



OUR REF F0595.6/AMK

YOUR REF

30 April 2014

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Copy to:
The International Swaps and Derivatives Association
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Dear Sirs

Netting with respect to repos cleared through the Government Securities Division of the Fixed Income Clearing Corporation

1. Background

- 1.1 You have asked us to give an opinion as to the laws of Scotland ("this jurisdiction") in relation to certain netting provisions in the Rules (as defined below) of the Government Securities Division (the "GSD") of the Fixed Income Corporation (the "CCP") in respect of the clearing of Transactions (as defined below), as such provisions apply between the CCP and Netting Members which are Scottish Banks (as defined below).
- 1.2 References in this letter to "this Opinion" are to this opinion letter.

2. Terms of Reference

- 2.1 This Opinion is given in respect of the Netting Provisions and the laws of this jurisdiction in force as at the date of this Opinion (the "Opinion Date").
- 2.2 This Opinion is given only in respect of Netting Members which are Scottish Banks.
- 2.3 The insolvency proceedings ("Insolvency Proceedings") which may apply to a Netting Member under the laws of this jurisdiction are:
 - 2.3.1 the approval of a voluntary arrangement in respect of it under Part 1 of the Insolvency Act;
 - 2.3.2 the obtaining of an initial moratorium by the directors of it where they propose a voluntary arrangement under Part 1 of the Insolvency Act;
 - 2.3.3 the appointment of an administrator to it under Schedule B1;
 - 2.3.4 the appointment of an administrative receiver over the whole (or substantially the whole) of its property by or on behalf of the holder of a floating charge granted either prior to 15 September 2003 or in connection with one of the excepted arrangements detailed in sections 72B to 72GA of the Insolvency Act;
 - 2.3.5 its voluntary winding up under the Insolvency Act;
 - 2.3.6 its compulsory winding up under the Insolvency Act;

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- 2.3.7 a scheme of arrangement under Part 26 of the Companies Act; and
- 2.3.8 the entry by it into bank insolvency or bank administration under the Banking Act.

2.4 The opinions are given in respect of only such of those CCP Contracts which, under their governing laws (and all other applicable law), are legal, valid, binding, enforceable and capable of being terminated and liquidated in accordance with the relevant Netting Provisions.

2.5 No opinions are given in this Opinion on (or in relation to):

- 2.5.1 the availability of any judicial remedy;
- 2.5.2 any matters of fact;
- 2.5.3 the enforceability of any net obligation resulting from the operation of the Netting Provisions;
- 2.5.4 any provisions of the CCP Documentation or the Rules other than the Netting Provisions;
- 2.5.5 the enforceability or effectiveness of any purported declaration of trust (or any provision which requires any asset to be held on trust) by any party under the CCP Documentation;
- 2.5.6 any person found or alleged to be a trustee of a constructive, implied, resulting or other trust constituted by operation of law or who is a trustee in sequestration, or an executor acting in that capacity;
- 2.5.7 any tax that may arise or be suffered as a result of the entry into or performance of the CCP Documentation, any Transaction or any CCP Contract;
- 2.5.8 any accounting policies;
- 2.5.9 the enforceability of:
 - (i) any Cross Margining Arrangement;
 - (ii) the inclusion in any termination, liquidation and/or netting under any Netting Provisions of any amount arising under or in connection with such Cross Margining Arrangement in circumstances where an Insolvency Proceeding has commenced in respect of a Netting Member or the Netting Member is otherwise insolvent; or
- 2.5.10 the enforceability of:
 - (i) the creation of any charge, mortgage, pledge or other security interest over any cash, securities or other asset (a "**Security Interest**") under or pursuant to the CCP Documentation; or
 - (ii) the inclusion of any rights or obligations arising under or in connection with any such Security Interest in any netting pursuant to any Netting Provision.

2.6 This Opinion is only given in respect of the netting of obligations under the Netting Provisions which are owed by one party to another under one or more CCP Contracts (whether or not the obligations are, prior to the CCP Contracts being terminated and netted, due and payable or otherwise performable).

2.7 No opinions are given on the enforceability of the Ordinary Course Netting Provision in circumstances where an Insolvency Procedure has commenced in respect of a Netting Member or the Netting Member is otherwise insolvent. Please see paragraph 5.3.3 below for a discussion on this point.

2.8 For the purposes of this Opinion we have reviewed the Membership Agreement and the Rules and no other documents.

2.9 This Opinion relates solely to matters of Scots law as applied by the Scottish courts as at the Opinion Date and we express no opinions on the laws of any jurisdiction other than Scotland. In particular, this Opinion does not consider the impact of the law of any other jurisdiction, even where, under Scots law, the law of that jurisdiction falls to be applied.

2.10 This Opinion and all non-contractual matters which arise out of it are governed by Scots law.

3. Definitions

3.1 In this Opinion:

3.1.1 "**1989 Act**" means the Companies Act 1989.

3.1.2 "**Applicable Amounts**" means any:

- (i) Receive Obligation(s) and Deliver Obligation(s) (and related payment obligations) comprised in a Net Settlement Position which has arisen by operation of any Applicable Netting Provision; and
- (ii) other liabilities and obligations owed by one Party to the other which (a) arise under or in connection with a CCP Contract (including as a result of its termination and liquidation and (b) are subject to netting under the Netting Provisions.

3.1.3 "**Applicable Netting Provisions**" means the Ordinary Course Netting Provisions, CCP Default Netting Provisions or Netting Member Default Netting Provisions, as appropriate.

3.1.4 "**Application Documents**" means the Membership Agreement and all other documents necessary for the Netting Member to obtain recognition as a Member and Netting Member.

3.1.5 "**Banking Act**" means the Banking Act 2009.

3.1.6 "**CCP Contract**" means a Transaction which has been the subject of a Novation, the rights and obligations in respect of which are therefore owed between a Netting Member and the CCP.

3.1.7 "**CCP Default Netting Provisions**" means Section 2(b) of Rule 22A (as applied by Rule 22B on a default of the CCP).

