bank. In particular, the court noted that the direction to participating institutions made by NAMA under s 131(3) of the Act states: "Nothing in this direction shall be deemed to constitute a partnership between the participating institution and NAMA, nor constitute either as the agent for the other for any purpose." Accordingly, the appointment of the Receivers had been an act of the Bank and was therefore valid.

COMMENT

This case serves as a reminder that it will be very difficult, if not impossible, for a party to bring in references to negotiations and other background when interpreting a written contract if the words used in the document are clear. While there may be any number of arguments as to why the contract would better be interpreted in one way or another if there is no apparent ambiguity in the terms of the document which needs to be addressed those arguments will not be taken into account.

This case also shows the value of reviewing the full suite of transaction documents when any of them is amended or a new facility is added. It appeared that certain individuals had assumed that the Original Guarantee (which was not "all moneys") and the TPLC were harmonious when in fact they were not. They had either failed to re-examine the documents years later when the new facilities were entered into or they had in fact never reviewed the older documents at all due to the fact that they had only become involved in the transaction at a much later date. ■

If you wish to contact Norton Rose Fulbright with regard to any item on this update please contact Farmida Bi + 44(0)20 7444 5842 or at farmida.bi@nortonrosefulbright.com

Regulation Update

A round-up of regulatory changes by **Norton Rose Fulbright**

FCA SAYS FIRMS MUST DO MORE TO ENSURE FINANCIAL PROMOTIONS FOR CONSUMER CREDIT PRODUCTS DO NOT MISLEAD

On 13 August 2014, the FCA issued a press release stating that since 1 April, it had reviewed over 1,500 financial promotions for consumer credit products. In the same period the FCA had opened 227 cases about non-compliant promotions for products such as payday loans, debt management services and credit brokers. A quarter of these cases relate to advertisements for high-cost short-term credit, with many not prominently displaying a risk warning or representative APR. Examples of financial promotions that did not meet the requirements include:

- advertisements for fee paying debt management firms that did not make it clear that services are not free of charge;
- promotions that guaranteed firms would provide credit regardless of customers' circumstances; and
- internet search terms that took consumers to unrelated sponsored links.

ECB PUBLISHES COMPREHENSIVE STRESS TEST MANUAL

On 8 August 2014, the European Central Bank (ECB) published a comprehensive stress test manual which covers both parts of the comprehensive assessment of banks deemed significant under the single supervisory mechanism. The two parts of the ECB's comprehensive assessment are:

- a systematic and centrally-led quality assurance of the stress test outcomes produced by the banks; and
- a join up of the asset quality review (AQR) and stress test outcomes.

The manual sets out in detail how the stress test quality assurance process will be carried out and then describes the methodology for combining the results of the AQR and the stress test. The methodologies for the AQR and the stress test are specified in separate publications, which together with the manual, form a complete methodology and process manual for the quantitative component of the comprehensive assessment. The ECB will publish the final results from the comprehensive assessment in the second half of October 2014.

FCA SETS OUT ITS APPROACH TO FINANCIAL PROMOTIONS IN SOCIAL MEDIA

On 6 August 2014, the FCA published Guidance Consultation 14/6: Social media and customer communications: the FCA's supervisory approach to financial promotions in social media (GC14/6). In GC14/6, the FCA seeks to clarify its approach to the supervision of financial promotions in social media.

In GC14/6, two key messages from the FCA are:

- communications through social media can reach a wide audience very rapidly, so firms should take account of that in their decision to promote through social media, and the nature of their promotions. Firms should ensure that their original communication would remain fair, clear and not misleading, even if it ends up in front of a non-intended recipient; and
- the requirements to be fair and not misleading imply balance in how financial products and services are promoted, so that consumers have an appreciation not only of the potential benefits but also of any relevant risks. Firms should consider the appropriateness of character-limited media as a means of promoting complex features of financial products and services. It may be possible to signpost a product or service with a link to more comprehensive information provided that the promotion remains compliant in itself. Alternatively, it may be more appropriate to use 'image advertising' to promote the firm generally.

GC14/6 also sets out further detail on specific areas that firms need to consider. This includes risk warnings and other required statements. The deadline for responding to GC14/6 is 6 November 2014.

