

CONSULTATION

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Consultation Paper 2003-[]

NETTING OF FINANCIAL CONTRACTS

CONSULTATION PAPER

The Jersey Financial Services Commission invites comments on this Consultation Document. Comments should reach the Commission by 31 October, 2003.

Responses should be sent to:

Paul de Gruchy
Advocate, Authorisation Division
Jersey Financial Services Commission
PO Box 267
Nelson House
David Place
St Helier
Jersey JE4 8TP

Telephone: 01534 822112
Facsimile: 01534 822047
E-mail: p.degruchy@jerseyfsc.org

Unless specifically requested otherwise, it is the Jersey Financial Services Commission's policy to make the contents of all responses available for public inspection.

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1. EXECUTIVE SUMMARY

OVERVIEW

- 1.1. The Jersey Financial Services Commission (the "**Commission**") aims to ensure that the laws of the Island provide a legal framework for commercial activity which protects the Island's reputation and which reflects the needs of the Island's economy.
- 1.2. This consultation paper (the "**Paper**") sets out the Commission's proposals in relation to the introduction into Jersey law of statutory provisions governing the effectiveness of contractual terms governing the netting of financial contracts.
- 1.3. Jersey companies are often party to contracts containing provisions by which the parties agree that, on the occurrence of a specified event, the outstanding liabilities between them, which will often be numerous, shall be calculated according to an agreed mechanism and converted into a single monetary obligation, payable by one party to the other ("**Netting Provisions**"). One of the specified events will almost invariably be the insolvency of one of the parties to the contract. Such provisions are often in a market standard form generally used in cross-border financial transactions (e.g. the International Swaps and Derivatives Association standard swap terms).
- 1.4. Both the Bankruptcy (Désastre) Law 1990, as amended (the "**Bankruptcy Law**") and the Companies (Jersey) Law 1991 (as amended) (the "**Companies Law**") include provisions governing the manner in which the assets and liabilities of insolvent Jersey companies are to be calculated. However, these provisions may not address the concerns which exist regarding the enforceability of Netting Provisions.
- 1.5. This consultation paper proposes the adoption of legislation which aims to bring Jersey into line with certain key European financial centres and competitor jurisdictions and in so doing to remedy a deficiency highlighted in the 1998 in the Edwards Report. The Commission believes that these proposals are in the interests of participants in the international financial markets generally. The reduced uncertainty will contribute to limiting market disruption in the event of the insolvency of a participant and limit risk to supervised financial market participants as well as limiting systemic risk..
- 1.6. The purposes of the Paper are to -
 - (a) set out the background and particulars concerning the issue;
 - (b) outline the Commission's proposals for addressing the current concerns in this area;
 - (c) request, in confidence, information that will assist the Commission in determining what action, if any, should be taken; and
 - (d) invite comment from all interested parties.

CONSULTATION

- 1.7 The Commission issues this paper under Article 8(2) of the Financial Services Commission (Jersey) Law 1998, as amended, where the Commission
“may, in connection with the carrying on of its functions consult and seek the advice of such persons or bodies whether inside or outside the Island as it considers appropriate.”
- 1.8 The Commission invites written comments from all interested parties on this Paper and the specific questions posed by it.
- 1.9 Following a general period of consultation, the Commission proposes to instruct the Law Draftsman do prepare draft legislation in relation to the efficacy of Netting Provisions.
- 1.10 The Commission would like to be in a position to place recommendations and draft legislation governing Netting Provisions before the Economic Development Committee by the end of 2003.

2. BACKGROUND

- 2.1 Jersey is a leading financial centre. The Island's financial services industry has well established banking, fund management, investment, and trust and company administration sectors, which have, in more recent years, been supplemented by a steady growth in insurance business.
- 2.2 A significant number of Jersey companies are established specifically to participate in international structured finance transactions. These are highly evolved transactions, the ultimate purpose of which is usually to raise monies on the global capital markets. The changes proposed in this Paper will particularly affect such companies.
- 2.3 The total number of Jersey registered companies as at 31 December 2002 was 33,043. The number of companies incorporated in 2002 was 2,829.
- 2.4 Companies are registered and administered in accordance with the Companies Law and the Control of Borrowing (Jersey) Order 1958, as amended. The regime governing insolvent companies is set out in the Companies Law and in the Bankruptcy Law.