3.1.8 "**CCP Documentation**" means:

- (i) the Application Documents;
- (ii) the documents and other confirming evidence exchanged between the parties to a Transaction that create, deliver, receive, and related payment obligations that comprise (or will comprise) one or more Net Settlement Positions; and
- (iii) the other documents required to be exercised by the CCM or Netting Member in connection with each trade that create, deliver, receive and related payment obligations that comprise (or will comprise) one or more Net Settlement Positions,

(and includes the Rules, to the extent that the terms of the Rules are incorporated into and form part of any of the foregoing).

3.1.9 "**CI Regulations**" means Credit Institutions (Reorganisation and Winding Up) Regulations 2004.

3.1.10 "**Collateral Regulations**" the Financial Collateral Arrangements (No. 2) Regulations 2003.

3.1.11 "**Companies Act**" means the Companies Act 2006.

3.1.12 "**designated system**" means a designated system for the purposes of the Settlement Finality Regulations.

3.1.13 "**FCA**" means the United Kingdom Financial Conduct Authority.

3.1.14 "**FSMA**" means the Financial Services and Markets Act 2000.

3.1.15 "**Insolvency Act**" means the Insolvency Act 1986.

3.1.16 "**Insolvency Representative**" means a provisional liquidator, interim liquidator, liquidator, administrator, receiver or other insolvency practitioner or representative appointed to or in respect of a Netting Member in relation to any Insolvency Proceedings.

3.1.17 "**Membership Agreement**" means the netting member agreement between the CCP and the Netting Member, in the form set out in the Annex to this Opinion.

3.1.18 "**Netting Member Default Netting Provisions**" means Section 2(b) of Rule 22A (as applied by Rule 22 on an insolvency of a Netting Member).

3.1.19 "**Netting Provisions**" means the CCP Default Netting Provisions, the Netting Member Default Netting Provisions and the Ordinary Course Netting Provisions.

3.1.20 "**Ordinary Course Netting Provisions**" means:

- (i) Sections 4 to 6 of Rule 11;
- (ii) Section 2 of Rule 13; and
- (iii) Section 2 and Section 5 of Rule 20.

3.1.21 "**Part 7**" means Part VII of the Companies Act 1989.

3.1.22 "**Party**" means the CCP or the relevant Netting Member and a reference to "**Parties**" is a reference to the CCP and a particular Netting Member.

3.1.23 "**PRA**" means the United Kingdom Prudential Regulation Authority.

3.1.24 "**recognised clearing house**" means a recognised clearing house within the meaning of section 285 of FSMA and for the purposes of Part 7.

3.1.25 "**recognised central counterparty**" means a recognised central counterparty within the meaning of section 285 of FSMA and for the purposes of Part 7.

3.1.26 "**recognised investment exchange**" means a recognised investment exchange within the meaning of section 285 of FSMA and for the purposes of Part 7.

3.1.27 "**Recognition Requirements Regulations**" means the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001.

3.1.28 "**Rules**" means the rules set out in the 23 January 2014 edition of the Corporation's GSD Rulebook.

3.1.29 "**Scottish Bank**" means a company which is formed and registered in Scotland under the Companies Act or the former Companies Acts (as defined in section 1171 of the Companies Act) and which:

- (i) has permission to accept deposits under Part 4A of FSMA; and
- (ii) does not also have permission under Part 4A of FSMA to effect or carry out contracts of insurance.

3.1.30 "**Settlement Finality Directive**" means Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998;

3.1.31 "**Settlement Finality Regulations**" means the Financial Markets and Insolvency (Settlement Finality) Regulations 1999.

3.1.32 "**Transaction**" means a Repo Transaction between two Netting Members which:

- (i) is eligible (and has been submitted) for netting and settlement through the Netting System in accordance with the Rules;
- (ii) has not yet been the subject of a Novation; and
- (iii) when the subject of a Novation, will comprise one or more Net Settlement Positions.

3.1.33 "**UK bank**" means an undertaking incorporated in or formed under the law of any part of the United Kingdom and having its head office in the United Kingdom, which has permission under Part IV of FSMA to accept deposits; but for the purposes of this Opinion does not include insurance companies or credit unions within the meaning of section 31 of the Credit Unions Act 1979.

3.2 In this Opinion:

3.2.1 references to the word "**enforceable**" and cognate terms are used to refer to the ability of a Party to exercise its contractual rights in accordance with their terms and without risk of successful challenge;

3.2.2 references to "**the opinions**" or to an "**opinion**" are to the opinions or an opinion given in this Opinion; and

3.2.3 references to a "**paragraph**" are (except where the context otherwise requires) to a paragraph of this Opinion.

3.3 Except where otherwise defined herein, terms defined in the Rules of the CCP have the same meaning in this Opinion.

4. Assumptions

We assume the following:

4.1 Each Party has the capacity, power and authority under all applicable law(s) to enter into the CCP Documentation, each Transaction and each CCP Contract and to be bound by and perform its obligations thereunder (including its obligations under the Rules).

4.2 Each Party has taken all necessary steps and obtained and maintained all authorisations, approvals, licences and consents necessary to execute, deliver and perform the CCP Documentation, each Transaction, each CCP Contract, and to ensure the legality, validity, enforceability or admissibility in evidence of the CCP Documentation, each Transaction, and each CCP Contract in this jurisdiction.

4.3 The CCP Documentation and each Transaction and CCP Contract accurately reflect the true intentions of the Parties and have been entered into and are carried out by the Parties in good faith, for the benefit of each of them respectively, on arms' length commercial terms and for the purposes of carrying on, and by way of, their respective businesses.

4.4 The CCP Documentation, each Transaction and each CCP Contract (including the Deliver Obligations, Receive Obligations and any related payment obligations of any Party) are legal and valid and are binding and enforceable on or against (as the case may be) each Party, in each case under the law by which they are expressed to be governed and all other applicable law (other than, in respect of the Netting Provisions, the law of this jurisdiction).

4.5 The Netting Provisions were Rules which were in force on the Opinion Date.

4.6 The law chosen by the Parties to govern the CCP Documentation and the Rules is not Scots law.

4.7 The opinions given in paragraphs 5.2 and 5.3 are a correct statement of the effect of the relevant Netting Provisions under the governing law of the CCP Documentation and the Rules.

