

Welcome to the Spring 2011 edition of Finance Focus, the regular update from Thomas Cooper's Finance Group, in which you can review the latest legal developments in your area of finance and keep up to date with Thomas Cooper news and forthcoming events.

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Basel III

On 6 April 2011, the Basel Committee on Banking Supervision (BCBS) published a speech given by Stefan Walker, BCBS Secretary General, on Basel III. In his speech, as well as outlining the Basel III reform package, Mr Walker discussed the need for global and consistent implementation of Basel III. He also talked about the BCBS' ongoing work to address the risks of systemic banking institutions. Key points of interest include the following:

- **Basel III implementation.** The BCBS has put in place mechanisms to help ensure more consistent implementation of Basel III and its other standards. These mechanisms are reinforced through additional institutional arrangements introduced at the level of the Financial Stability Board (FSB) and the G20. Moving forward, the BCBS' standards implementation group will play a critical role in carrying out thematic peer reviews of member countries' implementation of standards and sound practices. Implementation involves not only the introduction of the standards in legal form, but also rigorous and robust review and validation by supervisors. As a result, the BSBC is introducing processes to ensure the integrity of key elements of the framework (for example, the review of banks' risk weightings which should include the use of test portfolio exercises).
- **The "too big to fail" problem.** In close co-operation with the FSB, the BCBS is working to address the financial system externalities created by systemically important banks (SIBs). The BCBS has developed a methodology that embodies the key components of systemic importance. The BCBS' work on SIBs is part of the FSB's broader work to address the risks posed by systemically important financial institutions. The BCBS expects to consult on proposals to address the risks of global SIBs around the middle of 2011.
- **Shadow banking.** The BCBS considers that stronger, consolidated banking regulation and supervision (under the Basel III regime), will go a significant way towards containing the risks of the shadow banking sector. Bank-like risks that emerge in the shadow banking sector should be addressed directly. In addition, bank-like functions that are carried out in this sector should be subject to appropriate regulation, supervision and disclosure. The BCBS, the FSB and the Joint Forum of Banking, Securities and Insurance Supervisors will monitor developments in this sector closely, and promote appropriate responses, as required.

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First version of Finance Bill 2011 published: financial services implications

On 31 March 2011, HM Treasury published the first version of the Finance Bill 2011 together with explanatory notes. The official title of the Bill is the Finance (No.3) Bill 2010-11, but it will become the Finance Act 2011 when enacted. The Bill was read for the first time on 29 March 2011 (without debate). Second reading is due to take place on 26 April 2011 and the committee stage is due to start on 3 May 2011.

The 2011 Budget confirmed many of the measures which are now included in Bill. The financial services specific measures referred to in the budget and included in Bill include those relating to:

- Changes to bank levy (article 72).
- Amendment of the life insurance apportionment rules (article 56).
- The residence of foreign UCITS funds (article 59).
- Modernisation of the tax treatment framework for investment trust companies (articles 49 and 50).
- Amendments to the Schedule 19 stamp duty reserve tax regime to widen the definition of when an investment is an underlying collective investment scheme (article 84).
- Changes to the stamp duty land tax regime to reduce the misuse of Alternative Finance reliefs (article 82).
- Introduction of an irrevocable opt-in exemption from corporation tax on the profits for foreign branches of UK companies (article 48).

Bank of England Payment Services Oversight Report 2010

On 8 March 2011, the Bank of England (BoE) published its Payment Systems Oversight Report 2010.

The report sets out how the BoE has implemented and carries out the statutory regime for oversight of the recognised UK inter-bank payment systems under Part 5 of the Banking Act. The statutory oversight regime came into force on 31 December 2009 and, in broad terms, requires the BoE to oversee inter-bank payment systems which are formally recognised by HM Treasury. To date, HM Treasury has issued recognition orders for Bacs, CHAPS, CLS, Faster Payments Service, and the embedded payment arrangements within CREST, ICE Clear Europe Ltd and LCH.Clearnet Ltd.

In the report, the BoE details the work it is carrying out to meet its statutory responsibilities in this area, including regular contact and cooperation with the FSA regarding oversight of payment systems under the respective regulatory regimes. The report also identifies the principal developments in the key recognised UK inter-bank payment systems since the statutory oversight regime came into force. The BoE considers that these systems have continued to demonstrate high levels of operational availability and that developments have generally contributed to risk reduction. However, there remain certain areas where the BoE considers it necessary to take further measures to reduce potential systemic risks, including:

- Tiering (that is, the provision, by direct participants in a payment system, of payment services to other institutions to allow them indirect access to that system).
- Payment arrangements for central counterparties (CCPs).
- Contingency arrangements.
- Governance.

