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MAKING FRENCH BANKS SAFER: IMPACT OF THE NEW FRENCH LAW RELATING TO SEPARATION AND REGULATION OF BANKING ACTIVITIES ON NETTING AGREEMENTS

On July 26, 2013, law no. 2013-672 relating to the separation and regulation of banking activities, which was presented last December to the Government by the Finance Minister, Mr. Pierre Moscovici, was formally enacted (the "Regulation Banking Act").

The law addresses a number of sensitive issues. It was introduced to respond to lessons learned from the 2007–2008 financial crisis which highlighted the limited number of tools and resources available to supervisory authorities to limit the risks created in the financial system by systemically important financial institutions because of their size, complexity, or interconnectedness.

The European Union ("EU") is currently working on a proposed Resolution and Recovery Directive that will set out the necessary resolution framework to ensure that bank failures across the EU are effectively managed on a coordinated basis. On June 28, 2013, Member States' finance ministers agreed upon a general approach to such a draft directive. This opens the way for trilogue negotiations between the Council, the Commission, and the Parliament, with the aim of finalizing the directive before the end of this year—a schedule that many consider optimistic given the discrepancies among the three drafts currently proposed and a more general political debate on the topic.

The provisions of the Regulation Banking Act extend over a broad array of issues such as ring-fencing of certain proprietary trading activities, bank resolution regimes, anti-tax haven rules, money laundering, trading of agricultural commodities, high-frequency trading, transparency, market abuse, mandatory clearing, central counterparties' supervision, and local authorities' borrowings. This *Commentary* will focus on the Act's provisions relating to bank resolution and, in particular, how these provisions are likely to affect the enforceability of close-out netting provisions of

national and international market master agreements for financial transactions entered into by French banks and investment firms.

GENERAL CONCEPT AND CONTEXT

THE CONCEPT OF "RESOLUTION"

At the outset, an important distinction must be made between (i) "prudential administrative measures," (ii) "reorganisation and winding up measures" (as defined in European Directive 2001/24/CE of April 4, 2001 on the reorganization and the winding up of credit institutions (the "Banks' Winding Up Directive")), and (iii) "resolution measures." It is only because resolution measures are distinguished from reorganization and winding up measures that the French Parliament has concluded that it may enact a domestic resolution regime without waiting for a European position.

Indeed, since the adoption of the Banks' Winding Up Directive, the conditions for the enforceability of close-out netting provisions against the administrator of a French insolvent bank—and therefore against the relevant French supervisory authority (the *Autorité de contrôle prudentiel* or "ACP")—are not to be determined by French law (i.e., the country where the insolvency proceedings are opened (*lex fori*)), but solely by the governing law of the relevant netting agreement (*lex contractus*). If resolution were also to be considered as a reorganization or winding up measures, this conflict-of-law rule would, by designating the *lex contractus* as the sole competent law, have rendered any French resolution regime inapplicable.

THE RECENT CHALLENGE OF CLOSE-OUT NETTING REGIMES

Although often cited as one of the most effective legal tools against systemic risk, close-out netting has, since the onset of the financial crisis, often been presented as an obstacle to the reorganization process and recovery of a failing financial institution. Hence, a temporary stay on the exercise of close-out netting rights during a resolution proceeding has now officially been proposed at an international level by the *Key Attributes for Effective Resolution Regimes for Financial Institutions*, published by the Financial Stability Board (the "FSB") in October 2011.

Specifically, key attribute no. 4.2 proposes that the "entry into resolution and the exercise of any resolution powers should not trigger statutory or contractual set-off rights" or constitute an event enabling "any counterparty to exercise contractual acceleration or early termination rights provided the substantive obligations under the contract continue to be performed." Key attribute no. 4.3 further provides that in the event that such rights are nonetheless exercisable, the resolution authority shall be entitled to temporally stay such rights "where they arise by reason only of entry into resolution or in connection with the exercise of any resolution powers."

The stay may be discretionary or automatic, but in all circumstances, the following safeguards are required:

- The duration of the stay shall be strictly limited in time;
- The integrity of financial contracts shall be ensured, and legal certainty shall be provided to counterparties;
- The close-out netting rights of a counterparty shall not be affected when they rely on an event of default occurring before, during, or after the period of the stay but not related to the entry into resolution or the exercise of the relevant resolution power;
- The beginning and the end of the stay period shall be clearly determined; and
- In any event, creditors should have a right to compensation where they do not receive, at the minimum, what they would have received in the liquidation of the firm under the applicable insolvency regime (the "no creditor worse off than in a liquidation" principle).

One of the purposes of the Regulation Banking Act is to implement these safeguards in France.

CREATION OF A BALANCED RESOLUTION REGIME FOR FRENCH FINANCIAL COUNTERPARTIES

PERSONAL AND MATERIAL SCOPES OF THE RESOLUTION REGIME

The Personal Scope. The resolution regime applies to credit establishments, financial companies, mixed financial holding

companies, and investment firms, with the exception of portfolio management companies.