4.8 The CCP Documentation and each Transaction and CCP Contract has been entered into by the Parties, and each Deliver Obligation, Receive Obligation and the related payment obligations have been established (whether through a Novation or otherwise), prior to the commencement of any insolvency procedure under the laws of any jurisdiction in respect of either Party and without any intent to hinder, delay or defraud creditors.

4.9 Each Party performs its obligations under the CCP Documentation in accordance with their terms.

4.10 There are no:

- 4.10.1 provisions of the CCP Documentation which modify, amend, supersede or may otherwise affect the operation or enforceability of any Netting Provision (other than, for the avoidance of doubt, another Netting Provision); or
- 4.10.2 other agreements, instruments or arrangements between the Parties which modify or supersede the terms of the Netting Provisions in a way which would be material for the purposes of this Opinion,

and, in particular, in relation to the settlement of payments due in respect of Applicable Amounts, there are no provisions or rules of any relevant designated system (other than the CCP itself) which purport to override or are inconsistent with the Netting Provisions.

4.11 In relation to the opinions in relation to the CCP Default Netting Provisions and the Netting Member Default Netting Provisions only, an applicable event of default has occurred in respect of the CCP or the Netting Member (as appropriate) and, accordingly, that such Netting Provisions apply.

4.12 Neither Party is at any material time:

- 4.12.1 a recognised clearing house, a recognised central counterparty, a recognised investment exchange, an overseas investment exchange or clearing house which is recognised pursuant to section 292 of FSMA, an EEA central counterparty (as defined in section 285 of FSMA) or a third country central counterparty (as defined in section 285 of FSMA);
- 4.12.2 a system designated for the purpose of the Settlement Finality Directive in an EEA State or Gibraltar;
- 4.12.3 a "*group undertaking*" in relation to the other Party as that phrase is defined in Section 1161(5) of the Companies Act; or
- 4.12.4 a "*bridge bank*" as defined in section 12 of the Banking Act.

5. Opinion

On the basis of the foregoing terms of reference and assumptions and subject to the qualifications set out below, we are of the opinion that, under the laws of this jurisdiction:

5.1 Recognition of Choice of Law

The choice of law provisions in Rule 38 of the Rules would be recognised under the law of this jurisdiction notwithstanding that the CCP is not incorporated in this jurisdiction.

5.2 Netting prior to insolvency of a Netting Member

5.2.1 Prior to the commencement of Insolvency Proceedings in respect of the Netting Member:

- (i) the netting of Applicable Amounts in accordance with terms of the Ordinary Course Netting Provisions would be enforceable;
- (ii) following a CCP Default, the termination of all unsettled positions of a CCP with a Netting Member and the determination of a single net obligation owed to or by one of them by or to the other in accordance with the terms of the CCP Default Netting Provisions would be enforceable; and
- (iii) following a Netting Member Default, the termination of all unsettled positions of a CCP with a Netting Member and the determination of a single net obligation owed to or by one of them by or to the other in accordance with the terms of the Netting Member Default Netting Provisions would be enforceable.

5.2.2 We are of this opinion because under the laws of this jurisdiction a Scottish court would apply the law chosen by the Parties to govern the CCP Documentation in determining the enforceability of the Netting Provisions.

5.2.3 In Scotland, the general rules which govern set-off in an insolvency are common law rules (the "**Scottish Insolvency Set Off Rules**"). There is some case law which suggests that the Scottish Insolvency Set Off Rules may be applied when a person is insolvent (on a balance sheet or, possibly, cash flow basis) but in respect of which formal insolvency proceedings have not commenced. The relevant cases were decided in the context of a counterparty of the insolvent party attempting to rely on the Scottish Insolvency Set Off Rules to effect a set off in circumstances where the general set-off rules outside of insolvency did not provide a right of set off but the Scottish Insolvency Set Off Rules would have. While we consider that a Scottish court would be unlikely to seek to apply the Scottish Insolvency Set Off Rules when determining the enforceability of a contractual set-off or netting provision in these circumstances, this risk cannot be discounted.

5.2.4 If a Scottish court did apply the Scottish Insolvency Set Off Rules in these circumstances, it may consider whether the Netting Provisions are consistent with the Scottish Insolvency Set Off Rules. This is because a Scottish court may regard the Scottish Insolvency Set Off Rules as mandatory and, accordingly, may decide that any contractual netting or set-off provisions which are inconsistent with them are not enforceable to the extent of the inconsistency.

5.2.5 However:

- (i) we consider that the CCP Default Netting Provisions and Netting Member Default Netting Provisions are generally consistent with the Scottish Insolvency Set Off Rules and therefore that they would be enforceable on such insolvency; but
- (ii) as discussed further in paragraph 5.3.3 below (and for the reasons set out there), no opinions are given on the enforceability of the Ordinary Course Netting Provision in circumstances where an Insolvency Procedure has not commenced but the Netting Member is insolvent and the Scottish courts decide to apply the Scottish Insolvency Set Off Rules in determining the enforceability of any netting.

5.3 Netting Member insolvency

5.3.1 Following the commencement of Insolvency Proceedings in respect of the Netting Member:

- (i) following a CCP Default, the termination of all unsettled positions of a CCP with a Netting Member and the determination of a single net obligation owed to or by one of them by or to the other in accordance with the terms of the CCP Default Netting Provisions would be enforceable; and
- (ii) following a Netting Member Default, the termination of all unsettled positions of a CCP with a Netting Member and the determination of a single net obligation owed to or by one of them by or to the other in accordance with the terms of the Netting Member Default Netting Provisions would be enforceable.

5.3.2 We are of this opinion for the following reasons:

- (i) Prior to the commencement of Insolvency Proceedings, under the laws of this jurisdiction a Scottish court would apply the law chosen by the Parties to govern the CCP Documentation and the Rules in determining the enforceability of the Ordinary Course Netting Provisions or CCP Default Netting Provisions.
- (ii) Following the commencement of Insolvency Proceedings, under the laws of this jurisdiction where:
 - (a) the Insolvency Proceedings are a "relevant reorganisation" or "relevant winding up" for the purposes of the CI Regulations¹; and
 - (b) the CCP Default Netting Provisions or the Netting Member Default Provisions (as appropriate) constitute "set off rights" or a "netting agreement" for the purposes of Regulation 28 or Regulation 34 respectively of the CI Regulations (on which please see paragraph 6.2 below),
- (iii) a Scottish court would apply the law chosen by the Parties to govern the CCP Documentation and the Rules in determining the enforceability of the CCP Default Netting Provisions or the Netting Member Default Provisions (as appropriate).