Regulation Update

IOSCO LAUNCHES PUBLIC INFORMATION REPOSITORY FOR CENTRAL CLEARING REQUIREMENTS	On 5 August 2014, the International Organization of Securities Commissions unveiled an information repository for central clearing requirements for over-the-counter derivatives, which provides regulators and market participants with consolidated information on the clearing requirements of different jurisdictions. The repository sets out central clearing requirements on a product-by-product level, and any exemptions from them. The information in the repository will be updated quarterly.
EBA FINAL DRAFT RTS ON TREATMENT OF EQUITY EXPOSURES UNDER THE IRB APPROACH	On 5 August 2014, the European Banking Authority (EBA) published final draft regulatory technical standards (RTS) to specify the treatment of equity exposures under the internal ratings-based (IRB) approach under Art 495(3) of the Capital Requirements Regulation (CRR). The RTS establish that member state competent authorities are allowed to grant institutions a temporary exemption from the IRB treatment for certain equity exposures held by institutions as at 31 December 2007, the last date of application of the (now repealed) Banking Consolidation Directive. The exemption is temporary and will end on 31 December 2017. The EBA submitted the RTS to the European Commission (the Commission) for their adoption as EU Regulations that will be directly applicable throughout the EU.
EBA CONSULTS ON CRITERIA FOR INTERVENTION ON STRUCTURED DEPOSITS UNDER MIFIR	On 5 August 2014, the EBA published a consultation paper containing draft technical advice on possible delegated acts on criteria and factors for intervention powers concerning structured deposits under Arts 41 and 42 of the Markets in Financial Instruments Regulation. The deadline for comments on the Consultation Paper is 5 October 2014.
FCA GUIDANCE CONSULTATION ON FPC RECOMMENDATION TO LTI RATIOS IN MORTGAGE LENDING	On 4 August 2014, the FCA published Guidance Consultation 14/4: Guidance on the Financial Policy Committee's (FPC) recommendation on loan to income (LTI) ratios in mortgage lending (GC14/4). Within the FPC's recommendation, the PRA and FCA have been requested to ensure that mortgage lenders limit the proportion of mortgages at LTI multiples of 4.5 and above to no more than 15% of their new mortgages. It applies to all lenders that extend residential mortgage lending in excess of £100m per year and the FPC has requested that it be implemented as soon as possible. In GC14/4, the FCA sets out how it will: ➨ expect firms to act in light of the FPC's recommendation; ➨ determine which firms should apply the LTI limit when the guidance comes into effect; ➨ determine which firms should apply the LTI limit on an on-going basis; and ➨ monitor if a firm's mortgage lending is consistent with its expectations on the LTI limit and what supervisory action may be taken. The deadline for responding to GC14/4 was 15 September 2014.
EBA REVISES Q&AS ON SUPERVISORY REPORTING	On 1 August 2014, the EBA published a revised, final set of questions and answers (Q&As) on supervisory reporting. Whilst the Q&As were published in a consolidated format in June 2014 the EBA further updated them to reflect the Commission Implementing Regulation laying down implementing technical standards (ITS) with regard to supervisory reporting of institutions according to the CRR.
FCA RESTRICTS DISTRIBUTION OF COCOS TO RETAIL INVESTORS	Contingent convertible instruments (commonly known as CoCos) are hybrid capital securities that absorb losses when the capital of the issuer falls below a certain level. In the first use of new consumer protection powers, the FCA introduced on 5 August 2014 a temporary restriction on firms from distributing CoCos to the mass retail market. The restriction applies from 1 October 2014 to 1 October 2015.
BCBS REVISES BASEL III IMPLEMENTATION MONITORING WORKBOOK AND RELATED MATERIALS	On 4 August 2014, the Bank for International Settlements updated its webpage on Basel III current data collection exercises to include an updated version (version 2.8.1) of the BCBS' Basel III implementation monitoring workbook.
SRM REGULATION PUBLISHED IN OJ	On 30 July 2014, there was published in the Official Journal of the EU (OJ), the text of the Regulation for a Single Resolution Mechanism (SRM). The Regulation came into force 20 days after publication in the OJ, that is, 19 August 2014. It applies from 1 January 2016, with the exception of certain provisions relating to the establishment of the SRM and the making of delegated and implementing acts, which will apply at earlier dates.

CP14/15 RECOVERY AND RESOLUTION DIRECTIVE

On 1 August 2014, the FCA published Consultation Paper 14/15: Recovery and Resolution Directive (CP14/15). In CP14/15, the FCA sets out proposed changes to its Handbook that are required to transpose the Recovery and Resolution Directive (RRD) into the UK regulatory regime for investment firms and certain group entities that it regulates prudentially and that fall within the scope of the RRD.

The RRD must be transposed into national law by 31 December 2014 and applied from 1 January 2015. The deadline for comments on CP14/15 was 1 October 2014.

TR14/13: FCA PUBLISHES THEMATIC REVIEW ON BEST EXECUTION AND PAYMENT FOR ORDER FLOW

On 31 July 2014, the FCA published its thematic review on best execution and payment for order flow (TR14/13). TR14/13 is a key part of the FCA's wholesale conduct strategy. The findings in TR14/13 on the need for firms to control client execution costs in order to deliver best execution are closely linked to the FCA's on-going thematic and policy work to ensure that firms scrutinise and control their use of client dealing commissions to purchase services.

Payment for order flow (PFOF) is the practice of an investment firm which executes client orders, receiving commission both from the client originating the order and also from the counterparty with whom the trade is executed. In TR14/13 the FCA's key findings in relation to PFOF are:

- PFOF arrangements create a clear conflict of interest between the firm and its clients, are unlikely to be compatible with the FCA's inducements rule and risk compromising compliance with best execution rules; and
- that there were a small number of market participants who still continued to receive PFOF by changing the description of the service they provided to clients during the course of the FCA's thematic work. This recast PFOF arrangement sought to describe the commercial relationships in terms that were not consistent with the economic realities of the firms' activities and therefore still constituted a PFOF arrangement and were not compatible with FCA rules.