As the opening of a resolution proceeding will evidence the extreme difficulties encountered by the financial institution, such proceeding may be triggered only by the occurrence of one of the following circumstances:

- The entity no longer complies with applicable minimum capital requirements;
- The entity can no longer fulfil its payment obligations immediately or in the near future; or
- The entity needs financial assistance from the French Government.

The Material Scope. The resolution regime may apply to any agreement entered into with any of the financial institutions listed in the above paragraph.

Article L. 631-31-16 paragraph IV of the French Monetary and Financial Code provides for protection of the single agreement principle under master agreements and prevents the resolution authority from "cherry picking" or dismantling a master agreement by, for example, staying the equity derivatives transaction of a failing financial institution while transferring its fixed income transaction. In other words, assets, rights, and obligations governed by a netting agreement mentioned in article L.211-36-1 of the French Monetary and Financial Code may be transferred only as a whole. Thus, netting agreements entered into with French financial institutions will be effective, and counterparties will be able to take into account net positions for the purpose of determining capital requirements.

RESOLUTION MEASURES

Under this resolution regime, the ACP, renamed the Prudential Control and Resolution Authority (*Autorité de contrôle prudentiel et de résolution* or "ACPR"), is granted the power to manage such difficulties and may adopt a number of resolution measures.

Such resolution measures may consist of a variety of actions and prohibitions ranging from requesting information, appointing a special resolution administrator, changing governance, transferring all or part of a business unit (*branche d'activité*), temporarily using a bridge financial institution in support of all or part of the activities of the failing institution before their assignment, activating the loss absorption clause of subordinated bonds, mandatory recapitalizing of the failing institution, suspending payments, and suspending or prohibiting certain businesses of the failing financial institution.

Among these measures, two are of particular relevance to all financial derivatives counterparties to French banks and investment firms and affect, permanently or temporarily, the right to close out and net outstanding transactions as a result of a resolution. Specifically, they are as follows:

TRANSFER

The first measures would apply when the ACPR decides to:

- Transfer all or part of one or more business units of the failing institution. Such transfer will give rise to an outright transfer of assets and will occur on the date set out by the ACPR; or
- Temporarily transfer to a bridge financial institution all or part of the assets, rights, and obligations of such entity with the aim to permanently transfer them later.

In both situations, the Regulation Banking Act provides that "contracts relating to the transferred activities shall continue as no termination or close-out netting provisions may be invoked as a result of such transfer."

It should be noted that counterparties will remain free to close out their master agreements:

- If those agreements are not determined by the ACPR as being part of the relevant assigned business unit; and
- Once the transfer has been made, if an event of default or a termination event, not related to the transfer, occurs in respect of the succeeding counterparties.

GENERAL TEMPORARY STAY

The ACPR, when opening a resolution proceeding against a failing institution, may—but is not obliged to—declare a temporary stay of the exercise of early termination and close-out netting rights until 5:00 p.m. the next business day following the publication of such decision. When the ACPR decides upon the opening of a stay period, such period

shall start from the publication of the decision pronouncing such stay until 5:00 p.m. the next business day at the latest. All provisions to the contrary shall be deemed null and void.

At the expiry of the stay, the regime mentioned in the above paragraph ("Transfer") will apply or not depending on the actions/transfers decided upon by the ACPR during this period of time.

As mentioned above, in all instances, no dislocation of a single netting agreement is permissible.

EXTRATERRITORIALITY ISSUES

Upon the request of the FSB and national supervisory authorities, market associations are now working on the drafting of amendments to their master agreements in order to temporarily suspend the parties' termination rights following an event of default when such default results from the opening of a resolution proceeding. These amendments will be crucial for domestic resolution regimes, such as the new French one, so as to ensure their effectiveness in practice.

Moreover, in the absence of any international convention or European law providing for mutual recognition of resolution proceedings among Member States, it is highly debatable whether any such domestic regime can extend its effects beyond its borders.

From an international private law perspective, the extraterritorial effect of a domestic resolution regime is a particularly interesting issue to consider. While little doubt is left for derivatives netting agreements governed by French law, whether or not modified to take the new regime into account, one can question how an English or New York court would treat the exercise of close-out netting rights against a failing French institution on the sole ground that a domestic French resolution proceeding has been opened against it, absent express contractual provisions addressing the issue.

It is therefore essential that any non-French law governed netting agreement involving a French counterparty subject to the Regulation Banking Act—at least until an international or European law comes into force and renders it optional—provide for contractual provisions modifying close-out netting rights in a fashion that mirrors the terms of the Regulation Banking Act.

Prudential supervisors will doubtless consider whether persons and entities subject to their control have adequately reflected in their netting agreements the resolution regime and rules that they regard as essential to their administrative powers and supervisory prerogatives. Participants in the over-the-counter derivatives market should therefore carefully review their master and other netting agreements with French financial institutions for purposes of compliance and due diligence as well as from a credit risk analysis perspective.

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