Following the commencement of Insolvency Proceedings which are not a "relevant reorganisation" or "relevant winding up" for the purposes of the CI Regulations and/or where Regulation 28 or Regulation 34 of the CI Regulations do not apply:

- (a) a Scottish court would apply the law chosen by the Parties to govern the CCP Documentation and the Rules in determining the enforceability of the CCP Default Netting Provisions or the Netting Member Default Provisions (as appropriate);
- (b) a Scottish court may also consider whether the CCP Default Netting Provisions or the Netting Member Default Provisions (as appropriate) are consistent with the Scottish Insolvency Set Off Rules. This is because, as mentioned above, a Scottish court may regard the Scottish Insolvency Set Off Rules as mandatory and, accordingly, may decide that any contractual netting or set-off provisions which are inconsistent with them are not enforceable to the extent of the inconsistency;

¹ "Relevant reorganisation" and "relevant winding up" are defined for these purposes in Regulation 21 of the CI Regulations.

- (c) however, as mentioned above, we consider that the CCP Default Netting Provisions or the Netting Member Default Provisions are generally consistent with the Scottish Insolvency Set Off Rules; and
- (d) furthermore the additional protections under the Collateral Regulations described in paragraph 6 may apply depending on the circumstances.

5.3.3 As mentioned in paragraph 2.7 above, no opinions are given on the enforceability of the Ordinary Course Netting Provision in circumstances where an Insolvency Procedure has commenced in respect of a Netting Member or an Insolvency Procedure has not commenced but the Netting Member is insolvent and the Scottish courts decide to apply the Scottish Insolvency Set Off Rules in determining the enforceability of any netting².

5.4 Conditions

There are no rules of law of this jurisdiction which would require the fulfilment of any conditions before the exercise of rights of set-off under the Netting Provisions. It is not the case, as far as the laws of this jurisdiction are concerned, that such rights are enforceable only on the occurrence of some future event.

6. Statutory protections

6.1 Collateral Regulations

6.1.1 Under the Collateral Regulations:

- (i) a "**Financial Collateral Arrangement**" is either a "title transfer financial collateral arrangement" or a "security collateral arrangement";
- (ii) a "**title transfer collateral arrangement**" is, broadly, an arrangement (including a repurchase agreement) where:
 - (a) the purpose of the arrangement is to secure or cover financial obligations owed to the collateral taker; and
 - (b) the collateral provider transfers legal and beneficial ownership in financial collateral³ to the collateral taker on terms that the collateral taker must re-transfer equivalent financial collateral to the collateral provider;
- (iii) a "**security collateral arrangement**" is, broadly, an arrangement where:
 - (a) the purpose of the arrangement is to secure or cover financial obligations owed to the collateral taker;
 - (b) the collateral provider creates a security interest over financial collateral in favour of the collateral taker; and
 - (c) subject to any rights of substitution, the collateral is delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker;

² We have assumed for the purposes of this Opinion that in such circumstances the CCP would promptly cease to act for the Netting Member and close out its positions under the Netting Member Default Provisions. We note, however, that, if it did not do this, the CCP Documentation (and therefore the Rules) would continue to apply and Transactions would be Novated and CCP Contracts would be subject to netting under the Ordinary Course Provisions. It should be noted that a Scottish court might not regard such a Novation as being in effective in certain circumstances. In particular, a court might regard a Novation as a disposition of an asset which is invalidated by section 127 of the Insolvency Act (on which please see paragraph 7.9.1 below).

³ For the purposes of the Collateral Regulations, "financial collateral" is cash, financial instruments (including shares, bonds and other debt securities) and the benefit of bank loans / deposits.

- (iv) a "Close Out Netting Provision" is a term of a Financial Collateral Arrangement or of an arrangement of which a Financial Collateral Arrangement forms part under which on the occurrence of an enforcement event, whether through the operation or netting or set-off or otherwise:
 - (a) the obligations of the parties are accelerated or become immediately due and expressed as an obligation to pay an amount representing the original obligations' estimated current value or replacement cost or are terminated and replaced by an obligation to pay such an amount; or
 - (b) an account is taken of what is due from each party to the other in respect of such obligations and a net sum equal to the balance of the account payable by the party from whom the larger amount is due to the other party.
- (v) Where a Netting Provision is a Close Out Netting Provision Regulation 12 provides that that Netting Provision will remain enforceable on the taking of winding up or reorganisation measures (as defined in the Collateral Regulations) in relation to any party in accordance with its terms. However, Regulation 12 will not apply if at the time the relevant financial obligations came into existence:
 - (a) the CCP was aware, or should have been aware, that winding up proceedings or reorganisation measures (as defined in the Collateral Regulations) had commenced in relation to the insolvent Netting Member;
 - (b) the CCP had notice that a meeting of creditors of the insolvent Netting Member had been summoned under section 98 of the Insolvency Act 1986 or that a petition for the winding-up of the insolvent Netting Member or for it to be placed in bank insolvency under the Banking Act was pending; or
 - (c) the CCP had notice that an application for an administration order was pending, or that a person had given notice of intention to appoint an administrator, in respect of the insolvent Netting Member.

6.1.2 Regulation 10 of the Collateral Regulations disapplies (among other things) section 127 of the Insolvency Act (in relation to the avoidance of property dispositions) and any right of a liquidator to disclaim onerous property in relation to a financial collateral arrangement. Please see paragraphs 7.9.1 and 7.9.2 below for further discussion.