The FCA states that it is keeping this area under active review and has warned that it will take action against firms that evade its requirements on PFOF.

In relation to best execution the FCA found that overall many firms appeared to rely on the assumption that clients would switch to a competitor if they were not satisfied that best execution was being consistently delivered to them. The FCA states that firms should instead focus on meeting its requirements and exercising their own judgment in their clients' best interests. The FCA also sets out in TR14/13 its findings on best execution in four key areas:

- scope – the FCA found there was a poor level of understanding of which activities require best execution;
- monitoring – most firms lacked effective monitoring capability to identify best execution failures or poor client outcomes;
- internalisation and connected parties – firms which relied heavily on internalisation or on executing orders through connected parties were often unable to evidence whether this delivered best execution and how they were managing potential conflicts of interest; and
- accountability – it was often unclear who had responsibility and ultimate accountability within a firm for ensuring that execution arrangements and policies met the FCA's requirements. Firms usually only carried out superficial checks on policy documents.

EBA ISSUES AMENDED DRAFT ITS ON SUPERVISORY REPORTING FOR INSTITUTIONS

On 30 July 2014, the EBA published final draft ITS amending the Commission's Implementing Regulation on supervisory reporting of institutions under the CRR.

The ITS included minor changes to templates and instructions that were necessary to reflect some of the answers published in the EBA's single rulebook Q&As, as well as to correct legal references and other clerical errors. The amendments are expected to apply for reporting as of December 2014.

EBA REVISED FINAL DRAFT ITS ON CRR REPORTING AND ADDITIONAL MONITORING METRICS

On 24 July 2014, the EBA published revised versions of the final draft ITS relating to:

- asset encumbrance reporting under Art 100 of the CRR;
- supervisory reporting on forbearance and non-performing exposures under Art 99(4) of the CRR; and
- additional liquidity monitoring metrics under Art 415(3)(b) of the CRR.

Regulation Update

ESA STATEMENTS	On 31 July 2014, the Joint Committee of the European Supervisory Authorities published a statement on the placement of financial instruments with depositors, retail investors and policyholders (self-placement). In the statement firms were reminded of their responsibility to comply with rules governing conflicts of interest, remuneration, the provision of advice and suitability, and the appropriateness of products. The ESAs also reminded firms that they should not allow capitalisation pressures to affect their ability to comply with existing and future EU requirements. Separately, ESMA published a statement highlighting the potential risks associated with CoCos. ESMA noted that CoCos structures are highly complex and are non-homogenous in terms of trigger levels, necessary capital buffer levels and loss absorption mechanisms. If they work as intended in a crisis, CoCos can play an important role in inhibiting risk transfer from debt holders to taxpayers. However, ESMA warned that it is unclear whether investors fully understand the potential risks and are capable of correctly factoring these into their valuations. ESMA believes that there are specific risks to CoCos and that investors should take these risks into account before investing in these instruments. Also, as investing in CoCos requires a sophisticated level of financial literacy and a high risk appetite, ESMA considers that these may not be appropriate for retail investors.
PRA AND FCA CONSULT ON PROPOSALS TO IMPROVE RESPONSIBILITY AND ACCOUNTABILITY IN THE BANKING SECTOR	On 30 July 2014, the PRA and FCA published two joint consultation papers that contained proposals that are intended to improve individual responsibility and accountability in the banking sector – Consultation Paper 14/14: Strengthening accountability in banking: a new regulatory framework for individuals (CP14/14) and Consultation Paper 15/14: Strengthening the alignment of risk and reward: new remuneration rules (CP15/14). The proposals in the consultation papers are designed to create a new approval regime for the most senior individuals whose behaviour and decisions have the potential to bring a bank to failure or to cause serious harm to customers but also to introduce new rules on remuneration to strengthen the alignment between long term risk and reward in the banking sector. In CP14/14 there are proposals for a new Senior Managers Regime, a Certification Regime and a new set of conduct rules. The proposed conduct rules will apply to all individuals approved by the FCA or PRA as Senior Managers as well as individuals covered by the PRA's Certification Regime, and will replace the existing Approved Persons rules in certain circumstances. The PRA and FCA are seeking views on the implementation timetable for the introduction of the new regimes and expect to publish this along with their final policy statements and supporting guidance in Q4 2014/Q1 2015. The deadline for comments on CP14/14 is 31 October 2014. In CP15/14, the PRA and FCA set out proposed changes to the Remuneration Code to address weaknesses in the alignment between risk and reward. The following topics are covered: deferral, clawback, bailed-out banks, buy-outs, risk adjustment (PRA only) and the remuneration of non-executive directors. On clawback (a form of ex-post risk adjustment, whereby past awards of variable remuneration may be adjusted to reflect subsequent information about the underlying risks, including emerging evidence of poor risk management) it was proposed that firms should provide for an option to extend the clawback period for Senior Managers of up to a further three years at the end of the seven year clawback period (see below). The deadline for comments on CP15/14 is 31 October 2014. In addition, on the same day the PRA published Policy Statement 7/14: Clawback (PS7/14). In PS7/14 the PRA set out the final rules and feedback to its earlier consultation on clawback. In PS7/14 the PRA confirmed that the minimum period for clawback would be seven years from vesting, and the grounds for applying clawback had been narrowed. The new rules in PS7/14 come into effect on 1 January 2015.
FCA SPEECHES	The FCA has published the following speeches: - Sustainability (Tracey McDermott on 22 July 2014). - Dealing commission (Martin Wheatley on 10 July 2014).