THE COMMISSION

- 2.5 The Commission is a statutory body corporate established under the Financial Services Commission (Jersey) Law 1998, as amended, and is responsible for, among other things, maintaining a register of Jersey companies in accordance with the Companies Law.
- 2.6 The Commission's guiding principles require it to have regard to:
 - 2.6.1 the reduction of the risk to the public of financial loss due to dishonesty, incompetence or malpractice by, or the financial soundness of, persons carrying on the business of financial services in or from within the Island;
 - 2.6.2 the protection and enhancement of the reputation and integrity of the Island in commercial and financial matters;
 - 2.6.3 the best economic interests of the Island; and, in pursuit of the above,
 - 2.6.4 contributing to the fight against financial crime.

3. NETTING PROVISIONS - THE CASE FOR CHANGE

- 3.1 In common with many jurisdictions, Jersey has mandatory rules governing the treatment of the assets and liabilities of an insolvent company. In Jersey, these rules are primarily set out in the Bankruptcy Law, and are applied in the treatment of companies that are subject to a winding up through the mechanism provided by Article 166 of the Companies Law:

"...in a creditors' winding up the same rules prevail with regard to the respective rights of secured and unsecured creditors, to debts provable, to the time and manner of proving debts, to the admission and rejection of proofs of debts and to setting off debts as are in force for the time being with respect to persons against whom a declaration has been made under the [Bankruptcy] Law..."

- 3.2 The Bankruptcy Law sets out extensive provisions governing the manner in which the debts and assets of a bankrupt are to be calculated and distributed among creditors. In particular, Article 34 provides :

"Where there have been mutual credits, mutual debts or other mutual dealings between the debtor and a creditor, an account shall be taken of what is due from one party to another as at the date of the declaration [of désastre] in respect of such mutual dealings, and the sum due from one party shall be set off against any sum due from the other party, and the balance of the account, and no more, shall be claimed or paid on either side respectively."

- 3.3 Further rules, set out in the Companies Law, in relation to concepts such as voluntary arrangements may also have an impact when considering the status of Netting Provisions in the context of an insolvency. It is not certain how these rules may interact with Netting Provisions..

- 3.4 In 1997 the finance ministers of the G7 countries agreed to introduce legislative measures to ensure the enforceability of sound netting agreements in relation to insolvency and bankruptcy rules to reduce systemic risk in international transactions. Following this on 19 May 1998, the European Parliament passed EU Directive 98/26/EC, the primary aim of which was to reduce the legal risks associated with participation in settlement systems, in particular as regards the legality of Netting Provisions and the enforceability of collateral security. Since that time, the majority of EU member states, including France, Germany, Italy, Spain and the UK have passed legislation implementing the contents of the directive.

- 3.5 In his "Review of Financial Regulation in the Crown Dependencies" (1998), Andrew Edwards noted that "Jersey legislation regarding bankruptcy is unclear with regard to netting" (Part 2, s6.4) and was in danger of falling behind European standards.

- 3.6 As well as the move to introducing legislation in this area within the EU, several jurisdictions outside the EU have also introduced legislation, often based upon the Irish Netting of Financial Contracts Act 1995, which was the first significant law providing for the enforceability of Netting Provisions. Australia, the British Virgin Islands, the Cayman Islands, Luxembourg, Malta and New Zealand have all passed or are in the process of passing such legislation.

- 3.7 Although it is commonly believed by Jersey lawyers that the Royal Court, in the event of an insolvency, would uphold Netting Provisions, the point is not however settled and the parties to complex financing transactions require certainty. In the event that the Royal Court had to consider such arrangements significant market disruption could result even if ultimately it upheld them. As well as causing difficulties, and perhaps loss, to investors in the specific transaction, there would be the risk of contagion and inevitable damage caused to Jersey's reputation.