6.2 CI Regulations

- 6.2.1 Scottish Banks will be UK Credit Institutions for the purposes of the Credit Institution Regulations.
- 6.2.2 Regulation 28 of the CI Regulations provides that a relevant reorganisation or winding up shall not affect the right of creditors to demand the set-off of their claims against the claims of the affected UK Credit Institution where such set-off is permitted by the law applicable to the affected UK Credit Institution's claim. Accordingly, to the extent the Netting Provisions constitute set-off rights, the enforceability of those set-off rights should not be affected by the commencement of Insolvency Proceedings in this jurisdiction.
- 6.2.3 Regulation 34 of the CI Regulations provides that the effects of a relevant reorganisation or a relevant winding up on a netting agreement shall be determined in accordance with the law applicable to the relevant agreement. Accordingly, to the extent the Netting Provisions

are a netting agreement for the purposes of regulation 34, the enforceability of those Netting Provisions should not be affected by the commencement of Insolvency Proceedings in this jurisdiction.

7. Qualifications

7.1 Insolvency proceedings in relation to the CCP

The opinions are subject to all laws relating to the bankruptcy, insolvency, liquidation, administration, receivership, moratorium, reconstruction or reorganisation of the CCP (whether in the jurisdiction of the CCP, this jurisdiction or any other jurisdiction).

7.2 Choice of Law

7.2.1 The Scottish courts' application of the choice of law to govern a contract entered into on or following 17 December 2009 could be modified to the extent provided by and in the circumstances set out in Regulation (EC) No 593/2008 on the law applicable to contractual obligations (the "**Rome I Regulation**"), including in the following circumstances:

- (i) where all other elements relevant to the situation at the time of the choice of law are located in a country ("**Country X**"), other than the country whose law has been chosen, any provisions of the law of Country X which cannot be derogated from by agreement will apply; or
- (ii) where the obligations arising out of the contract have to be or have been performed in another country ("**Country Y**"), any overriding mandatory provisions of the law of Country Y rendering the performance of the contract unlawful may apply; or
- (iii) where the application of a provision of law of the governing law of the contract (as determined by the Rome I Regulation) is manifestly incompatible with Scottish public policy, the provision may not be applied.

7.2.2 The Scottish courts' application of the choice of law to govern a contract entered into prior to 17 December 2009 could be modified to the extent provided by and in the circumstances set out in the Contracts (Applicable Law) Act 1990 (the "**1990 Act**"), including in the following circumstances:

- (i) effect may be given to the rules of law of a jurisdiction which cannot be derogated from by contract ("**Mandatory Rules**") where the contract has a close connection with that jurisdiction and, under the laws of that jurisdiction, those Mandatory Rules must be applied whatever the governing law of the contract;
- (ii) effect will be given by the Scottish courts to Mandatory Rules of this jurisdiction notwithstanding that the governing law of the contract is not Scots law; and
- (iii) where the application of a provision of law of the governing law of the contract is manifestly incompatible with Scottish public policy, the provision may not be applied.

7.2.3 We express no opinion as to a choice of law to govern:

- (i) contractual obligations falling outside the scope of the Rome I Regulation or the 1990 Act; or
- (ii) non-contractual obligations.

7.3 **Valuation of future, contingent or unascertained obligations under the general law of insolvency set off in Scotland**

Date of valuation

- 7.3.1 There is almost no authority as to the date on which a set off (or "balancing of accounts in bankruptcy") under the Scottish Insolvency Set Off Rules is effected, and no modern authority on the subject at all. However, we consider that it is more likely than not that that date would be the date of commencement of any Insolvency Proceedings of a Netting Member (the "**Commencement Date**").
- 7.3.2 If the date that CCP Contracts are terminated, valued and netted for the purposes of the Netting Provisions occurs after the Commencement Date, the question therefore arises as to whether, if any valuation of future, contingent or unascertained obligations of either Party which fall to be included in the relevant Netting Provisions is required, that value is required to be calculated as at the Commencement Date notwithstanding that, under the CCP Documentation, it would (or could) be calculated as at a later date.
- 7.3.3 If we are correct that the valuation date would be the Commencement Date, then there is a risk that, in any Insolvency Proceedings in respect of a Netting Member, a Scottish court would require valuation of the underlying obligations which are the subject of the netting or set-off to be made as at that date, at least for the purposes of calculating the CCP's (net) claim in those Insolvency Proceedings. This is because a Scottish court may regard the Scottish Insolvency Set Off Rules as mandatory and the designation of any other valuation date as an attempt to contract out of those rules.

Valuation methodology

- 7.3.4 There is very little authority in Scots law on the specific methodology to be applied to value future, contingent or unascertained obligations (both in the context of calculating the claims of a creditor in insolvency proceedings and in calculating the amount to be included in respect of such obligations in any insolvency set off calculation). It is accordingly not certain what approach a Scottish court would take if it was asked to consider the valuation of obligations in the context of the Netting Provisions.
- 7.3.5 However, we consider that, provided that the valuations of future, contingent or unascertained obligations for the purposes of the Netting Provisions is commercially reasonable, a Scottish court would not seek to interfere with them.

The Collateral Regulation and the CI Regulations

- 7.3.6 Where the Applicable Netting Provision is a Close Out Netting Provision for the purposes of the Collateral Regulations (on which please see paragraph 6.1 above) or the Netting Member is subject to winding-up proceedings or reorganisation measures for the purposes of the CI Regulations (on which please see paragraph 6.2 above), we consider that a Scottish court would not interfere with the valuation provisions in the Netting Provisions. The reason for this is that, as discussed above, the Collateral Regulations require that a close out netting should take effect in accordance with its terms. Similarly, under the CI Regulations, the effect of a relevant reorganisation or winding-up on a netting agreement is to be determined in accordance with the law applicable to the relevant agreement (in this case New York law).

7.4 **Mutuality**

7.4.1 As noted in paragraphs 5.2.3 and 5.3.2 above, a Scottish court may consider whether any Netting Provisions are consistent with the Scottish Insolvency Set Off Rules in determining their enforceability where Insolvency Proceedings in respect of the Netting Member have commenced or (possibly) the Netting Member is insolvent but Insolvency Proceedings in relation to it have not commenced.