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PROTECTING (OR NOT) THE ENFORCEABILITY OF "ALL MONEYS" GUARANTEES

■ Guarantees are commonly used to support the primary obligations of one party to another. The obligations of the guarantor are a secondary obligation and are contingent on, and limited to, the underlying primary obligations of the contracting party. Guarantors have historically been granted considerable protection by the courts (for example, certain changes to the underlying transaction have led to the liability of the guarantor under the guarantee being discharged, extinguished or reduced), but these protections may not be available in the case of certain "all moneys" guarantees. In the case of an "all moneys" guarantee it is important that both the lender and the guarantor consider a number of important practical steps.

In *Holme v Brunskill* (1877) 3 QBD 495, where a guarantee is given in relation to a specific obligation (eg the debtor's obligations under a facility agreement), the liability of the guarantor may be discharged if the terms of the underlying contract which has been guaranteed are varied without the guarantor's consent, unless the variation is not substantial or not capable of adversely affecting the guarantor.

Interpretation of "all moneys" guarantees

The rule in *Holme v Brunskill* does not apply to "all moneys" guarantees. However, whether a guarantee is in fact an "all moneys" guarantee will depend on the interpretation of the guarantee itself and the surrounding circumstances. In *Bank of Baroda v Patel* [1996] 1 Lloyd's Reports 391, the court held that an apparent "all moneys" guarantee should be read in conjunction with a specific facility letter in respect of which the guarantee had been given (and which had been subsequently varied). As the guarantee was given in respect of this specific facility letter and this was the reason for granting the guarantee, it could not be considered an "all moneys" guarantee.

This can be contrasted with the guarantee in *National Merchant Buying Society v Bellamy* [2013] All ER (D) 69 (May), [2013] EWCA Civ 452, (previously reported in [2013] 5 JIBFL 293). In this case, the Court of Appeal found that the drafting of the guarantee had been clear and that it had been drafted to cover anything due or to become due, without limit, and there was nothing in the surrounding circumstances to support any implied limitation. As the guarantee was not specifically linked to a credit limit (but rather was given in respect of obligations arising out of a contemplated course of dealing) it had not been discharged by a later variation being made to that credit limit.

In *National Merchant Buying Society v Bellamy*, the guarantee was found to be an "all moneys" continuing guarantee which would not be discharged by a variation of the obligations that existed between the underlying parties. Provided the course of dealing was within the scope of that contemplated by the guarantee the exact details of the deal between the parties to the underlying agreement would not affect the ongoing liability of the guarantor.

The recent case of *Ashwood Enterprises Ltd v The Governor and the Company of the Bank of Ireland* [2014] EWHC 2624 (Ch) considered whether the reference to "all moneys" in a legal charge could be construed as limited to the initial facility. The court applied established principles of construction and in particular stressed that the language used in the contract must be considered and it would be necessary to establish what a reasonable person (with all the background knowledge that would have been reasonably available to the parties in the situation in which they were at the time of the contract) would have understood the parties to have meant. Once again, it was noted that all the relevant surrounding circumstances must be taken into account (including in this case the fact that the charge was known to be registrable). Also, where the wording is clear and unambiguous, the court must apply it.

Practical considerations for the lender and guarantor

Whilst the decision in *National Merchant Buying Society v Bellamy* suggests that the provisions of a well drafted "all moneys" guarantee should be upheld, despite any variation of the underlying guaranteed obligations, it would still be prudent for a lender to obtain the express prior written consent of the guarantor to any change to the guaranteed obligations. This should also confirm that the guarantee will remain in full force and effect, notwithstanding the changes to the underlying transaction, so that the guarantee is not discharged inadvertently and to make sure any new obligations will also be covered under the guarantee. From the lender's perspective, this is the most effective method to ensure that the guarantor will continue to provide the guarantee and any new obligations are caught.