4 POSSIBLE COURSES OF ACTION

- 4.1 For the reasons outlined in the preceding section, the Commission believes that there is a pressing need to introduce legislation governing Netting Provisions. Importantly, such legislation will ensure that the Island meets best international practice in this area, aimed at ensuring that any risks to the stability of financial markets are minimised.
- 4.2 The Commission does not believe there is any drawback in introducing legislation in this area. The principal effect of legislation will be to bring certainty to the situation. Although, theoretically, it can be argued that the enforcement of Netting Provisions may place certain creditors in a worse position than they would otherwise be, it is felt that this risk is small, unlikely to arise in practice, and that, in any event, upholding Netting Provisions will lead to a more equitable and orderly distribution of the assets of an insolvent entity. Further, the costs of an insolvency are likely to be reduced in the event that Netting Provisions are upheld, which will be of benefit to the creditors of an insolvent company in general.
- 4.3 The Commission has identified two alternative methods by which legislation in this area could be introduced:
 - 4.3.1 The first option is to bring in a new "Netting of Financial Contracts (Jersey) Law". This would have the advantage of being a stand-alone piece of legislation, which would be short and have a clear purpose. A similar approach has been taken by most jurisdictions that have brought in netting legislation.
 - 4.3.2 Alternatively, provisions governing netting could be set out in the Bankruptcy Law and incorporated in the Companies Law through the mechanism set out in the existing Article 166 of the Companies Law. This approach offers several advantages. The Bankruptcy Law currently includes many of the provisions applicable to the treatment of assets and liabilities in an insolvency, and there are clear benefits in ensuring that this remains the case. In addition, at present the Commission is consulting on the Bankruptcy Law Amendment No.5¹ (the "**Bankruptcy Law Amendment**"). Among the proposals being put forward in that paper are a recommendation to include provisions governing the efficacy of contractual subordination clauses. These are related to the efficacy of Netting Provisions.
- 4.4 Assuming that the responses received to this Paper are broadly supportive, it is likely to be possible to include provisions relating to netting within the Bankruptcy Law Amendment. This would probably be the quickest way of introducing legislation in this area, as well as having the advantages set out in 4.3.2 above. For these reasons, the Commission's preferred position is to include provisions concerning the efficacy of Netting Provisions as part of the Bankruptcy Law Amendment.
- 4.5 Netting Provisions are primarily used in the context of capital markets transactions, and will be particularly helpful to participants in these transactions who currently live with the uncertainties described above and

¹ Consultation Paper 2003 No.4, available from www.jerseyfsc.org

the attendant increases in legal and other costs. Such transactions inevitably evolve with market practice, and so the Commission's preferred approach is to provide legislation that upholds the principles of netting in the most general terms.

- 4.6 However, the Commission does not believe that it will be helpful for legislation in relation to netting to apply outside of the context of financial contract transactions. This is largely because the existing legislation governing set off between a debtor and a creditor, set out in Article 34 of the Bankruptcy Law, is felt to be sufficient in relation to all but such transactions. As a result, the Commission feels that little benefit would accrue through applying legislation governing Netting Provisions to arrangements that are currently dealt with, without any significant difficulty arising, under the set-off provisions currently provided in the Bankruptcy Law.
- 4.7 It is therefore proposed that any legislation in relation to netting apply only to classes of "financial contract" as defined in legislation or by the Commission from time to time. This is a similar approach to that taken in other jurisdictions and will allow the stated class of financial contracts to which the legislation applies to be altered to reflect market needs and any directives issued by international bodies.

5 QUESTIONS

- 5.1 Do you agree that Jersey should introduce legislation confirming the efficacy of Netting Provisions?
- 5.2 Would you prefer to see stand-alone legislation or provisions incorporated into the Bankruptcy Law?
- 5.3 Would you be concerned if the Jersey provisions were not, in terms of their drafting, modelled on those adopted by other jurisdictions?
- 5.4 Do you see any problems in allowing legislation in this area to apply to Netting Provisions between more than two parties?
- 5.5 Do you have any concerns in relation to the position of other creditors of an insolvent company as a result of the introduction of legislation in this area? If so, please provide details together with suggestions as to how such concerns might be addressed.
- 5.6 Do you agree that legislation in this area should only apply to a defined class of "financial contracts" or do you believe that it should apply to all transactions?
- 5.7 Do you think there are any types of transaction that should be expressly excluded from the proposed legislation?
- 5.8 Do you think there are any other particular issues that should be addressed in any such legislation?