7.4.2 Where a Scottish court does this, it is unlikely to allow any Applicable Amounts or other rights and obligations which are the subject of a netting under the Netting Provisions to be netted or set off against each other if they are not "mutual" between the Parties. This is because the Scottish Insolvency Set Off Rules only allow liabilities or obligations which are "mutual" to be set off against each other. For these purposes:

- (i) where Applicable Amounts or other rights and obligations have arisen under CCP Contracts or CCP Documentation which a Party has entered into in one capacity (e.g. as agent, trustee of a trust or principal) may not be mutual with other Applicable Amounts that have arisen under CCP Contracts or CCP Documentation which that Party has entered into in another capacity⁴; and
- (ii) an Applicable Amount or other rights and obligations which is subject to a mortgage, charge, pledge, lien, encumbrance, right in security or security interest or which has been arrested may not be mutual with any other Applicable Amount.

7.5 **Additional set off under the Scottish Insolvency Set Off Rules**

In the case of any Insolvency Proceedings in respect of a Netting Member, where any sum is owed (or non-monetary obligations are required to be performed) by one Party ("party 1") to the other ("party 2") as a result of the operation of an Applicable Netting Provision (the "net sum") and party 2 has a separate monetary and/or non-monetary obligations to party 1 (whether under another Applicable Netting Provision, another provision of the CCP Documentation or Rules or otherwise) (the "other sum"), a Scottish court would be likely to allow the net sum (together with any other sum owed by party 1 to party 2) to be set off against the other sum, at least for the purpose of calculating any overall (net) claim of the CCP in the insolvency of the Netting Member⁵. This would be the case even if such a set off is not expressly provided for (or is prohibited) in the CCP Documentation.

7.6 **Banking Act**

7.6.1 The Banking Act provides for various remedies for a failing UK bank, which include the ability of the Treasury or the Bank of England to cause the transfer of securities issued by a UK bank or property of a UK bank to another person, by means of a "share transfer order", a "share transfer instrument", or a "property transfer instrument".

7.6.2 Section 75 of the Banking Act gives power to the Treasury to change the law (except the Banking Act itself) for the purpose of enabling the powers granted to the Financial Conduct Authority, the Prudential Regulation Authority, the Treasury and the Bank of England under Part I of the Banking Act to be used effectively. Such changes might affect private law rights and might be used with retrospective effect. Furthermore, under sections 23 and 40, a share transfer instrument or order, or a property transfer instrument, may include incidental, consequential or transitional provisions which might have impact on private law rights.

⁴ For the avoidance of doubt a contract entered into by a Netting Member as agent for one third party would not be mutual with a contract entered into by that Netting Member as agent for another third party. In addition, a contract entered into by a Netting Member as trustee of a trust would not be mutual with a contract entered into by that Netting Member as trustee of another trust.

⁵ Where a contingent, future, unascertained or non-monetary obligation that has not been converted to a monetary obligation that is due and payable under the Netting Provisions is to be included in such a set off, the court will be required to value that obligation.

7.6.3 A property transfer instrument may apply to only part of a UK bank's assets and liabilities (such a transfer being referred to as a "*partial property transfer*"). This may be the case because the property transfer instrument concerned expressly applies to only part of the UK bank's business or because it is unenforceable in relation to foreign property, which may include CCP Contracts or obligations arising under CCP Contracts which are governed by the laws of a non-UK jurisdiction. A partial property transfer could apply so as to cause the transfer of some, but not all, of the CCP Contracts (or obligations arising under CCP Contracts), with the result that the ability to set-off or net the amounts due in respect of different CCP Contracts against the amounts due in respect of others is impaired.

7.6.4 However, in this regard, Article 3 of the Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 (the "**Safeguards Order**") prohibits a partial property transfer which applies to some, but not all, of the "protected rights and liabilities" between a particular person and a UK bank. "Protected rights and liabilities" means rights and liabilities which a party is entitled to set off or net under a set-off arrangement, netting arrangement or title transfer Financial Collateral Arrangement, so long as they are not "excluded rights" or "excluded liabilities".

7.6.5 Accordingly, Article 3 of the Safeguards Order protects the Party which is not the affected UK bank against the adverse consequences of a partial property transfer affecting the Applicable Netting Provisions or CCP Contracts except if any CCP Contract is not a "relevant financial instrument" as defined in the Safeguards Order, Article 3 may not apply in relation to that CCP Contract. For these purposes "relevant financial instrument" means: (a) an instrument listed in section C of Annex I to the Markets in Financial Instruments Directive (2004/39/EC), read with Chapter VI of the Commission Regulation 1287/2006/EC; (b) any option, future, swap, forward, contract for differences or other derivative contract not falling within (a); and (c) any combination of the foregoing, a deposit, a loan, an instrument falling within article 77 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (disregarding the exclusions in article 77(2)(b) to (d)) or any contract for the sale, purchase or delivery of transferable securities, currency of any country, territory or monetary union, any precious metal or any other commodity.

7.7 **Recognition of foreign insolvency proceedings**

7.7.1 Under section 426 of the Insolvency Act ("Section 426"), the Scottish courts may apply the law of one of a list of specified jurisdictions to the insolvency of an entity if so requested by the competent court of that other jurisdiction in giving assistance to those courts. Those specified jurisdictions are currently: other parts of the United Kingdom (i.e. in respect of Scotland, England and Wales and Northern Ireland), the Channel Islands, the Isle of Man, Anguilla, Australia, The Bahamas, Bermuda, Botswana, Canada, Cayman Islands, Falkland Islands, Gibraltar, Hong Kong, Eire, Montserrat, New Zealand, St Helena, Turks and Caicos Islands, Tuvalu, Virgin Islands, Malaysia, South Africa and Brunei Darussalam. Accordingly, the enforceability of a Netting Provision may be determined by reference to the laws of one of these jurisdictions (as to which we express no opinion) and the Scottish courts could take some other action which impacts on the enforceability of the Netting Provisions.

7.7.2 At common law, a Scottish court may seek to assist the courts or insolvency representatives in a foreign jurisdiction in respect of insolvency proceedings in that jurisdiction and may accordingly exercise its discretion to (a) apply the law of the foreign jurisdiction rather than Scots law to determine the enforceability of a Netting Provision or (b) take some other action which impacts on the enforceability of a Netting Provision.