The wording in such a confirmation letter is fairly standard and not likely to be subject to extensive negotiation. However, where there are any doubts about whether consideration has been provided by the lender for the guarantor's confirmation, the confirmation should be executed by way of a deed. In terms of the drafting of an all moneys guarantee, it is best practice to:

- Ensure that the drafting of the guarantee makes it clear that the guarantee intends to cover all present and future obligations, sums and liabilities of the underlying obligor to the lender.
- Check that the guarantee includes an indemnity (the primary nature of the obligations under an indemnity are advantageous for a lender if the underlying facility agreement turns out to be void or unenforceable).
- Include "waiver of defences" provisions under which the guarantor agrees to waive all defences that arise from the guarantor protections. Any waiver of defences provision in guarantees which include indemnities should be drafted widely so that they also apply to the indemnity. It is important for lenders to be aware that waiver of defence provisions are a complex area of law and must be read in light of the rules relating to the "purview of the guarantee" (see [2013] 11 JIBFL 739 and [2014] 5 JIBFL 293). As such, the provisions may well be ineffective making the express prior written consent essential for a lender seeking to enforce the guarantee. ■

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DLA Piper is a global law firm with 4,200 lawyers located in more than 30 countries throughout the Americas, Asia Pacific, Europe and the Middle East. With one of the largest specialist banking and finance litigation teams in the world, we are well positioned to help companies with their legal needs, wherever, and whenever they need it. The UK team, which is made up of "dedicated and experienced banking and finance litigation practitioners" (Chambers & Partners UK 2013), acts for hundreds of financial institutions, including all the major UK clearing banks and provides advice and representation to banks, mortgage banks, building societies, finance houses, factors and invoice discounters and merchant acquirers as well as regulatory authorities.

Market Movements

DLA Piper UK LLP review key market developments in the banking sector

Domestic banking

The **Bank of England** will carry out an annual review of business interests of members of the Financial Policy Committee to tighten up controls and prevent conflicts of interests – *Telegraph, 21 August 2014*

Barclays Bank has sold its Spanish retail banking and wealth management business to **CaixaBank** at a loss of £500m. The division's 262 branches and 2,400 staff will transfer to **Caixa** when the deal is completed – *thetimes.co.uk, 1 September 2014*

Following measures taken by the **Bank of England** to curb irresponsible lending by lenders, **Barclays** has increased its "stress test" mortgage rate by 0.25% up to 6.99%. This is the rate that the bank uses when testing whether customers will be able to make their monthly repayments if mortgage rates were to rise – *Financial Times, 18 August 2014*

From November, **HSBC** and its **First Direct** subsidiary will introduce a £5 per day charge for all customers who go over their pre-arranged overdraft limits. The charge will replace the current £25 set-up fee that is charged each time a customer goes into their informal overdraft – *Guardian, 16 August 2014*

Fifteen of **HSBC**'s top bankers have been given "fixed pay allowance arrangements" in shares worth £7.1m. Big banks plan to sidestep EU rules capping bonuses to 200% of basic pay by increasing executives' basic pay. The new payments are treated as fixed pay, which allows banks, with approval from shareholders, to pay bonuses of 200% of their bankers' collective basic and fixed pay – *Guardian, 14 August 2014*

Coutts has made a £110m provision for compensation it is likely to have to pay out to customers who were mis-sold investments over the previous six decades. The move comes after a review of **Coutts**' advice going back to the 1950s was carried out by the Financial Conduct Authority (FCA) – *thetimes.co.uk, 30 August 2014*

The FCA has fined **RBS** over £14m after it found the bank had not trained its employees properly in relation to mortgage sales. The FCA said that there were "serious failings" in the advice given by **RBS** to customers purchasing mortgage products which, in over 50% of cases from two reviews of sales, was found to be unsuitable – *Telegraph.co.uk, 27 August 2014*

As part of **RBS**'s move to sidestep new EU rules which limit bank bonuses, ten of its senior executives, including the deputy chief executive and the new finance director, have been given "role-based" awards worth £3.5m – *Times, 13 August 2014*

Domestic general

A nascent retail bank aiming to win its first current account customers by the middle of 2015, is just weeks away from putting in its application for a formal banking licence. The venture, which will have no branches and will be aimed at 24 to 35-year olds, is backed by WPP and two leading accounting firms. Former **Allied Irish Banks**' chief operating officer, Anne Boden, will be the bank's chief executive – *Times, 4 September 2014*

New figures from the Financial Ombudsman Service have shown that the first half of 2014 saw an almost 42% drop in the number of complaints made against Britain's banks. The fall is largely attributable to a drop in the number of loan insurance mis-selling cases. The period saw 191,000 new complaints received, compared to 327,000 in the first six months of 2013 – *Telegraph.co.uk, 2 September 2014*

Despite the economic recovery, business lending continues to be in the doldrums after a further weak performance was reported by the Funding for Lending Scheme in the second quarter of 2014 – *Guardian, 29 August 2014*

A "huge under-recording" of the level of credit-card and electronic fraud in the crime statistics has been acknowledged by Metropolitan police commissioner, Sir Bernard Hogan-Howe, who blames banks and credit companies for the omission, saying that they do not want to reveal "how vulnerable they are" or how much has been lost – *Times, 28 August 2014*

The Serious Fraud Office (SFO) is examining allegations that high street banks have abused government schemes designed to increase lending to small businesses. The SFO is examining a range of issues, including the claim that there has been wrongful securing of government-funded guarantees in order to remove companies' overdrafts and pass risky SME loans on to the taxpayer. It is not yet clear whether the SFO will launch a full-scale formal investigation – *Times, 18 August 2014*