The BoE notes in the report that, later in March 2011, the Committee on Payment and Settlement Systems and the Technical Committee of the International Organisation of Securities Commissions are expected to publish for consultation draft revised standards for systemically important payment systems, securities settlement systems and CCPs. This follows a comprehensive review of the existing standards, carried out during 2010. In the light of the proposed new standards, when published, the BoE intends to review its fourteen principles providing high level guidance with which operators of recognised UK payment systems must comply.



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ISDA responds to proposals on EU framework for bank recovery and resolution

On 8 March 2011, the International Swaps and Derivatives Association (ISDA) published its *response*, dated 3 March 2011, to the European Commission's consultation paper on the technical details of a possible EU framework for bank recovery and resolution.

In view of its focus on the privately negotiated derivatives markets, ISDA comments principally on those aspects of the Commission's proposals which will have a direct impact on derivatives transactions. In particular, the response is concerned with:

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

In responding to the proposals in these areas, ISDA adopts the perspective of a market counterparty carrying out derivatives transactions with a failing financial firm. ISDA considers the extent to which the proposals, if implemented, could have a negative impact on the integrity of and legal certainty regarding the enforceability of existing transactions and related netting and collateral arrangements. Key concerns are:

- The legal uncertainty created by the possible exercise of resolution powers, if those powers are inadequately defined and circumscribed.
- The legal uncertainty which may arise as to the scope or effect of any related safeguards.

In the response, ISDA stresses that there could be a resulting "material and adverse impact" on firms' ability to obtain robust legal opinions as to the enforceability of netting and collateral arrangements, and that this would, in turn, negatively affect their regulatory capital requirements.

Nil Loss argument again rejected: reliance on section 2(a)(iii) of ISDA Master Agreement is denied following automatic early termination (High Court)

Pioneer Freight Futures Company Ltd v TMT Asia Ltd [2011] EWHC 778 (Comm)

The High Court has once again dismissed a non-defaulting party's "nil loss" argument, when considering the effect of "Automatic Early Termination" on the ability of parties to rely on section 2(a)(iii) of the ISDA Master Agreement to avoid making payments to a counterparty, following an event of default. The court also considered the construction of "Loss" and "Second Method" under the 1992 ISDA Master Agreement. The court confirmed the decision in *Britannia Bulk plc v Pioneer Navigation Ltd and others [2011] EWHC 692 (Comm)* that reliance on section 2(a)(iii) of the ISDA Master Agreement is only open to parties under a transaction that has not yet been terminated. Accordingly, in determining its loss or gain, a non-defaulting party must not factor in the occurrence of an event of default.

The non-defaulting party had argued that it had not made any gain because the condition precedent to payment (that no event of default is continuing) under section 2(a)(iii) had not been satisfied.

The court's ruling that, once Automatic Early Termination is triggered, a party cannot rely on section 2(a)(iii) to withhold payments it owes under the ISDA Master Agreement, is welcome clarification of the scope of the section. Also welcome is the court's confirmation of the derivative market's understanding of how Second Method and Loss operate:

- Second Method operates without regard to fault, obliging whichever party is out of the money under a 1992 ISDA Master Agreement to pay the other party following early termination of the agreement.
- Loss deems all conditions precedent to have been satisfied under a 1992 ISDA Master Agreement, meaning that a non-defaulting party must not take its counterparty's default into account when calculating its losses or gains.

In an obiter statement, the court also confirmed that the effect of section 2(a)(iii) is to suspend rather than extinguish payment obligations.

Bribery Act 2010: Guidance

On 30 March 2011 the Ministry of Justice published its guidance about procedures which commercial organisations can put into place to prevent persons associated with them from bribing (guidance). If an organisation can prove that it has adequate procedures in place, then they can form the basis of a defence to the offence of failing to prevent bribery under section 7 of the Bribery Act 2010.

Like the draft guidance published in September 2010, the guidance sets out six principles that are intended to give all commercial organisations a starting point for planning, implementing, monitoring and reviewing their bribery free business regime. However, the principles have been amended from those in the draft guidance to include two new principles, Principle 1: Proportionate procedures and Principle 5: Communication, in the place of the principles in the draft guidance headed: Clear practical and accessible policies and procedures and Effective implementation.