7.7.3 However, a court may not in pursuance of Section 426 (or any common law power of recognition) recognise or give effect to an order of a foreign court or an act of a foreign insolvency official insofar as this would be prohibited by Part 3 of the Collateral Regulations if made by a court in the United Kingdom or an office holder in any insolvency proceedings in the United Kingdom. Part 3 of the Collateral Regulations disapplies certain provisions of United Kingdom insolvency law in relation to Financial Collateral Arrangements (on which see paragraph 6.1 above). Regulation 10 and Regulation 12 are in Part 3.

7.7.4 Unless it is otherwise required to recognise insolvency proceedings conducted in a foreign jurisdiction, a Scottish court may refuse to recognise proceedings (even in the jurisdiction of incorporation or organisation of the party subject to the proceedings) where it is of the opinion that:

- (i) the insolvency proceedings offend against some fundamental principle of public policy;
- (ii) there has been a breach of natural justice;
- (iii) the insolvency proceedings are tainted by fraud or have been invoked to avoid Scottish proceedings;
- (iv) the insolvency proceedings are to enforce the penal laws of another country; or
- (v) the insolvency proceedings are solely to enforce the revenue laws of another country.

7.8 **Gratuitous alienations and unfair preferences**

7.8.1 Under section 242 of the Insolvency Act a transaction entered into at any time within certain specified periods ending with the commencement of certain Insolvency Proceedings whereby assets of the relevant party are "alienated" may be reduced and an order for restoration of the property made on application to the court. The court will not grant such an order if it is shown that after the date of the alienation the assets of the relevant party were greater than its liabilities or the alienation was made for adequate consideration or it was a birthday, Christmas or other conventional gift or was a charitable gift to a non-associate which in all the circumstances it was reasonable to make⁶.

7.8.2 Under section 243 of the Insolvency Act anything done within specified periods ending with the commencement of certain Insolvency Proceedings which has the effect of creating a preference in favour of a creditor to the prejudice of the general body of creditors may be challenged and reduced. However certain transactions cannot be challenged, namely:

- (i) a transaction in the ordinary course of business;
- (ii) a payment in cash for a due debt, unless such payment was collusive with the purpose of prejudicing the general body of creditors;
- (iii) a transaction whereby the parties to it undertake reciprocal obligations, unless the transaction is collusive as aforementioned; and

⁶ It is also possible under common law to challenge a transaction giving rise to an alienation where the Netting Member did not receive adequate consideration. There is no time limit beyond which such a challenge becomes unavailable. However, for a challenge to succeed, the Netting Member would need to be insolvent (on a balance sheet or cash from basis) for the whole of the period from the transaction giving rise to the alienation until the date of formal insolvency proceedings.

(iv) the granting of a mandate authorising payment of arrested funds to the arrestee where decree for payment or a warrant for summary diligence has been given and this was preceded by arrestment on the dependence of the action or followed by arrestment in execution⁷.

7.9 General

7.9.1 Where the winding up of a Netting Member under the Insolvency Act is commenced by the presentation of a petition for winding up under section 127 of the Insolvency Act, any disposition of that party's property made after the presentation of the petition is void, unless the Court orders otherwise. This may affect the validity of the transfer of any asset by the Netting Member pursuant to the terms of the CCP Documentation and could prejudice the operation of the provisions of the CCP Documentation (including the Netting Provisions) in relation to those assets. However, where any provisions of the CCP Documentation are a Financial Collateral Arrangement for the purposes of the Collateral Regulations (on which see clause 6.1 below), Regulation 10 of those regulations provide that section 127 does not apply to:

- (i) avoid any transfers of property under that Financial Collateral Arrangement; or
- (ii) prevent any Close Out Netting Provision included within that Financial Collateral Arrangement from taking effect in accordance with its terms.

7.9.2 Under Scots common law a liquidator may be able to disclaim a contract prior to it being terminated and liquidated in accordance with the Netting Provisions, although there is a recent case on this point in which the court considered that there was no general right of disclaimer of property. If this is correct, it is unlikely that a liquidator would have a right to disclaim a contract. However, the position is unclear and so, to the extent that each CCP Contract constitutes a separate contract there might, therefore, be scope for a liquidator or trustee to "cherry pick" profitable CCP Contracts and disclaim unprofitable CCP Contracts if this was done prior to a netting under the relevant Netting Provisions being triggered. However, provided that each of the CCP Contracts to which the relevant Netting Provisions apply are regarded under their respective governing law (which we assume will be New York law) as constituting one contractual arrangement, we consider that this should be sufficient to remove the risk of cherry picking. Further, if the Collateral Regulations apply, the Agreement constitutes a financial collateral arrangement (on which please see paragraph 6.1 above) and the Counterparty is the subject of a winding up, Regulation 10 of the Collateral Regulations provides that it will not be possible for a liquidator to repudiate them.

7.9.3 Under Section 186 of the Insolvency Act, a court may, on the application of a liquidator entitled to the benefit subject to the burden of a contract made with a Counterparty make an order rescinding the contract on such terms as to the payment by or to either Counterparty of damages for the performance of the contract or otherwise as the court thinks just. Where such an order is made in relation to the CCP Documentation (or any CCP Contract) this could prejudice the operation of the provisions of the CCP Documentation.

⁷ It is also possible under common law to challenge a preference in favour of a creditor. There is no time limit beyond which such a challenge becomes unavailable. However, for a challenge to succeed, the Netting Member would need to be insolvent (on a balance sheet or cash from basis) for the whole of the period from the transaction giving rise to the preference until the date of formal insolvency proceedings.