Market Movements

Britain's banking industry has accused the taxman of being too incompetent to be trusted with powers that will enable it to raid people's bank accounts. The British Bankers' Association (BBA) has written to George Osborne stating that HM Revenue and Customs cannot be trusted with the power to take money straight from the bank accounts of those who have not paid their tax bills – *Telegraph, 16 August 2014*

With a total bill already approaching £1bn, the most recent costly scandal to hit the banking sector stems from a wave of mistakes in credit and loan agreements. **HSBC** has found errors in the paperwork of personal loan customers which meant that, effectively, for a period, interest payments were legally unenforceable. The bank has become the latest to announce the setting aside of hundreds of millions of pounds for refunds. Other banks that have admitted finding similar mistakes include **Barclays**, the **Co-operative Bank** and **Northern Rock** – *Guardian, 9 August 2014*

European banking

The FCA has fined **Deutsche Bank** £4.7m for the misreporting of derivative transactions over a five-year period. According to the FCA, between November 2007 and April 2013, 29 million transactions were "incorrectly reported" by the bank's London branch – *Guardian, 29 August 2014*

With the recovery in the Eurozone losing momentum, and with an increasing risk of a geopolitical shock from the ongoing crisis in Ukraine, plans to launch new growth-boosting measures are being accelerated by the ECB. According to the ECB president, Mario Draghi, the ECB has "intensified preparatory work" on quantitative easing as a possible means of battling economic stagnation and deflation – *Guardian, 8 August 2014*

The Government has been told it can sue French banking giant **Societe Generale** for allegedly mis-selling financial products to **Northern Rock** that were partly to blame for the UK lender's collapse. The highest court in New York has ruled that **Northern Rock Asset Management** should be allowed to take legal action against **SocGen** for allegedly mis-selling $34m of mortgage products in the run-up to the financial crisis. The case is expected to pave the way for a flurry of similar lawsuits – *Telegraph, 14 August 2014*

European general

The continuing stand-off over Ukraine is being viewed with increasing concern by banks in western Europe with economic sanctions against Russia posing a threat to their business. Senior executives at both **Raiffeisen Bank International of Austria** and **Rabobank of the Netherlands** have warned about the tensions between Russia and the EU – *Financial Times, 22 August 2014*

In a move that will put the already strained relationship between Europe and the City of London under more pressure, the European Union has called for the UK's financial regulators to lose some powers to Brussels, with the three financial European Supervisory Authorities to play a bigger role in the regulation of banks, insurers and markets, giving them powers that would weaken the effectiveness of the Bank of England and the FCA – *Telegraph, 9 August 2014*

International banking

A settlement has been reached between almost 2,500 UK-based former **Lehman Brothers**' bankers and representatives of the collapsed investment bank, ending a six-year legal battle. The deal, brokered by trustees of the scheme and the Pensions Regulator, is a victory for the former bankers and means they will have their pensions honoured – *Telegraph, 20 August 2014*

General unsecured creditors of **Lehman Brothers** are at last on the brink of getting back some of the money they lost. Court documents filed in New York show that $4.6bn (£2.7bn) has been ring-fenced by the bank's trustees to pay unsecured creditors, with payments to begin on or around 10 September – *Telegraph, 16 August 2014*

International general

The US Federal Reserve has warned that the country's biggest banks have a $100bn shortfall to make up in order to fulfil new rules on liquidity that are designed to prevent a future crisis – *Financial Times, 4 September 2014*

In an effort to stop a repeat of the situation which recently saw Argentina go into default, a group representing debt issuers, investors and 400 of the biggest banks in the world has agreed a plan for dealing with financially stricken countries and their creditors – *Financial Times, 29 August 2014*

As new terms are demanded by the authorities to settle claims of mortgage sales abuses, billions of dollars more in relief will have to be offered by big banks to communities in the US hit hardest by the financial crisis – *Financial Times, 8 August 2014* ■

QUOTE OF THE MONTH

"We really have three very different approaches to what structural reform is supposed to look like."

Etay Katz, Allen & Overy, referring to the UK and US ring-fencing regimes and EU proposals; FT 15/8/14

Deals

Our monthly round up of industry news, major transactions, their significance and the players involved

Slaughter and May advised AngloGold Ashanti, a leading global gold producer headquartered in South Africa, on a new US$1bn, five-year unsecured revolving credit facility, maturing in July 2019. This replaces the group's existing five-year US$1bn unsecured facility. The new facility extends maturities and carries more favourable covenants, including an increased net debt to adjusted EBITDA covenant ratio of 3.5 times, with one conditional six-month period waiver of up to 4.5 times, further improving financial flexibility. The Slaughter and May team was led by financing partner Matthew Tobin who was supported by associates Brandon Ovington and Grace Somers.