The principles as set out in the guidance are:

- Principle 1: Proportionate procedures
- Principle 2: Top level commitment
- Principle 3: Risk assessment
- Principle 4: Due diligence
- Principle 5: Communication
- Principle 6: Monitoring and review

The guidance is aimed at giving clarity on how the Bribery Act will operate and is intended to help commercial organisations of all sizes and sectors understand the procedures they can put in place to prevent bribery as mentioned in section 7(1). The guidance strongly advocates a risk based approach to adopting adequate procedures, acknowledging that different procedures will be appropriate depending on the size of the organisation, the sectors and jurisdictions in which it does business, as well as the nature of its business partners and transactions. Procedures should be proportionate to the risks faced by the organisation.

The guidance is not prescriptive, but it does now suggest procedures which are designed to help organisations address the relevant principles. It will now be for organisations to review their businesses, carry out the relevant risk assessments and determine whether their procedures are adequate to prevent bribery. Where they are not, they should seek to implement anti-bribery procedures without delay.

The Bribery Act will come into force on 1 July 2011.

Insolvency: balance sheet test

In *BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL PLC and others*, the Court of Appeal interpreted a contractual event of default clause under which a notice could be served on the company in question if, among other things, it was unable to pay its debts within the meaning of section 123(2) of the Insolvency Act 1986, as if the words 'it is proved to the satisfaction of the court' did not appear in the sub-section and as the section was amended from time to time.

The court held that, when considering the application of the clause, the incorporation of the section required it to give the statutory provision the meaning and effect it had in the statute without qualification or adjustment, save to the extent spelt out. Accordingly, the first question to be considered was the meaning of section 123(2) (the balance sheet test). Whether section 123(2) applied did not simply turn on the question of whether the liabilities of a company exceeded its assets. The section was intended to cover a case where, although it could not be said that a company was "[currently] unable to pay its debts as they fall due", it was, in practical terms, clear that it would not be able to meet its future or contingent liabilities. The section applied to a company whose assets and liabilities (including contingent and future liabilities) were such that it had reached the point of no return.

The figures in the company's balance sheet, and audited and signed off annual accounts, should be accorded weight in the exercise envisaged by section 123(2). The fact that the figures had been audited and were said to convey a "true and fair" view of the company's position in the opinion of its directors should normally have real force. However, the figures would inevitably be historic, usually be conservative, based on accounting conventions, and rarely represent the only true and fair view. The court would ultimately have to form its own view as to whether the company in question had reached the point of no return. When considering if section 123(2) applied in this case, the court was content to take as the starting point the asset and liability position revealed by the company's most recent accounts, but that might not be appropriate in all cases. Here, the company's substantial assets, the relatively long period over which its liabilities had to be met, and the potential for significant change in the differences between the value of its assets and liabilities, meant it had not reached the point of no return, or the point at which the shutters should be put up.

The financial situation of the company had not been shown to be such that it was, on any commercial view, insolvent.

This is the first time that an appellate court has considered the balance sheet test, and the decision is clearly of interest to banks in relation to insolvency events of default contained in their credit documentation.

Corporate veil: liability of beneficial owner under contract

In *Antonio Gramsci Shipping Corp and others v Stepanovs*, the High Court held that there was a good arguable case, for the purposes of the jurisdiction of the courts of England and Wales, that where companies had been used by one of their ultimate beneficial owners as a device for the purpose of a fraud on the claimants, the veil of incorporation should be pierced to permit the claimants to seek to enforce, against that beneficial owner, contracts which the claimants had been caused to enter into with the companies as part of the fraud. It did not matter that the beneficial owner was not in sole control of the companies: if there were a number of wrongdoers, with a common purpose, in control of a creature company, the veil of incorporation could be lifted against one or all of them. It was not a requirement for the claimants to show, at the outset of proceedings, that the claim to pierce the corporate veil was necessary to provide them with an effective remedy. There was no good reason of principle or jurisprudence why a puppeteer should not be held party to the puppet company's contract, or why a victim could not enforce an agreement against both the puppet company and the puppeteer who, all the time, was pulling the strings.

Thomas Cooper News

Trade Finance Seminar Many of you attended our annual Trade Finance Seminar at Salters' Hall. We hope that the presentations on maritime piracy and Incoterms 2010 were of interest to you. Thank you for joining us and making the event so enjoyable.

Natalie Cardozo-Richards joins Finance Group The Finance Group Team would like to welcome Natalie Cardozo-Richards, who joins us in September 2011.

FEEDBACK

Thank you for your feedback on the previous edition of Finance Focus. We hope you have enjoyed this edition. Please pass this news letter onto any of your colleagues or friends who you think would be interested in the content. If you have any comments, requests for topics to be covered in the next edition or would like us to add colleagues to our circulation list, please e-mail: financegroup@thomascooperlaw.com

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