- 7.9.4 Failure by the CCP to exercise its rights under the Netting Provisions prior to the approval of a scheme of arrangement under Part 26 of the Companies Act or a voluntary arrangement under Part I of the Insolvency Act (if applicable) by the Netting Member's creditors may prejudice the CCP's rights to enforce the Netting Provisions or any CCP Contracts.
- 7.9.5 Any provision to the effect that any calculation, determination or certification will be conclusive and binding will not be effective if such calculation, determination or certification is fraudulent, and a Scottish court may regard any calculation, determination or certification as no more than *prima facie* evidence of the matter calculated, determined or certified. Furthermore, notwithstanding the terms of the Netting Provisions, the certification, determination, notification or opinion of any party as to any matter therein provided might be held by a Scottish court not to be conclusive if it could be shown to the satisfaction of the court to have any unreasonable or arbitrary basis.
- 7.9.6 An exchange contract⁸ is unenforceable in the United Kingdom if (i) it involves the currency of any member of the International Monetary Fund and (ii) it is contrary to the exchange control regulations of any member of the International Monetary Fund which are maintained or imposed consistently with the International Monetary Fund Agreement.
- 7.9.7 The opinions expressed in this Opinion are subject to the effects of any United Nations, European Union or UK sanctions or other similar measures implemented or effective in the United Kingdom with respect to any Party which is, or is controlled by or otherwise connected with, a person resident in, incorporated in or constituted under the laws of, or carrying on business in a country to which any such sanctions or other similar measures apply, or is otherwise the target of any such sanctions or other similar measures.

8. Other issues

There are no other material issues relevant to the issues addressed in this Opinion which we wish to draw to your attention.

9. Reliance

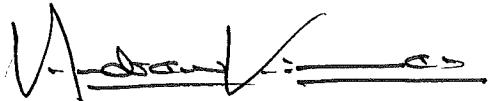
- 9.1 This opinion is given for the benefit of FIA Europe. This opinion may be disclosed to:
 - 9.1.1 the International Swaps and Derivatives Association, Inc. ("ISDA")
 - 9.1.2 such of FIA Europe's members (excluding associate members) or ISDA's members (excluding associate members) as subscribe to the FIA Europe's opinions library and whose terms of subscription give them access to this opinion (each a "subscribing member") and the officers, employees, and professional advisors of such subscribing member;
 - 9.1.3 any affiliate of a subscribing member (being a member of the subscribing member's group, as defined by the UK Financial Services and Markets Act 2000) and the officers, employees, and professional advisors of such affiliate; and
 - 9.1.4 the officers, employees and professional advisors of FIA Europe,
(each a "**Relevant Person**").

⁸ "Exchange contract" here has the meaning used in the International Monetary Fund Agreement and related legislation, and is not a reference specifically to on-exchange derivative contracts. There is inconsistent authority on what amounts to an "exchange contract" for these purposes. It is not clear whether the term encompasses any contract which in any way affects a country's exchange resources or only a contract for the exchange of one currency for another, although the better view is probably that the latter (narrow) interpretation is correct.

9.2 Each Relevant Person is authorised to make a copy of this opinion available to its auditors solely as evidential matter in support of their evaluation of a Relevant Person's management's assertion that the requirements of IAS 32 have been met, and a copy of this opinion may be furnished to them in connection therewith. In authorising Relevant Persons to make copies of this opinion available to their auditors for such purpose, we are not undertaking or assuming any duty or obligation to Relevant Persons or their auditors or establishing any lawyer-client relationship with them. Further, we do not undertake or assume any responsibility with respect to financial statements of any Relevant Person.

9.3 We accept responsibility only to FIA Europe in relation to the matters opined on in this opinion.

Yours faithfully



Andrew Kinnes
For and on behalf of Shepherd and Wedderburn LLP
andrew.kinnes@shepwedd.co.uk
DL: 0131 473 5212

ANNEX

Netting Member Agreement

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NETTING MEMBER AGREEMENT

The Depository Trust & Clearing Corporation
Subsidiary: Fixed Income Clearing Corporation
Division: Government Securities Division

**FIXED INCOME CLEARING CORPORATION
GOVERNMENT SECURITIES DIVISION**

55 Water Street
New York, NY 10041

NETTING MEMBER AGREEMENT

(hereinafter the "Agreement")

_____, a domestic person (the "Netting Member"), hereby makes application to become a Netting Member of the Fixed Income Clearing Corporation, the owner of the division that provides clearing and other services with respect to Government securities, (hereinafter called "FICC" and "Government Securities Division"). The Netting Member agrees as follows:

1. It shall abide by the Rules and Procedures of the Government Securities Division (the "Rules and Procedures") and shall be bound by all the provisions thereof.
2. It shall abide and be bound by an amendment to the Rules or Procedures with respect to any transaction occurring subsequent to the time such amendment takes effect, as fully as though such amendment were now a part of the Rules and Procedures, provided, however, that no such amendment shall affect the undersigned's right to cease to be a Netting Member unless before such amendment becomes effective the undersigned is given an opportunity to give written notice to FICC of the undersigned's election to terminate such membership.
3. Notwithstanding that it may have ceased to be a Member, the undersigned shall continue to be bound by the Rules and Procedures as to all matters and transactions occurring while it was a Member.
4. It shall submit to either FICC or another United States Securities and Exchange Commission-registered clearing corporation for comparison, netting, and settlement, data on all trades that are eligible for netting.
5. It shall deliver to FICC or receive from FICC the net securities settlement positions that arise from trades that have been reported as being netted, and all funds related thereto, in accordance with the Rules and Procedures.
6. It shall pay to FICC in a timely manner all costs and compensation provided for in the Rules or Procedures.
7. It shall pay or deliver to FICC in a timely manner all amounts due pursuant to Rule 4.
8. The determination of the Board of Directors of FICC as to any questions arising with regard to any payment, fee, or deposit to which the undersigned may be subject shall be final and conclusive.

The undersigned acknowledges that it has reviewed the Rules and Procedures in effect as of the date hereof, including the provisions of Rule 4 relating to the Clearing Fund and loss allocation. This Agreement shall take effect on the date it is accepted by FICC, and shall continue thereafter until terminated by either party pursuant to the Rules or Procedures. This Agreement shall inure to the benefit of and be binding upon the parties hereto and their respective successors and assigns.

[The rest of this page is intentionally left blank.]

THIS AGREEMENT SHALL BE GOVERNED BY AND CONSTRUED IN ACCORDANCE WITH THE
LAWS OF THE STATE OF NEW YORK.

Dated as of: _____

(Firm Name)

(Seal)

By: _____
(Authorized Officer's Signature)

(Authorized Officer's Name)

(Authorized Officer's Title)

FIXED INCOME CLEARING CORPORATION

By: _____
(Authorized Officer's Signature)

(Authorized Officer's Name)

(Authorized Officer's Title)

Date: _____