Clifford Chance has advised Abu Dhabi Islamic Bank, Dubai Islamic Bank and Commercial Bank of Dubai on a US$425m Islamic financing and leasing (*ijara*) to Emirates for two aircraft, including Emirates' 50th Airbus A380, marking a significant milestone for the airline. Abu Dhabi Islamic Bank acted as security trustee, security agent, investment manager and investor while Dubai Islamic Bank and Commercial Bank of Dubai acted as investors. The UAE based Clifford Chance team advising the banks was led by Antony Single and included senior associate Shauaib Mirza, associate Asim Arshad and trainee Jack Parker.

Ashurst has advised Shanks and Interserve on the £213m funding for the development of a mechanical biological treatment facility and waste gasification plant in Derby under their 30-year PPP waste services contract with Derby City and Derbyshire Country Councils. The funding will be provided by the UK Green Investment Bank, Bayern LB and Sumitomo Mitsui Banking Corporation with sponsor commitments from Shanks Group plc and Interserve Group plc. The Ashurst team was led by infrastructure partners Nick Stalbow, Jan Sanders, Patrick Boyle and Nikhil Markanday.

Allen & Overy LLP advised Freudenberg SE in connection with a €250m syndicated facility, the transaction marking the firm's first retainer by Freudenberg. In charge of the transaction were Gunnar Blanck (in-house) and, from Allen & Overy, partner Dr Neil George Weiand and senior associate Dr Urs Lewens (both banking and finance, Frankfurt).

Herbert Smith Freehills has advised Bank of America Merrill Lynch (BAML) in relation to its role as sole bookrunner for Kuwait Energy's inaugural high yield bond which is comprised of US$250m senior guaranteed notes due 2019. Kuwait Energy is an independent oil and gas company actively engaged in the exploration, appraisal, development and production of hydrocarbons across the MENA region and certain other jurisdictions. The Herbert Smith Freehills team was led by US capital markets partner Alex Bafi.

Global law firm **White & Case LLP** has advised a syndicate of banks led by Banca IMI SpA, as agent, and Banca IMI SpA, Banca Nazionale del Lavoro SpA and UniCredit SpA as arrangers and bookrunners, on a €130m term and revolving credit facility for Esprinet SpA. Esprinet is a wholesale distributor of IT and consumer electronics that operates in Italy and Spain, serving around 40,000 reseller clients and supplying 600 brands. The White & Case team was led by partners Nicholas Lasagna and Iacopo Canino, with support from associate Silvia Pasqualini, all based in Milan.

DLA Piper has advised long-term client Linc Energy Ltd ("Company") on the successful offering of US$125m 9.625% due-2017 first-lien senior secured Notes. The notes were issued by the Company's wholly owned subsidiaries Linc USA GP and Linc Energy Finance (USA), through which the company is engaged in the production, development, exploitation and acquisition of crude oil and gas producing properties in the United States. The DLA Piper team was led by Stephen Peepels in Hong Kong, with support of Steven Weerts (Tax) in Los Angeles, Tony Lopez (Finance & Projects) in London, and Glenn Reitman (Corporate & Securities) in Houston.

Shearman & Sterling advised Citigroup Global Markets Inc and JP Morgan Securities LLC, as joint lead arrangers and joint book runners, in connection with a $4bn 364-day credit facility for The Procter & Gamble Company and some of its subsidiaries. The Shearman & Sterling team included partner Maura O'Sullivan (New York-Finance) and counsel Susan Hobart (New York-Finance).

Milbank represented Credit Suisse, Barclays, BNP Paribas, ING, Natixis and Nomura as joint lead arrangers and joint bookrunners for the first and second lien senior secured credit facilities in connection with the €1.2bn acquisition by Clayton, Dubilier and Rice of the Mauser Group, a worldwide leading company in industrial packaging headquartered in Germany. The Milbank Global Leveraged Finance team was led by New York-based partner Marc Hanrahan, Frankfurt-based partner Thomas Ingenhoven and London-based partner Suhrud Mehta. ■

International Briefings

France

Author Martin Le Touzé, Senior Associate at Hogan Lovells (with the assistance of Elena Kormosh)

NEW LAW FOR VALIDATING STRUCTURED LOANS: GENERAL PUBLIC INTEREST PREVAILS OVER LOCAL INTEREST

On 23 April 2014, a draft law on securing structured loans entered into by public legal entities was presented to the Council of Ministers and has been registered with the Presidency of the Senate.

This new law intends to validate *a posteriori* structured loans executed between a credit institution and a public legal entity, under which the global interest rate (TEG), the periodic rate or the period duration are specified incorrectly or simply missing.

The Government had already included a similar mechanism in Art 92 of the draft Finance Act 2014, aiming to validate structured loans which do not provide a TEG or where the TEG provision is incorrect. However, in a Decision No 2013-685 DC dated 29 December 2013, the Constitutional Council found that this validation bill was not in line with the Constitution insofar as the scope of the proposed validation was excessively broad and inconsistent with the objective pursued by the legislator.

It is a well-known fact that the legislator has the power to infringe the principle of non-retroactivity of the law, by way of the so-called validation bills – permitting retroactivity, as long as the following cumulative conditions are met: non-interference with definitive court decisions, existence of general interest, narrow scope and, in criminal matters, compliance with the principle of non-retroactivity of more severe laws.

However, regarding the validation of structured loans, the Constitutional Council found that the scope of the validation suggested was excessively broad compared to the purpose pursued by the legislator, ie the preservation of public finances from the financial consequences of three judgments handed down by the High Court of Nanterre on 8 February 2013. These three judgments ruled that a two-way correspondence by fax should be regarded as forming a loan agreement and therefore, failure to mention the TEG in such faxes would result in the application of the (lower) legal interest rate in place of the conventional one (thereby lowering the extortionate interest payments which the French municipalities would have had to pay on loans to Dexia and other banks).

In a judgment dated 7 March 2014, the High Court of Nanterre further extended and hardened its jurisprudence in ruling that the requirement to specify a periodic rate and period duration, resulting from Art R 313-1 of the Consumer Code, does apply to a contract entered into between a credit institution and a public legal entity. Failure to specify the periodic rate and period duration in these circumstances would also result in the insertion of the (lower) legal interest rate in place of the conventional one.

These decisions were widely criticised from a legal standpoint as well as a financial one. In fact, the French State has become a shareholder of Dexia bank and SFIL, therefore the financial risk resulting from the above decisions has automatically been carried over to the state's accounts.

The explanatory memorandum of the new law is particularly clear in this respect and indicates that in the absence of a legislative validation, the maximum financial risk for the State could be estimated at approximately 17 billion euros, of which 9 billion euros would materialise by the end of 2014 or early 2015. The explanatory memorandum concludes by stating that "given the significant financial risk for SFIL and Dexia, of which the State is a shareholder at 75% and 44% respectively, the securing of loan agreements remains crucial and meets a compelling objective of general interest".

Based on this explicit observation, and the lessons learned from the abovementioned decision of the Constitutional Council, the new law provides, in its final version, a simple and circumscribed legislative validation mechanism within four sections.

The first article of the law states that, subject to judicial decisions having the authority of *res judicata*, the interest rate within any written confirmation of a loan agreement or amendment executed prior to the entry into force of the law between a credit institution and a public legal entity is validated, notwithstanding the failure to provide the TEG, periodic rate or period duration.

Nevertheless, the first Article of the law provides three conditions which have to be fulfilled for this retrospective validation. In fact, the written confirmation of a loan agreement or amendment should indicate jointly:

- the amount or the method of calculation of the instalments of the loan and the interest;
- the frequency of these instalments; and
- the number of these instalments or the duration of the loan.

The second Article of the law is similar to the first one, but it only relates to circumstances where the TEG provision is incorrect and not missing. In addition, this Article indicates that in the event that the erroneous TEG specified in the contractual documentation is lower than the TEG calculated in accordance with Art L 313-1 of the Consumer Code, the borrower is entitled to the payment by the lender of the difference between the erroneous TEG owed and the validly calculated TEG.

The third Article excludes from the scope of the new law the loan agreements which provide for a fixed interest rate or a floating interest rate calculated by the addition of an index and a percentage margin. In other words, the law only targets the so-called structured loans, ie loans with a certain level of sophistication and complexity.

Finally, the fourth Article introduced by the National Assembly, mentions that eight months after the publication of the law, the Government will hand over an official report to the Parliament relating to a possible reform of the TEG rules.

The new law was voted on by the National Assembly on 10 July 2014. The text was approved by the Senate, on a second reading, on 17 July. An official publication occurred on 29 July 2014. The final version of the text has fulfilled the requirements set forth by the Constitutional Council with respect to the validation bills, particularly in that it provides for the non-interference with the definitive court decisions and focuses on the existence of an objective of general interest with a narrow scope (Decision No 2014-695 DC dated 24 July 2014).

As a counterpart of this validation bill, which had become inevitable, the local public entities will benefit from a support fund replenished by 100 million euros annually over 15 years. The aim of this support fund is to provide aid to local public entities for early repayments of structured loans and swaps. This fund was created by the Finance Act 2014.

In addition to this, the Government indicated that a support scheme for hospitals, which are the most exposed to the structured loans, will soon be established. This scheme will take the form of "state aids" in order to facilitate unwinding these loans. The total amount of the state aids could reach up to 100 million euros, although their exact nature remains unknown.

The banks will contribute to the support fund for the local public entities and the support scheme for the hospitals. This contribution has been negotiated by the Government in exchange for the validation of the structured loans.

It is very likely that this new law will put an almost definitive end to the litigation relating to the structured – or sometimes referred to as "toxic" – loans executed by local public entities and their public institutions. Beyond the political affiliations of the elected representatives, it appears that the general public interest has prevailed over the local one.

Nevertheless, the endorsement of this law will not solve the issue of the structured swap agreements executed by local public entities, which are numerous and remain an abundant source of litigation. The first court decisions are being handed down and appear rather favourable to credit institutions. However, in the absence of a clearly established case law, banks and local public entities will take the litigation to the Supreme Court. ■

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